Khalid Howladar
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Gulf Affairs: Why is Islamic finance so important in the GCC?

Khalid Howladar: Initially a niche market for orthodox Muslims, Islamic finance has become much more mainstream, now ranging from around 15-50% of total banking assets across the GCC. This is driven by strong retail interest for these products among consumers and the sector is growing faster than conventional banking. It is also a positive (and capitalist) expression of cultural identity.

Gulf Affairs: What role does Islamic finance play in economic development and diversification?

Howladar: Currently, most of Islamic finance actually replicates conventional, therefore its role is actually shared with that of a general regional move towards developing deeper and more sophisticated credit markets. These markets have a key role in helping to foster private sector growth and SMEs in a regional economy with an oversized public sector. Demand going forward is likely to be driven by several factors. Unusually compared to other sectors, drivers are both bottom-up (retail customer driven) and top-down (public policy driven).

Gulf Affairs: What are the most important regional, national or global risks relevant to the sector?

Howladar: From a sector specific angle, Islamic Financial Institutions (IFIs) favor tangible assets, which in the GCC tends to be volatile real estate. As a result, they tended to have the worst asset quality metrics (and weaker than conventional). However, they are much better capitalized at around 14-15% of regulatory capital, higher than their conventional peers. On a global perspective, the Islamic interbank markets are fragmented and small, thus liquidity management is a more pronounced risk at IFIs.

Gulf Affairs: Tell us about the role your organization "Acreditus" plays in support of Islamic finance, GCC credit and associated trends.

Howladar: Since the onset of low/volatile oil prices and high deficits, many private sector corporations have looked to bonds and sukuk to break their correlated dependency on local bank funding. We at Acreditus provide strategic credit advisory to these firms, sometimes before they choose to seek formal credit ratings. In addition, we support investors and other stakeholders with independent regional risk assessments to help them better price their exposures and assess counterparties.

Gulf Affairs: You have spent time at a ratings agency and now run a credit analysis consultancy as well as supporting the next generation of experts? Could you talk about the positives and challenges of credit ratings? Is there a need for a different way of assessing credit and resilience?

Howladar: The credible and global benchmarking offered by the big three CRAs provides a valuable and credible second/third opinion to investors, but the cost structure is too high to apply beyond the larger issuances or to provide more timely credit risk assessments.

I think the use of AI and machine learning techniques involving big data is a massive threat to their business models. If a Google or IBM decide to move into this space it will prove massively disruptive and bring the market a much wider access to credit ratings that are probably more accurate and cheaper. They need to be careful they don't go the way of Kodak.

Gulf Affairs: Some GCC countries have been considered overbanked. Do you agree?

Howladar: Absolutely. I would say Dubai is the most overbanked, but we are in the midst of an ongoing consolidation drive in the region. The external economic pressures, internal technology, regulatory and compliance pressures are too much for the smaller banks.

Gulf Affairs: Does this also apply to Islamic financial institutions or are they better poised to grow?

Howladar: There are definitely higher growth prospects for IFIs, but it is a marginal difference given the scale and confluence of pressures on the financial sector more generally. These include pressures on local property markets, lower liquidity and other macro trends.

Gulf Affairs: Being asset based, some Islamic finance instruments have been significantly exposed to regional and global real estate and commodity markets. Is this exposure a vulnerability?

Howladar: It is a bit of a misnomer as in substance, Islamic finance favors asset-backed and equity finance. 'Asset-based' is a misleading term that actually describes the unsecured bond-type instruments where the assets actual have no bearing on the risk/return profile. These instruments are anecdotally 95%+ of the market.

Gulf Affairs: Do Islamic financial instruments and investment options benefit from the increase in ESG screens?

Howladar: In theory, there is about a 95% overlap between ESG screening and Islamic finance, but one has to ensure that the principles are applied in substance and not just form for this premise to be valid. Governance in the sector should be improved.

Gulf Affairs: How does GCC Islamic finance vary from South East Asia, which has some of the longest running operations?

Howladar: Asia tends to be perceived as more liberal than the GCC, but in my mind when the final outcome replicates an identical credit product the distinction is arbitrary. Nonetheless this regional division (and divergence between some GCC countries) fractures the market and creates illiquidity.

Khalid Howladar is the Managing Director and Founder of Acreditus, a Gulf focused credit, risk and Sukuk Advisory. He is also the Chief Strategy & Risk Officer for Blossom Finance, an Indonesian based startup focused on issuing digital Sukuk notes for social impact projects.