Perspective

Peter Vayanos
Dr. Philipp Wackerbeck
Dr. Peter T. Golder
George Haimari

booz&co.

Competing Successfully In Islamic Banking

Booz & Company is a leading global management consulting firm, helping the world's top businesses, governments, and organizations.

Our founder, Edwin Booz, defined the profession when he established the first management consulting firm in 1914.

Today, with more than 3,300 people in 58 offices around the world, we bring foresight and knowledge, deep functional expertise, and a practical approach to building capabilities and delivering real impact. We work closely with our clients to create and deliver essential advantage.

For our management magazine *strategy+business*, visit www.strategy-business.com.

Visit www.booz.com to learn more about Booz & Company.

CONTACT INFORMATION

Beirut
Peter Vayanos
Partner
+961-1-336433
peter.vayanos@booz.com

Dubai
George Haimari
Principal
+971-4-3900260
george.haimari@booz.com

London
Dr. Peter Golder
Principal
+44-20-7393-3234
peter.golder@booz.com

Munich
Dr. Philipp Wackerbeck
Senior Associate
+49-89-54525-659
philipp.wackerbeck@booz.com

COMPETING SUCCESSFULLY IN ISLAMIC BANKING

Executive Summary

The market for Islamic banking has grown rapidly over the past few years, and this robust growth is expected to continue for the foreseeable future. In many markets, Islamic banking has evolved from being a niche offering into being part of the mainstream financial services landscape.

At the same time, the competitive landscape is being redrawn, with more Islamic financial services institutions in the marketplace than ever before. Incumbent banks and new market entrants are facing vastly different market conditions and need to develop new sources of differentiation beyond compliance with sharia (Islamic law) to compete or remain successful in the future.

This paper seeks to analyze the drivers of growth behind Islamic banking and the changing competitive landscape, and to explore potential sources of differentiation for Islamic banks, as well as the challenges that are unique to these banks.

Background of Islamic Banking

Since its inception in the mid-1970s, Islamic banking has emerged from being a niche offering to become part of the mainstream financial services landscape. Although there are few official statistics on the size of the market and estimates vary widely, the total volume of Islamic assets is believed to be about US$500 billion.

Dubai Islamic Bank is generally acknowledged to be the first full-fledged Islamic bank. Since that bank's formation in 1975, the number of institutions operating in line with sharia has mushroomed. Today there are more than 500 Islamic financial services institutions worldwide.

In just the past two to three years, more than 50 Islamic financial services institutions have been launched (see Exhibit 1). In particular, the Middle East has witnessed an explosion in the number of these institutions, both banks and nonbanks. For example, Boubyan Bank was launched in Kuwait, Bank Al Bilad was established in Saudi Arabia, and, more recently, Noor Islamic Bank and Al Hilal Bank were formed in the United Arab Emirates, while Bank Al Inma is nearing operational launch in Saudi Arabia. The total capital of these banks alone is in the region of $15 billion.

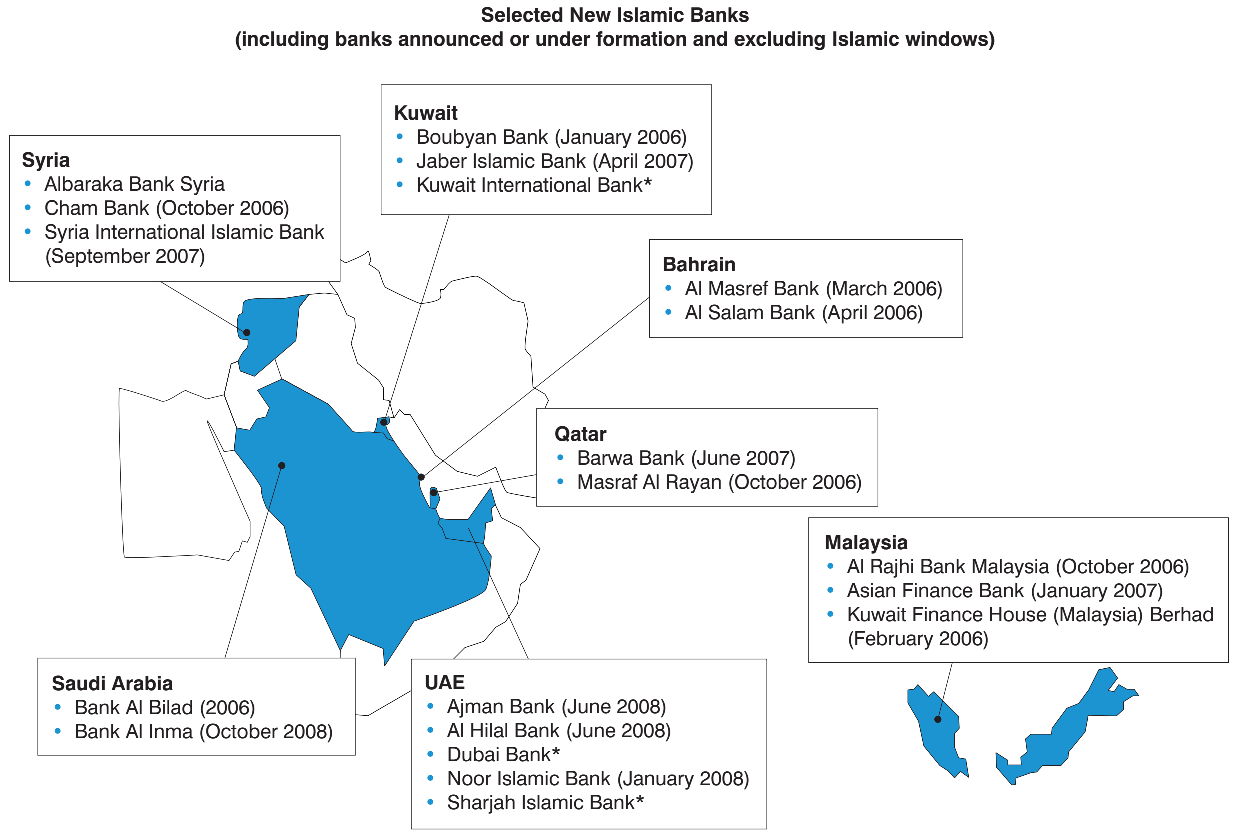
A Growing Market

Historically, the growth in Islamic banking has been driven by the needs of retail banking customers seeking to borrow and invest in accordance with their personal beliefs. However, Islamic banking products were initially not as competitive as their conventional equivalents, in terms of both pricing and service offerings.

In certain countries, governments have fostered the development of the Islamic banking sector. For example, in Malaysia, the government drove the sector's development by funding Islamic financial services institutions and by creating the enabling legal and regulatory frameworks.

Over time, Islamic banking has expanded, as economic and demographic growth in predominantly Muslim countries has spurred the demand for sharia-compliant solutions. But the supply side has also had a role to play: The increase in financial services institutions offering Islamic banking products has raised the level of awareness among customers. However, it

Exhibit 1:
Examples of New Islamic Banks



* Conversions of conventional banks to Islamic banks
Source: Central Banks; *The Banker;* Islamic Business and Finance Network; Islamic Development Bank; Booz & Company

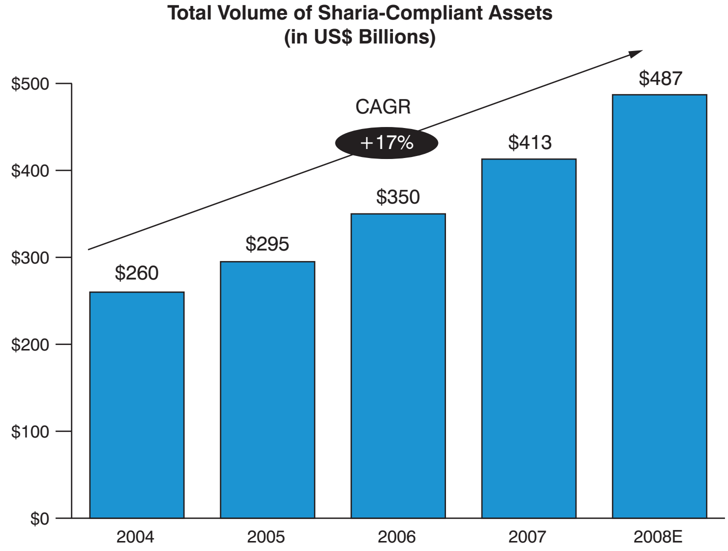
also has raised the competitive intensity of the market.

As a result, Islamic assets have grown between 15 and 20 percent annually for the past five years, making Islamic banking one of the fastest-growing sectors in the global financial services industry (see Exhibit 2). By the end of 2008, the total volume of sharia-compliant assets could reach almost $500 billion.

The Islamic banking boom has not been limited to retail and commercial banking. On the asset management side, sharia-compliant funds have experienced exponential growth in recent years (see Exhibit 3). By 2009, the number of Islamic mutual funds could rise to 925—an increase of 28 percent in one decade.

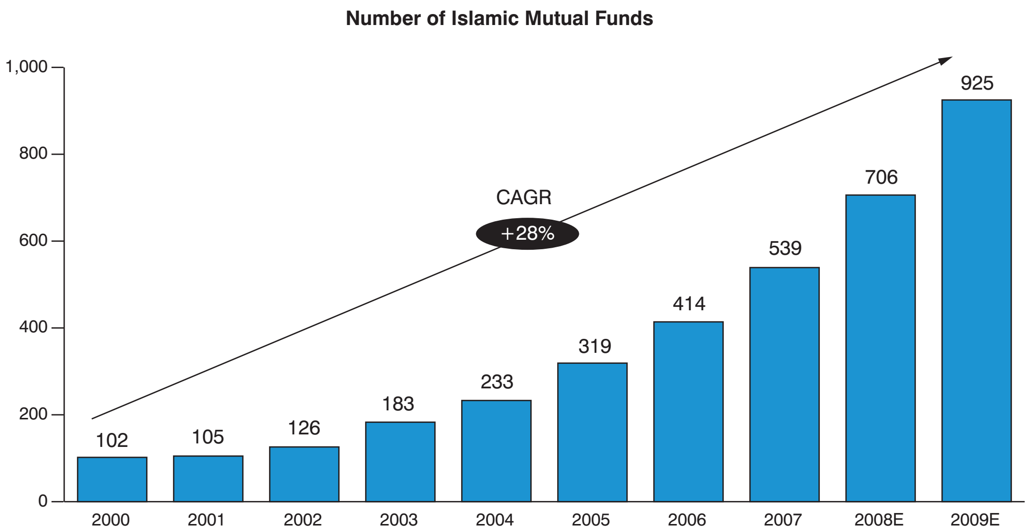
At the same time, Islamic capital markets have witnessed a wave of innovation. Today, the products and solutions of most conventional capital markets can be replicated in a sharia-compliant manner. The most notable instrument (by volume) that has

Exhibit 2:
Growth of the Islamic Banking Industry



Source: Booz & Company

Exhibit 3:
Number of Islamic Mutual Funds



Source: Failaka; Zawya; Booz & Company

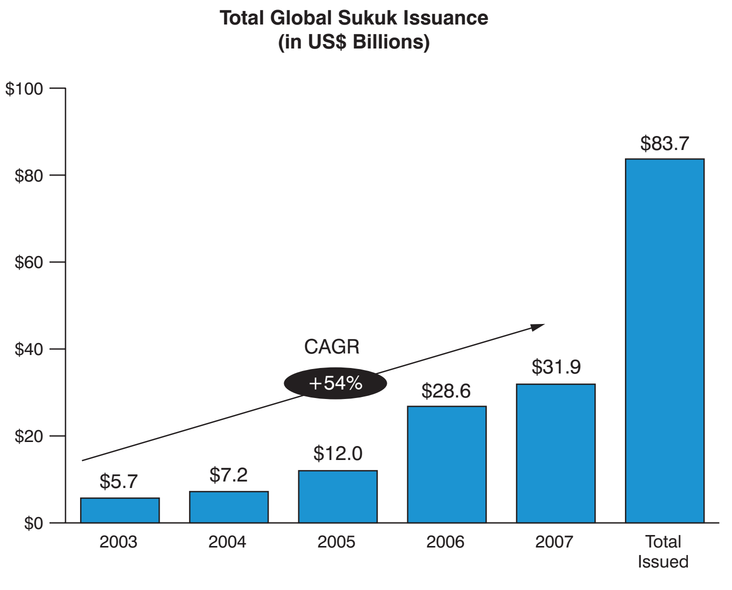
emerged is the sukuk, an Islamic financial vehicle similar to a bond. From 2003 to 2007, nearly $85 billion was raised through sukuk (see Exhibit 4).

The sukuk market recently faced a major setback when the sharia board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Bahrain-based standardization body, decreed that most of the innovative sukuk structures ran afoul of religious rules. It said that buying back the underlying assets of a sukuk at a predetermined price represents a guarantee and is therefore in violation of sharia requirements. However, the AAOIFI has issued new guidelines, so the sukuk market is about to blossom again, once the tailback is resolved and pending transactions are restructured appropriately—presumably with SukukAl-Ijara becoming the predominant structure going forward.

Islamic banking has evolved into a global phenomenon with double-digit growth rates throughout the Muslim world. However, there is no uniform definition of Islamic banking thus far. There are no binding global standards in place for all Islamic banks, leading to a fairly heterogeneous industry. For example, in Malaysia, sharia-compliant call options are based on istijrar and khiyar; in the Gulf Cooperation Council (GCC), arboon and salam are favored. Short selling, revolving credit cards, and overdraft facilities (which are usually based on tawarruq) are prohibited in most Gulf countries, but in Malaysia such products are permitted.

Heterogeneity in the industry is usually the result of different Islamic schools of jurisprudence or different financial needs in Southeast Asia and the GCC. However, there are varying tendencies even within the GCC. While the UAE is shifting more toward replicating the most innovative conventional financial institutions, Islamic banks in Saudi Arabia tend to develop products such as mudharabah-based investment accounts, which better reflect the Islamic ideal of a fair share of risk and reward. While regional idiosyncrasies may persist in local markets, we believe that the stricter GCC rules will need to prevail globally in order to attract cash-rich GCC investors. We expect harmonization at GCC level to take place over the next 10 to 15 years.

Exhibit 4:
Sukuk Market Growth



Note: Domestic and international sukuk; estimate includes both sovereign and corporate issues.
Source: IIFM analysis, IFIS, Booz & Company

The Root Causes of Growth

We believe that the market for sharia-compliant financial services will continue to grow, driven by both demand and supply factors.

On the demand side, we expect not just retail customers but, increasingly, corporations to want to conduct all financial transactions in accordance with sharia. There is evidence of pressure from the public and shareholders in the Middle East and Southeast Asia on corporations and sovereigns to apply sharia-compliant solutions. This includes, for example, the use of sukuk or syndicated lending based on mudharabah or ijara contracts to raise funds. Interestingly, non-Muslim countries such as the U.K., Japan, and China have recognized this shift and are preparing sharia-compliant debt issues to target the liquidity-rich Middle East.

The changing demographics of Muslim countries will also drive the demand for sharia-compliant financial services. Many Muslim countries have young populations, with more than 50 percent of the people under 21, coupled with population growth rates of more than 3 percent per year. At the same time, there is evidence that youthful consumers are increasingly sophisticated about financial services. The twin effects of population growth and increasing sophistication are likely to result quite soon in a large number of savvy retail consumers who require sophisticated and competitive financial solutions.

Finally, the overall macroeconomic growth in Muslim countries will drive the growth of financial services in general, leading to further growth of sharia-compliant banking. This is particularly relevant in the oil-rich countries of the Gulf where state-owned enterprises, which tend to strictly adhere to sharia, are the immediate beneficiaries of the booming hydrocarbon prices.

On the supply side, the main driver of growth in Islamic banking is the increasing number of financial services institutions offering sharia-compliant solutions. In addition to the new Islamic banks that are being formed, there is an emerging trend among existing conventional banks to convert their operations to become sharia compliant. For example, Dubai Bank in the UAE and Kuwait Real Estate Bank (now Kuwait International Bank) in Kuwait recently converted their entire operations to be sharia compliant.

With increasing competition in their home markets, a number of Islamic banks in the Middle East have started to expand globally, with an initial focus on Asia and Africa. Recent examples include Dubai Bank, Qatar Islamic Bank, and Al Rajhi Bank.

The increase in supply has two effects. First, with a greater number of players in the marketplace, public awareness of sharia-compliant products and services is heightened. This is important, since in many countries, including Muslim ones, the level of awareness and understanding of sharia-compliant products is remarkably low.

Second, the increased competition in the marketplace resulting from a larger number of providers will lead to improved product innovation and pricing. This in turn will boost the attractiveness of sharia-compliant solutions to both Muslims and non-Muslims alike.

In conclusion, the market for Islamic banking shows rich potential. The question facing both the incumbents and new market entrants is how to win in this market.

A Changing Competitive Environment

The competitive landscape and the basis of competition in Islamic banking are changing. Originally, Islamic banks derived their competitive advantage not only from being sharia compliant but also from being the only pure-play Islamic bank in town. For example, Al Rajhi Bank in Saudi Arabia, Kuwait Finance House in Kuwait, and Dubai Islamic Bank in the UAE long benefited from monopoly-like status in their respective markets.

This situation has changed considerably over the past few years. For example, in the UAE, there are now eight full-fledged Islamic banks and many conventional banks with Islamic offerings, known as windows, in addition to Islamic finance companies. Saudi Arabia has three full-fledged Islamic banks, and all the remaining banks offer sharia-compliant solutions through various distribution channels.

The increasing number of players in the marketplace is putting pressure on pricing and eroding margins. At the same time, consumers are increasingly demanding a return on their funds—either through direct income from deposits in mudharabah-based profit-and-loss-sharing investment accounts or by switching to investment products such as mutual funds. The effect is to negate the traditional funding advantage of Islamic banks.

Additionally, with Islamic banking integrating into the mainstream, and with more and more conventional banks offering sharia-compliant products, the clear distinction between Islamic and conventional banking is vanishing.

As competition intensifies, the providers of Islamic financial services need to develop new sources of differentiation beyond sharia compliance. It is quite possible that these sources will need to be different for full-fledged Islamic banks and for those banks with Islamic windows.

Changing the Basis of Competition

In our view, the future sources of differentiation for Islamic banks will likely revolve around three areas:

- Product development and innovation
- Distribution
- Operational excellence

Product development and innovation: Product development in Islamic finance has made significant advances in recent years. Today, most conventional products—whether in banking, asset management, or capital markets—can be replicated in a sharia-compliant manner.

Product innovation has emerged not only in response to the increasingly competitive environment, but also to address emerging customer needs. For example, on the retail side, more and more customers are seeking a return for the funds deposited with their banks. Mudharabah-based profit-and-loss-sharing investment accounts have been designed as a vehicle to address this need. Likewise, the need to be able to fund purchases of real estate over long periods of time has led to the development of Islamic mortgages.

In Islamic wealth management, an increasing number of customers are looking for sharia-compliant alternatives to conventional bond funds: products offering a stable, predictable income stream. Ijara and sukuk funds will most likely address such needs for wealthier clients. In corporate and investment banking, the focus is shifting from plain-vanilla sukuk to innovative structured solutions, such as products based on the Wa'd concept, Islamic profit rate swaps, and hedge fund platforms.

The challenge facing Islamic banks is not only to offer products that cover the same scope as those of conventional banks, but also to ensure that their products are different from those of their Islamic peers. In this regard, having a well-honed product development capability is paramount.

In our opinion, the following key requirements need to be in place to establish a differentiated product development capability:

- A market intelligence process that captures customers' needs;
- A robust methodology for rapid development and deployment of products;
- A mechanism to engage the sharia board early on to seek approval for the proposed product or service;
- Automated monitoring and compliance tools that ensure compliance of increasingly complex products with the relevant fatwa, or religious ruling, in a cost-effective manner; and
- A management information system to track performance and fine-tune the product or service as needed.

The above requirements are common to all banks, with the exception of the mechanism to secure sharia board approval. However, that is the one that often causes the product development process in Islamic banks to be protracted. The absence of universal standards to govern Islamic products only exacerbates this problem.

The solution to the problem is to have a sharia board well versed in financial services matters, and a process that seeks to engage the board early on for preliminary approval. To the extent possible, adopting a set of standards would also measurably improve the product development process.

Distribution: Islamic banking products are inherently more complex than their conventional counterparts. As well as having to avoid riba (interest), gharar (speculation), and maysir (gambling), Islamic transactions generally involve two legs, with ownership in contracts transferred twice: from the seller to the bank and from the bank to the ultimate buyer.

This places a burden on distribution, which has to explain the intricacies of the products to clients and, in some cases, convince them of the products' sharia compliance, as well as engage asset or commodity providers as part of the transaction.

The solutions to these problems are straightforward. Leading Islamic banks offer their front-line staff extensive training that covers not only the product features but also how the transaction is processed. This in turn allows the front-line staff to satisfy the increasing number of customers who are not satisfied with a simple statement that the product is sharia compliant, but want to understand the underlying features of the product or service.

In general, Islamic banking products are more complicated than conventional ones because of the sharia-compliance requirements as defined in the product-specific fatwa. Consequently, the sale of a sharia-compliant product requires the special knowledge of a well-trained sales force.

In distribution channels, a well-established solution is to partner with asset/commodity providers. For example, Kuwait Finance House operates two auto showrooms where sales representatives of various dealers present new and used cars. When a customer decides to purchase a car, he can arrange the financing with KFH's bankers, who are present in the showroom. After completing the assessment of creditworthiness, the bank's murabahah department purchases the car from the dealer's sales representative and resells it to the customer at a profit. The benefit of this approach, of course, is that the entire transaction takes place under one roof.

Operational excellence: The increasing competitive intensity among Islamic banks is putting pressure on prices. At the same time, the historic advantage of Islamic banks—the non-interest-bearing deposit—is coming under threat because of customers' desire to invest in higher-yielding products. As mentioned earlier, Islamic banks have inherently more complex operations than their conventional counterparts. All of the above are placing pressures on margins and driving Islamic banks to seek avenues for improving operational performance.

Performance improvement is even more relevant for Islamic windows, as conventional and Islamic operations are run in parallel—with the associated disadvantageous economics. A major component of operational excellence is a high-performance infrastructure and flexible IT systems, allowing for straight-through processing and an industrialized production. Thus, there's a need for modular IT solutions in which standard components can be individually combined to enable both conventional and Islamic transactions.

From a customer perspective, operational excellence means that an organization takes into account the variety of marketing channels and the fact that clients are likely to continue to buy both conventional and sharia-compliant products. Organizations therefore must determine how they can best respond to different customer needs through distinct channels in a consistent and coherent manner. Customers would prefer to have a single interface with a financial institution, but they require the assurance that any Islamic products and services they purchase follow strict sharia requirements across the entire life cycle of the products. This in turn poses internal challenges to coordinate and structure processes, infrastructure, and people in a manner that yields efficiencies and effectiveness across the entire organization.

Challenges for Islamic Banks

The unique characteristics of Islamic banking give rise to a set of challenges that have to be addressed by Islamic banks. These include:

- Establishing appropriate risk and liquidity management techniques
- Achieving consistent sharia supervision
- Managing the talent pool
- Addressing legal and tax restrictions

Establishing appropriate risk and liquidity management techniques: The risk profiles of Islamic financial institutions differ from those of their conventional counterparts because of some of the Islamic financing techniques. For example, in an auto murabahah transaction, there is a risk that the customer will not purchase the vehicle from the bank even though he committed to do so. The less standardized the goods financed through murabahah, the greater the risk. This risk is even more relevant in the mutajarah business, in which the bank purchases certain assets or commodities and holds them as inventory.

As a result, Islamic banks need to evaluate their risk management techniques and deploy appropriate capabilities to counter or mitigate risks. Conventional risk management techniques and instruments are not fully sufficient for all Islamic banks. When an Islamic bank engages in the mutajarah business, for example, risk associated with holding inventory must be managed, and thus cross-industry know-how—such as that of retailers—needs to be transferred and applied accordingly.

A major challenge facing Islamic banks is the absence of short-term liquidity management and longer-term refinancing instruments. As a result, asset liability management is becoming a real problem. On the short-term side, sharia-compliant money market instruments are in short supply and commodity-based reverse murabahah transactions can only be regarded as an interim solution. A similar problem exists on the long-term financing side, where the issuance of sukuk is the only option available but requires an underlying asset on which to base the financing. Islamic banks need to foster the development of appropriate sharia-compliant liquidity management and funding instruments to ensure that short- and long-term funding requirements are met. The short-term funding need is particularly acute because customers increasingly shift funds from non-interest-bearing current accounts to off-balance-sheet investment accounts. Long-term funding can be achieved through the issuance of sukuk, as this market is already well developed.

Achieving consistent sharia supervision: The market for Islamic finance faces a major problem: the absence of universal standards. Geographic differences exist, and even within one country, different sharia boards may deliver different interpretations. Unless standardization of the regulatory framework of Islamic banking is significantly improved, sharia arbitrage will continue to exist and grow. Sharia approval will be obtained by banks in a manner that best suits customers' needs and the circumstances of individual products or transactions. The absence of universal standards, and the lack of transparency regarding the application of sharia, places a huge burden on the marketing of Islamic financial services.

Managing the talent pool: As noted previously, the Islamic banking industry has experienced rapid growth over the past few years, and this growth is expected to continue for the foreseeable future. A major impediment, however, to realizing the future potential of Islamic banking is the limited available talent pool, especially for senior positions.

At present, there are simply not enough people with the requisite skills available in the marketplace. This situation exists at all levels in financial services institutions, but is particularly prevalent at the sharia board level. It takes many years of education and practical experience to become a sharia scholar. As a consequence, there are few scholars available and many of them sit on multiple boards, raising the inevitable issue of conflict of interest.

As educational institutions respond to the demand for Islamic finance training courses, the gap between demand and supply will narrow over time. However, in the short term, the lack of skilled resources will likely persist and limit the development of the industry.

Addressing legal and tax restrictions: In many non-Muslim countries, Islamic and conventional banks are not on a level playing field, as there are numerous legal and tax restrictions that make it difficult for Islamic banks to compete. For example, in many jurisdictions, Islamic real estate financing through the diminishing musharaka technique leads to a double taxation, with conveyance duty on the acquisition of the real estate.

Some countries, such as the U.K., have taken the lead in abolishing legislation that places Islamic finance at a disadvantage.

However, until other countries follow a similar path, the development of this form of finance will be limited.

Conclusion

In conclusion, the market for Islamic banking shows rich potential. However, as the competitive intensity increases, the winning players will be those that are able to deploy differentiated capabilities and address the existing challenges unique to Islamic banks.

AUTHOR INFORMATION

Peter Vayanos is a partner with the financial services practice of Booz & Company, based in the Beirut office. He specializes in the development and implementation of transformation strategies for retail banks, private banks, and insurance companies. He can be reached at +961-1-336433 or peter.vayanos@booz.com.

Dr. Philipp Wackerbeck is a senior associate with the financial services practice of Booz & Company in the Munich office. He specializes in reorganizations and the development of growth strategies for financial services companies, particularly with regard to Islamic finance. He can be reached at +49-89-54525-659 or philipp.wackerbeck@booz.com.

Dr. Peter T. Golder is a principal with the financial services practice of Booz & Company, based in the London office. He specializes in the development of growth and transformation strategies and risk management for corporate banks and capital markets intermediaries. He can be reached at +44-20-7393-3234 or peter.golder@booz.com.

George Haimari is a principal in the financial services practice of Booz & Company in the Dubai office. He specializes in the development of growth and market entry strategies, as well as organizational restructuring and operating model design, for companies in the banking and capital markets sectors, including Islamic banks. He can be reached at +971-4-3900260 or george.haimari@booz.com.

BOOZ & COMPANY WORLDWIDE OFFICES

Asia
Beijing
Hong Kong
Mumbai
Seoul
Shanghai
Taipei
Tokyo

Australia, New Zealand, and Southeast Asia
Adelaide
Auckland
Bangkok
Brisbane
Canberra
Jakarta
Kuala Lumpur
Melbourne
Sydney

Europe
Amsterdam
Berlin
Copenhagen
Dublin
Düsseldorf
Frankfurt
Helsinki
London
Madrid
Milan
Moscow
Munich
Oslo
Paris
Rome
Stockholm
Stuttgart
Vienna
Warsaw
Zurich

Middle East
Abu Dhabi
Beirut
Cairo
Dubai
Riyadh

North America
Atlanta
Chicago
Cleveland
Dallas
Detroit
Florham Park
Houston
Los Angeles
McLean
Mexico City
New York City
Parsippany
San Francisco

South America
Buenos Aires
Rio de Janeiro
Santiago
São Paulo

The most recent list of our office addresses and telephone numbers can be found on our Web site, www.booz.com.

10/08 Printed in Germany