The Future Of Banking: Islamic Finance Needs Standardization And FinTech To Boost Growth

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S&P Global Ratings believes the global Islamic finance industry will expand slowly in 2018 and 2019. We think standardization and financial technology (fintech) could help accelerate the industry's growth in the short to medium term. In particular, standard Sharia interpretation and legal documentation could simplify sukuk issuance, while making room for innovation. Fintech, on the other hand, could stimulate growth by making transactions quicker and easier.

However, fintech could also disrupt the market. In the medium term, we envisage some disruption in the payment services sector, an increase in the number of people using financial services, as well as greater use of regulatory technology (regtech) for Sharia compliance, and blockchain to support transaction traceability and identity protection.

Key Takeaways

- We expect the Islamic finance industry will grow by only about 5% on average over the next two years, owing to tepid economic conditions in certain core markets.
- In our opinion, standardized Sharia interpretation and legal documents would boost the industry's growth by clarifying risks for investors, streamlining the sukuk issuance process, and creating extra scope for innovation.
- While new technology could disrupt the industry, it also has the potential to spur growth, strengthen mechanisms for Sharia compliance, and increase the traceability of transactions through blockchain.

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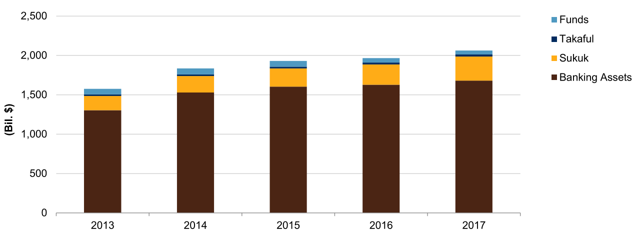
Growth Will Likely Remain Slow Through 2019

We believe the Islamic finance industry will continue to grow slowly in 2018-2019. It expanded by about 5% in 2017 compared with about 2% the previous year, according to our estimates (see chart 1), with strong support from the sukuk market. Last year, most of the growth stemmed from jumbo sukuk issuances in some Gulf Cooperation Council (GCC) countries. However, sluggish economic conditions in certain core markets weighed on Islamic banking growth, with Malaysia, Indonesia, and Turkey being the main exceptions. Since we anticipate only a mild economic recovery in the GCC (see chart 2), and it's uncertain how the sukuk market will perform in 2018, we believe a low single-digit growth rate over the next two years is a fair assumption. However, we see two factors that could act as accelerators in the medium term: standardization and fintech.

Chart 1

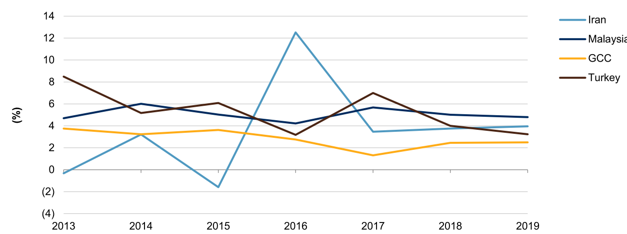
Islamic Finance Assets



Source: Central banks, Eikon, S&P Global Ratings.

Chart 2

Real GDP Growth In The Main Islamic Finance Markets



Source: S&P Global Ratings and International Monetary Fund.

The First Accelerator: Standardize And The Market's Potential Will Increase

In our view, a prerequisite for faster growth is standardization of Sharia interpretation and legal documentation. This would fuel growth by streamlining the sukuk issuance process, which is still more complex and time consuming than for conventional bonds. That's why some issuers favor the conventional route rather than launch sukuk. Investors are also voicing concerns about the complexity of assessing risk exposure when they invest in sukuk. The recent default of Dana Gas on its sukuk, reportedly due to a lack of Sharia compliance, acted as another wakeup call for the industry.

We see three main trends that will shape the future performance of the sukuk market and Islamic banking.

More stringent application of the profit-and-loss sharing principle

Over the past few years, the debate about the way forward for Islamic finance has resurfaced. Some market participants have expressed the view that the industry was too focused on replicating conventional instruments instead of producing a real benefit through a new way of financing. We believe that a key value-added of the industry lies in reconnecting the financial system with the real economy, and creating a more equitable and responsible financial system. Some countries allow the Islamic finance industry to develop both types of products, or replicas of conventional and specific products. This approach helped develop their Islamic finance industries. Malaysia, for example, authorized banks to offer both Murabaha-based profit-and-loss sharing investment accounts (PSIAs) and Mudaraba-based PSIAs. For the former, depositors bear the risk of the issuer's failure to deliver on its contractual obligations. For the latter, depositors bear the risks related to the underlying assets' performance and value.

Banks' customers and fixed-income investors are accustomed to a certain way of financing their transactions and investing funds. A very strong divergence from this, due to the application of more stringent profit and loss sharing, could push them back to the conventional industry. Some market participants invest in sukuk because they perceive them as fixed-income instruments. If this perception were to change, the size of investible assets and the investor base would likely change as well, shifting toward equity investors from fixed-income investors. Issuers' cost of funding or the fees users pay for banking services would likely also increase. We can rate sukuk with profit-and-loss sharing features, but the rating is likely to be lower than that on the sponsor. The hybrid issuances that allow for profit deferral and loss absorption at the point of nonviability are good examples.

Scarcity of real assets to back transactions

This is an important impediment that the industry has reported. Our view is different, especially in emerging markets where the government tends to play a significant role in the economy, including as a shareholder. The market has handled this issue relatively well through asset-light structures, where issuers are allowed to combine a certain percentage of tangible assets with commodities to increase the size of their issuance. However, the tangibility ratio varies from one jurisdiction to another. In our view, standardization of this ratio requirement could help institutions plan issuances and use their assets in a more efficient manner.

Insufficient clarity on post-default resolution mechanisms

The recent default of a sukuk has returned the standardization debate to the top of policymakers' agendas. Fixed-income investors tend to shy away from instruments with limited visibility on post-default resolution. Standardized Sharia requirements could prevent potential uncertainty on compliance after a transaction closes, and is therefore key in helping investors better understand the risks involved. Similarly, standard legal documentation provide clarity for investors on the recourse options available in the event of a default of a conventional bond. This is still lacking in Islamic finance. We recognize, however, that the Islamic finance market has achieved a certain level of standardization for the most common structures, while a few new instruments still need some refinements. In particular, investors are asking for additional clarity on the risks attached to the Murabaha-Mudaraba structure that is widely used in some jurisdictions.

The Second Accelerator: Fintech Offers New Avenues For Growth

Market participants typically see fintech as a risk for the financial industry, but we think fintech could also help unlock new growth opportunities through faster execution and better traceability of transactions. According to a recent edition of "IFN Islamic Fintech Landscape," there were around 100 Islamic fintech companies at the end of February 2018 (see chart 3). About 70% of these companies were active in financial services provision (such as money transfer, crowdfunding, and digital banking) and another 30% operate in technical infrastructure (IT, artificial intelligence, and robotics among other things). Around 46% of these companies are based in Asia (see chart 4). Some (for example, crowdfunding companies) are likely to complement the current Islamic banking offer, while others could disrupt the mainstream Islamic finance institutions' businesses.

We believe that fintech could help the industry in several ways:

Ease and speed of transactions. This is particularly true for payment services, money transfer, and infrastructure facilitators. The Islamic finance industry can benefit from the possibilities fintech offers to enhance their services to clients and therefore their attractiveness within the industry or compared with conventional finance. Technology could also reduce costs, allowing redeployment of staff to higher-added-value operations. An interesting example is the recent partnership of Noor Bank and UB QFPay, which together will launch new mobile solutions in the United Arab Emirates for secure payments from Chinese tourists.

Traceability of transactions. Using blockchain could help reduce the industry's exposure to risks related to transaction security or identity theft. This use of blockchain technology is not unique to Islamic finance. In 2017, some Canadian banks announced similar initiatives in an effort to prevent fraud. Another example of using blockchain to enhance security and traceability of transactions is Emirates Islamic Bank's application of blockchain and quick response (QR) code technologies to reduce fraud. Some of the cheques it issues contain QR codes that are registered in a blockchain.

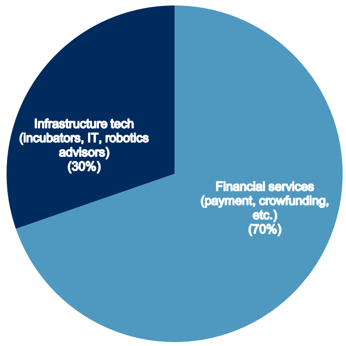
Greater accessibility of Islamic financial services. Fintech could also help the industry broaden its reach and tap new customer segments currently excluded from the banking system. For example, mobile banking for clients in remote areas, or provision of products such as crowdfunding for affordable housing or to small and midsize enterprises could provide new growth prospects. Beehive in Dubai or Invoice Wakalah in Pakistan are good examples of crowdfunding at work.

Improved governance. Regtech could affect the Islamic finance industry in a positive manner through more robust tools to achieve compliance with regulations and Sharia requirements, assuming globally agreed Sharia standards are in place. It could minimize the reputation risk related to a potential breach of Sharia requirements, and free up Sharia scholars to focus on innovation.

A prerequisite for fintech's ability to enrich the Islamic finance industry is the implementation of the necessary supervision and regulatory framework. That is why several regulators/authorities in the GCC and elsewhere have launched incubators or specific regulatory sandboxes where fintech companies can test innovations in the real market, but in a restricted regulatory environment. We understand that GCC regulators are looking closely at fintech, not only from the perspective of potential disruption, but also from one of collaboration.

Chart 3

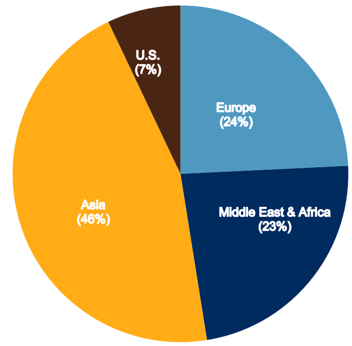
Islamic Finance FinTech Landscape



Source: IFN Islamic Fintech Landscape.

Chart 4

Islamic Finance FinTech By Geography



Source: IFN Islamic Fintech Landscape.

The Impact On Ratings In Islamic Finance

The market's push for more stringent application of the profit-and-loss sharing principle would likely result in lower sukuk ratings than on the sponsors. Sukuk holders' subordination to other creditors, and the issuer's capacity to defer the payment of periodic distributions on sukuk, are factors that we typically consider when notching down from the issuer credit rating to derive the rating on hybrid sukuk.

We foresee only a marginal influence of fintech on our Islamic bank ratings over the next two years. We consider that Islamic banks will be able to adapt to their changing operating environment through a combination of collaboration with fintech companies and cost-reduction measures. We also believe that regulators across the wider Islamic finance landscape will continue to protect the financial stability of their banking systems.

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