COVER STORY

# Whither the Middle East banks here?

BY ADELINE PAUL RAJ

It has been some 10 years since Malaysia opened up its Islamic banking sector to foreign players but the Middle Eastern financial institutions that were first to come have made little headway.

The early birds were Kuwait Finance House (Malaysia) Bhd (KFH Malaysia), Al Rajhi Banking & Investment Corp (Malaysia) Sdn Bhd and Asian Finance Bank (Malaysia) Bhd (AFB).

Paltry returns and increasingly tough competition from local rivals over the years are taking a toll on them, raising questions about their future here.

Industry sources say some of AFB's shareholders are looking to exit and are currently in talks for their stakes to be acquired by Malaysian Industrial Development Finance Bhd (MIDF), via a potential merger. AFB's shareholders are Qatar Islamic Bank with a 66.67% stake, Saudi Arabia's RUSD Investment Bank Inc (16.67%), Yemen's Tadhamon International Islamic Bank (10%) and Financial Assets Bahrain WLL (6.67%).

"The due diligence was completed a few weeks ago. It's now a question of getting an offer from MIDF," a source tells *The Edge*. As early as August last year, *The Edge* had reported that the two unlisted financial entities were in merger talks.

AFB, in an email response to questions, acknowledges that there are negotiations at the shareholder level but does not make specific mention of MIDF.

"As far as the bank is concerned, we are aware that there are negotiations going on between the shareholders and a new party for a block of shares to be transacted. At the moment, the bank is not privy to this transaction, as it is conducted by the shareholders."

AFB emphasises, however, that there are no plans for it to exit Malaysia.

"We wish to state very clearly that there are no such plans, and the current shareholders of the bank are committed to grow the bank within the economic and business environment in Malaysia. Should the share transaction as stated above, not materialise, then the current shareholders shall take all necessary steps to grow the bank to the next level."

Given the "transitory situation of the possibility of the shares in the bank changing hands", AFB says it has deferred the appointment of a new CEO to replace Datuk Azahari Kamil (picture), who retired on Jan 1. The bank is currently managed by an Interim Management Committee, of which the chairman is treasurer Azidy Daud.

MIDF, a financial services entity wholly owned by Permodalan Nasional Bhd (PNB), is about twice the size of AFB in terms of assets. Its key businesses are investment banking, development finance and asset management. MIDF is believed to be keen on AFB so as to be able to expand into corporate/commercial banking. It did not respond to a request for comment.

AFB had been making intermittent annual losses since it began operations in 2007, but managed to swing to a net profit of RM7.57 million in FY2013, which then almost doubled to RM14.98 million in FY2014. For the nine months of FY2015, its net profit slipped to RM5.58 million compared with RM12.32 million in the previous corresponding period.

It has two branches — one in Kuala Lumpur and the other in Johor.

Apart from AFB, the talk in banking circles is that Kuwait Finance House (KFH), the parent company of KFH Malaysia — the first and largest of the three Middle East banks here — is keen on selling the Malaysian unit to focus on other growing Islamic banking markets like Turkey.

In May last year, the Kuwaiti entity said it hired Credit Suisse to advise on its options, which included a potential sale of KFH Malaysia. But, in September, after Qatar National Bank came out to say it had ended preliminary talks to buy KFH Malaysia, KFH's CEO Mazin al-Nahedh told Reuters that the company was ruling out a sale or merger for the Malaysian

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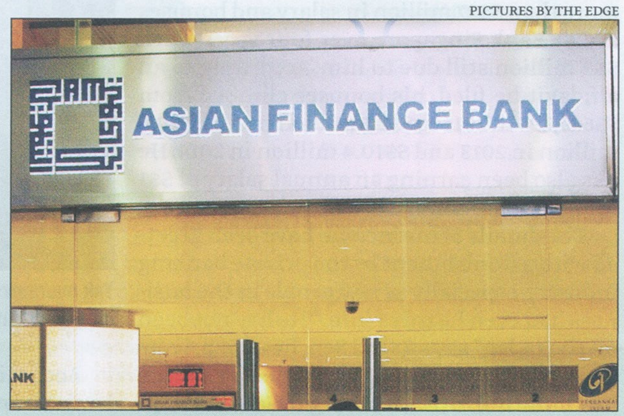



PICTURES BY THE EDGE

## Malaysia: Islamic finance milestones

SOURCE: PWC

### Islamic finance institutions

- **1969** Islamic savings institution Pilgrims Fund Board or Tabung Haji established
- **1983** Enactment of Islamic Banking Act. First Islamic bank established
- **1984** Enactment of Takaful Act. First takaful operator established
- **1993** Conventional banks allowed to set up Islamic banking windows
- **1996** Securities Commission Malaysia (SC) establishes Shariah Advisory Council
- **1997** Bank Negara Malaysia establishes the National Shariah Advisory Council
- **2002** Becomes founding member and host country of the Islamic Financial Services Board (IFSB)
- **2005** Banks with Islamic banking windows allowed to convert to Islamic banks. Foreign Islamic bank licences issued to Kuwait Finance House, Al Rajhi Bank and Asian Finance House Bank
- **2006** Establishment of the Malaysia International Islamic Financial Centre (MIFC) initiative. Establishment of the International Centre for Education in Islamic Finance (INCEIF)
- **2008** Establishment of the International Shari'ah Research Academy for Islamic Finance (ISRA)
- **2009** Foreigners allowed to take up to 70% stakes in Islamic banks and takaful operators, up from 49%
- **2010** BNM to issue two new licences for both Islamic banking and takaful. New blueprint for financial services sector. Second capital market master plan

1970 1980 1990 2000 2010

### Islamic finance products

- **1990** First sukuk based on Bai' Bithaman-Ajil
- **1999** Launch of Kuala Lumpur Shariah Index (KLSI)
- **2001 – 2002** World's first global corporate sukuk and first Ijarah corporate sukuk. World's first global sovereign sukuk
- **2003 – 2004** First Islamic asset-backed securities (ABS). Issuance of ringgit sukuk by supranational body, International Finance Corporation[1]
- **2005** First Musharakah sukuk ABS. World's first Islamic residential mortgage-backed securities. First jurisdiction in the world to put in place Shariah-compliant deposit insurance scheme
- **2006** World's first Islamic exchangeable bond. First Islamic REIT. First sukuk Musharakah to use shares as underlying investment
- **2007** World's first international subordinated sukuk. World's first hybrid sukuk. Launch of first Asian Islamic exchange traded fund (ETF). World's largest corporate sukuk issuance by Malaysia-based Binariang GSM
- **2009** World's largest international sukuk by Petronas since the US$1.5 billion Dubai port issue in 2007. First Shariah-based commodity trading platform on Bursa Malaysia[2]

[1] International Finance Corporation is a private arm of the World Bank
[2] Bursa Malaysia operates the national stock and futures exchanges

# Local Islamic banks shine, but at the expense of conventional banking?

BY **JOYCE GOH**

Unlike some foreign Islamic banks which are still struggling to establish a firm foothold in Malaysia, local banking groups are going from strength to strength despite the rising competition.

From setting up small Islamic windows over two decades ago, a number of local banks have grown to become serious standalone global Islamic banking players today.

Maybank Islamic Bank is currently number one in the region and among the top three Islamic banking players worldwide, while CIMB Islamic Bank is the largest sukuk player globally, issuing US$5.2 billion worth of sukuk as at Dec 31, 2015.

Maybank's income from its Islamic banking scheme grew 3% year on year to RM2.98 billion for its nine months ended Sept 30, 2015, while CIMB's income from Islamic banking operations grew 6.4% y-o-y to RM1.15 billion for the same period. RHB's Islamic banking business grew 20% y-o-y to RM639.1 million. Islamic financing as a percentage of RHB group's total domestic gross loans and financing increased to 21.4% in September from 19.5% as at Dec 31, 2014.

Bank Negara Malaysia liberalised the Islamic finance system in the country in 2004 by issuing three new Islamic bank licences to foreign Islamic financial institutions. Today, six out of 16 Islamic banks here are foreign.

The Islamic banking playing field has become more crowded over the years as the Islamic banking landscape develops further and more players attempt to grab a piece of the pie.

Malaysia remains one of the front runners in the game today but some of the foreign Islamic banking groups that have set up shop here in the country have not exactly been as successful as they had hoped to be, industry observers say. Some are mulling an exit (see main story).

Industry observers say a reason foreign Islamic banks are finding it difficult to grow their business in the region using Malaysia as its base is partly because they find it tough to compete with local Islamic banking groups backed by larger balance sheets.

While the Islamic banking units of local banking groups declined to comment on this specifically, CIMB Islamic Bank CEO Mohamed Rafe Mohamed Haneef (picture) says Islamic banks need to scale up to compete not only among themselves but also to rival their bigger conventional peers.

"Banks operating on a smaller scale and balance sheet may have to consider inorganic expansion to sustain and compete further in the banking industry. This is applicable to both Islamic and conventional banks," he tells *The Edge*.

Malaysia'a roots in Islamic banking can be traced back to 1969 with the establishment of an Islamic savings institution known as the Pilgrim Fund Board or Tabung Haji, as the first Islamic financial institution in the country.

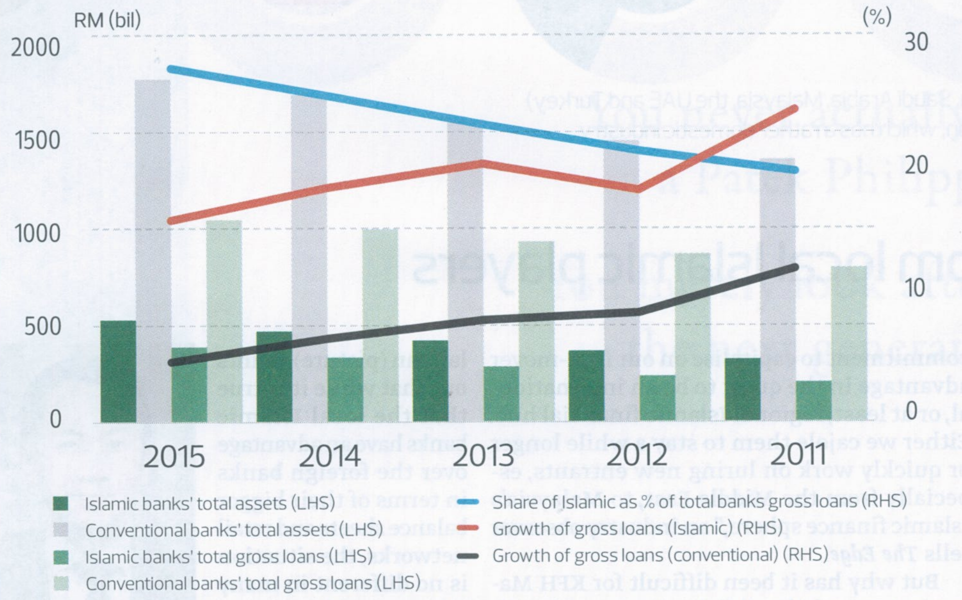
Fast forward to today, the Islamic banking landscape here has since developed immensely. Malaysia has successfully created a dual banking system, established an Islamic interbank market and developed an Islamic capital market.

Just last week, six Malaysian Islamic banks launched the first bank-intermediated financial technology platform, known as the investment account platform (IAP).

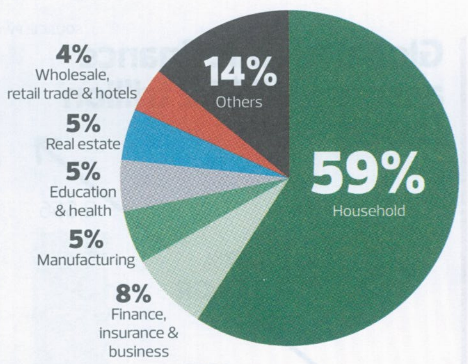
The IAP is a strategic initiative of the Islamic finance industry to operationalise investment accounts and will serve as a central marketplace to finance small and medium-sized businesses. The Malaysian government is backing the scheme with an initial RM150 million in funds.

SOURCE: FITCH RATINGS

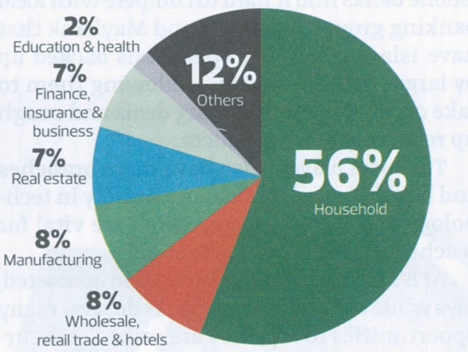
### Lending growth of Malaysia's Islamic and conventional banks




### Islamic bank loans by sector




### Conventional bank loans by sector




## A RISING STAR

According to Bank Negara data, Malaysia's Islamic bank financing was RM389.9 billion at end-2015, equal to 27% of its banking system loans, compared with 25% in 2014.

Fitch Ratings notes that Islamic financing expanded 16.2% in 2015 while the conventional banking system grew 5.2%. It adds that Islamic finance had a compound annual growth rate (CAGR) of 18.2% since 2011, against conventional banks' average of 7.0%.

It is obvious that Islamic banking is the rising star here.

However, industry observers say this could also be because of the low base Islamic banks are starting from.

Some also point out that the growth in Islamic banking business could be at the expense of its conventional business, resulting in a zero sum game. For example, some banks have an Islamic-first policy — market an Islamic product before the conventional product — thereby potentially cannibalising the conventional business.

This observation generally applies to any company that offers more than one product to the customer as economic demand and customer behaviour is very dynamic, states PwC Malaysia's risk assurance services practice executive director Nik Shahrizal Sulaiman.

He points out that looking at the financial data in the Malaysian banking industry during the last few years, one can see that both conventional and Islamic banks have been growing their asset base at the same time.

"The only difference is that Islamic banking assets have been growing at a faster rate than conventional banking assets. So I would not strictly use the word 'cannibalise' as it would imply that the market opportunity is a fixed constant, when in fact it has been growing in various directions. The more plausible explanation I can think of is that many people and companies simply find Islamic finance solutions to be attractive, which drives the growth of Islamic banking," he adds.

Meanwhile, both Maybank Islamic and CIMB Islamic say Islamic products are created to "complement" conventional products.

CIMB's Rafe says Islamic banking should be viewed as complementing conventional banking products and adding to the suite of products and services with the aim of meeting customer's banking needs.

"It is especially essential for certain customers (individuals and corporates) who choose not to or cannot bank with conventional banks. These include customers from the halal food industry and shariah-compliant listed companies on the exchange. Islamic banks must provide a comprehensive set of products and services to bridge any gap," he notes.

"Islamic banking and finance is still nascent in terms of volume and scale compared with conventional banks. It is understandable that banks may choose selected product categories to achieve the needed volume and scale to be competitive and profitable. As Islamic banking and finance is an identified niche for Malaysia to distinguish itself internationally, various developmental initiatives and enhancements to its regulatory environment have been implemented over the past few decades to further develop the industry," he adds.

Nor Shahrizan Sulaiman (picture), Maybank Islamic deputy CEO, shares that Islamic banking products and services in Maybank are designed not to cannibalise but to complement conventional products and services.

"The intent is to provide viable options and alternatives to all our customers, regardless of the segment they represent. Maybank Islamic currently has about 50% non-Muslim customers, which is testimony to the fact that Islamic banking products and services have been widely accepted by both the Muslim and non-Muslim population here in Malaysia," he says.

## STAYING AHEAD IN TURBULENT WATERS

While growth has been good for local Islamic banks, they are not disregarding the fact that the macroeconomic environment and the banking landscape today have become more challenging.

RHB Islamic Bank's managing director Tuan Haji Ibrahim Hassan (picture) says economic headwinds remain a big concern for the industry.

A key focus in trying times is to sustain business momentum and to ensure the quality of service is not compromised amid operational cost rationalisation measures, he adds. An urgent strategy, going forward, is to maintain and strengthen the loyalty and satisfaction of customers.

Nor Shahrizan of Maybank Islamic says the bank remains prudent in growing its business and has always adopted a proactive risk management stance in dealing with the changing banking landscape and the economic climate.

"In managing the bank's operations, all potential scenarios in the economy, both domestic and global, would have been taken into consideration. This includes undertaking various stress tests on the bank's portfolios and analysing the impact such tests have on the bank's liquidity, capital and profitability," he notes.

Meanwhile, CIMB Islamic's Rafe opines that competition is likely to intensify as banks compete to acquire customer deposits.

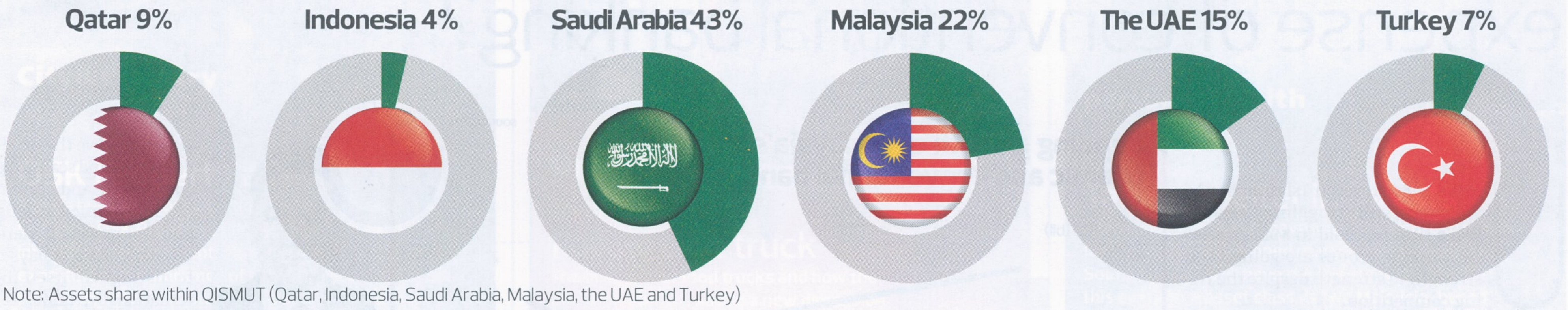
"There will also be continued opportunities to increase its market share in selected business segments such as corporate and commercial, where demand for Islamic finance is growing among the shariah-compliant listed companies," he says.

"The bank intends to continue to look out for more opportunities in the region to grow the Islamic banking business through a series of strategic actions, including reasserting profitability of its core businesses, innovating products, deepening customer and client relationships, developing new fee income segments, and increasing the deposit franchise. To achieve the strategic goals outlined, the bank will rely on its investments in people, technology and processes to ensure effective and efficient delivery of its services in the region," he adds. E

## COVER STORY

### Islamic banking assets with rapid-growth markets

The six Islamic rapid growth markets look highly promising. The combined Islamic banking assets with commercial banks reached US$567 billion in 2012.




Note: Assets share within QISMUT (Qatar, Indonesia, Saudi Arabia, Malaysia, the UAE and Turkey)
International Islamic banking assets exclude Iran, which has a rather domestic industry

Sources: Central banks, BMI, EY analysis

# Tough competition from local Islamic players

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unit and that it would begin restructuring the unit with immediate effect.

KFH Malaysia, which slipped into a net loss of RM5.92 million in the first nine months of FY2015 compared with a net profit of RM75.78 million in the corresponding period in FY2014, has been keeping a low profile since. "I think, at the right price, they might sell. But they are not actively looking for buyers at the moment," an industry source tells *The Edge*.

KFH Malaysia, in an email response to *The Edge*, says: "Our parent company in Kuwait is committed to the growth of business at KFH Malaysia. With that in mind, we are working closely with them to ensure the business aspirations and goals are met."

In FY2014, KFH Malaysia made a net profit of RM92.83 million, slightly lower than the RM97.74 million it turned in a year earlier.

KFH Malaysia hit some rough patches in the three years from FY2009 to FY2011, incurring losses after having to make massive provisions for problematic loans that drew much scandal in the industry at the time.

Bank Negara Malaysia came down hard on it amid speculation that its problems were a result of mismanagement in the earlier years and lax risk management practices. KFH Malaysia returned to the black in FY2012 after a change in leadership and concerted efforts to clean up its books.

The bank's current CEO, its fourth so far, is Ahmed S Al Kharji, a Kuwaiti who took the helm in April last year.

Al Rajhi, which has a stronger focus on retail banking, was the only one of the three Middle East banks to see marginal growth in profit for the first nine months of FY2015. It reported a net profit of RM12.74 million in the period compared with RM2.05 million in the previous corresponding period. Annual profit in FY2014 stood at RM4.8 million compared with RM3.15 million in FY2013.

The bank has yet to appoint a CEO since Datuk Azrulnizam Abdul Aziz quit in late 2014. The acting CEO is Selamat Sirat.

## WHY THEY STRUGGLE

The fact that the Middle East banks are struggling, with some likely considering an exit, does not bode well for Malaysia's ambition to become an international Islamic finance hub. This is especially so now that other hubs are emerging, industry observers say.

The country needs to be able to attract and retain large foreign Islamic banks if it is to remain competitive.

"It could deal a major blow to Malaysia's ambition to become a major international Islamic financial hub. Since we began the liberalisation and opening up of our Islamic financial services industry in 2004-2005, we have not been able to attract other foreign (Islamic) players, especially from the Middle East. This gives the sense of lethargy or lack of commitment to capitalise on our first-mover advantage in the quest to be an international, or at least, regional Islamic financial hub. Either we cajole them to stay a while longer or quickly work on luring new entrants, especially from the Middle East, to Malaysia's Islamic finance sphere," an industry observer tells *The Edge*.

But why has it been difficult for KFH Malaysia, AFB and Al Rajhi's business to take off? Some 10 years on, they have, at best, seen tepid growth not just in profits, but also assets and market share.

Industry sources put this down to a combination of factors. A key one is that these standalone banks find it hard to compete with local banking groups like CIMB and Maybank that have Islamic banking operations backed up by larger balance sheets — allowing them to take on the bigger financing deals and cough up relatively more products.

The local players also have more branches and have invested much more heavily in technology and infrastruture, which are vital for reaching out to retail customers.

AFB's former CEO, Azahari, when contacted, says while the Middle East banks do have many opportunities to tap, they are sometimes curtailed by their relatively smaller capital base.

"As you know, with Islamic banks, the challenges are always about liquidity. And when you talk about the three banks that have got licences in Malaysia, their capital is very small. This is where the challenge is — we do not have the liquidity or the infrastructure to compete effectively with the established Islamic banks in Malaysia."

He says the risk appetite of most of these banks is small. "They do not want to take extraordinary risks. So generally, in order for them to do the bigger financing, it has to be part of a syndication. But because their balance sheets are rather small, they will never be able to participate in the big syndications."

He says the banks' Middle Eastern shareholders, most of which have deep pockets, would likely pump in more capital if they find that there is a strong value proposition. "It's for the management to convince the shareholders that the returns on their investment would reciprocate the risk-return framework."

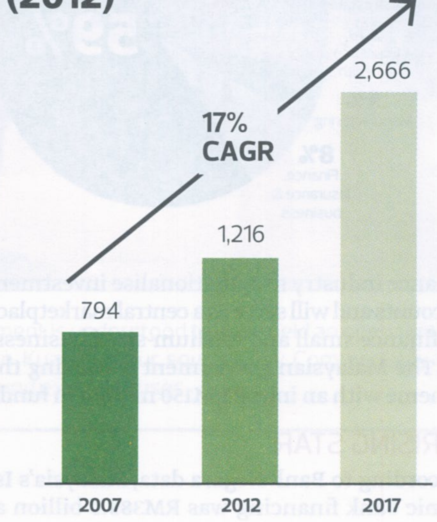
An industry observer remarks that, in some cases, it is the lack of pertinacity on the shareholders' part to commit more investments into Malaysia that has held back the banks' growth. "It's for reasons known only to them, although we can guess a few: the need to invest more back home to develop their own Islamic financial services industry; their perception that Malaysia's appeal as an international hub for Islamic finance has dimmed; and, resource conservation in preparation to move to another Islamic financial centre deemed as more attractive from various perspectives."

PwC Malaysia executive director of risk assurance services practice, Nik Shahrizal Sulaiman (picture), points out that while it is true that the local Islamic banks have an advantage over the foreign banks in terms of their bigger balance sheets and retail networks, the situation is no different in many other countries.

"But it does not stop the foreign-owned banks from competing effectively in the market. I think the issue goes back to what is the market niche or differentiator which drives the foreign Islamic bank's distinctive value to the customers. Banks which are able to offer superior customer service, a wide array of banking services and robust risk management practices would generally flourish in any environment."

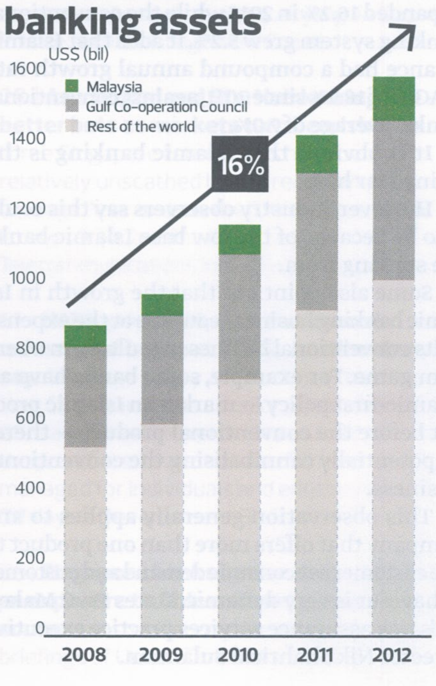
SOURCE: PWC

### Global Islamic finance assets ~ US$1.2 trillion (2012)




SOURCE: EY

### Global Islamic banking assets




Industry observers note that since most foreign Islamic banks dabble in large part in corporate and investment banking, relationships and connections count a lot to secure big deals and transactions, particularly those from the public sector, including government-linked companies.

"This is one area where Middle East Islamic banks lag quite far behind compared with their local counterparts and even Western Islamic banks," one remarks.

It is also a crowded market for a small country like Malaysia which has a population of around 30 million. According to Bank Negara Malaysia's website, there are 16 Islamic banks in Malaysia, of which six are foreign — the three Middle East ones, as well as HSBC Amanah Bhd, Standard Chartered Saadiq Bhd and OCBC Al-Amin Bank Bhd.

Additionally, there are three that are categorised as "international Islamic banks", namely Bahrain's AlKhair International Islamic Bank Bhd (formerly known as Unicorn International Investment Bank), Deutsche Bank Aktiengesellschaft and PT Bank Syariah Muamalat Indonesia Tbk.

"This is quite a big number of players for a relatively small market. As such, stiff competition and even crowdedness could be another issue which Middle Eastern Islamic banks may have barely been able to overcome through product differentiation or unique propositions especially in retail banking, given the tendency of the banking and finance industry to offer rather homogenous products and services," the earlier industry source says.

The Islamic arms of big global/regional banks have fared better than the Middle East banks. Over the FY2011-FY2014 period, HSBC Amanah's profit grew in each year to peak at RM143.97 million in FY2013, before dipping marginally to RM141.83 million in FY2014. OCBC Al-Amin's profit showed a similar trend, peaking at RM107.49 million in FY2013 before falling to RM70.53 million in the following year.

Over the same period, Standard Chartered Saadiq's profit peaked at RM65.85 million in FY2012 before falling in the next two years. Profit stood at RM10.25 million in FY2014.

What's clear is that the foreign banks here need to up their game if they are to survive for the long term. For Malaysia, what's at stake, is that losing them could be a gain for other emerging Islamic banking markets such as Indonesia. Indonesia, whose industry is still at the infancy stage, has of late been drawing plenty of interest from Middle East banks keen to tap the world's largest Muslim population.

Bank Negara Malaysia says it will respond to *The Edge*'s questions on the state of the industry this week. E