ATKearney

The Future of Islamic Banking

Declining growth rates and eroding profitability suggest it is time to better leverage the Islamic banking potential. In order to do this, Islamic banks should revisit their strategic positioning and improve their operational efficiency.

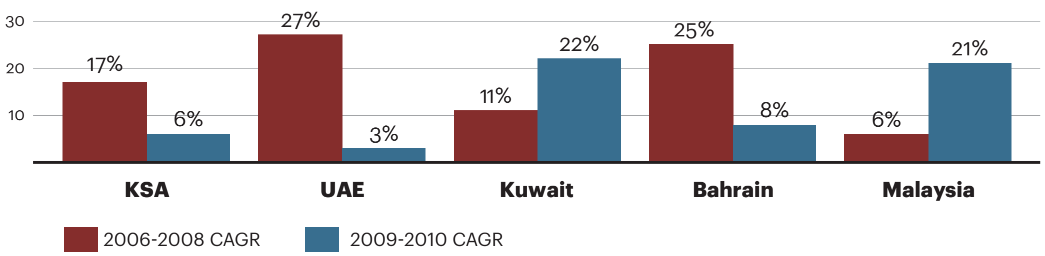
For years, many Islamic banks have witnessed double-digit growth rates, surpassing their conventional peers. At first glance, all seems well for the Islamic banking industry. There is ample room for growth as Islamic banking rarely exceeds a third of total market share, even in the Gulf Cooperation Council (GCC) countries and Malaysia. Several potential markets with large Muslim populations remain largely untapped, such as India and the Commonwealth of Independent States countries, made up of the former Soviet republics. In addition, overall banking penetration in many of the industry's core markets is still low. For example, GCC countries have not yet achieved the banking penetration levels of countries such as France or the United Kingdom. At the same time, several new markets have opened up for Islamic banking, with even more on the horizon (see sidebar: A Market Overview on page 4).

The Changing Dynamics of Islamic Banking

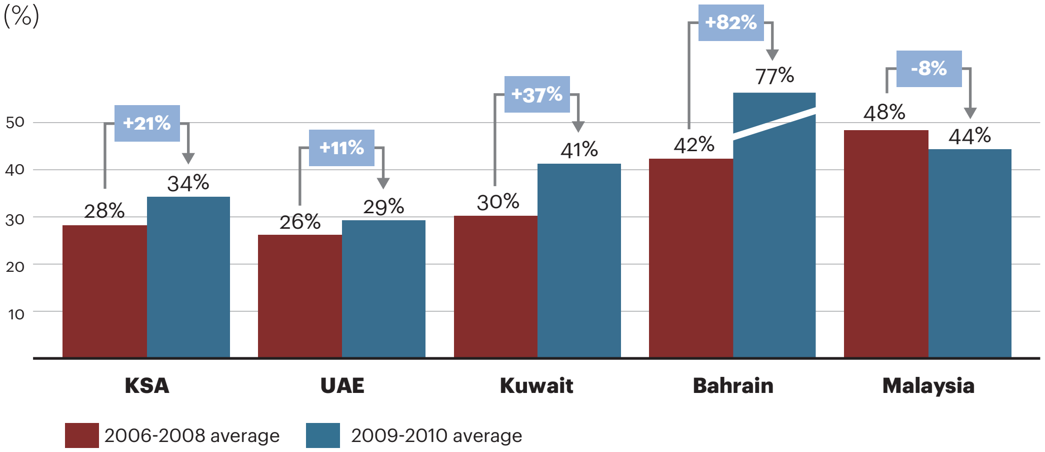
A closer look, however, suggests the market dynamics are changing. Two key indicators should be cause for reflection in the Islamic banking industry: growth rate and profitability (see figure 1).

Figure 1
Declining growth rates and profitability suggest Islamic banks revisit their strategies

Banking asset outgrowth
(%)



Cost income ratio
(%)



Note: Outgrowth is defined as the difference between Islamic banking asset growth and conventional banking asset growth.
Source: A.T. Kearney analysis

Slowing growth. After years of rapid growth in which Islamic banks outpaced conventional banks in most markets, outgrowth is waning in key geographic regions, including Saudi Arabia and the United Arab Emirates. Soon, growth in Islamic banking could match the general market, suggesting that Islamic banks may have exhausted their "natural" share.[1] While the data at this time remains inconclusive, it should be viewed as an early warning sign.

Eroding profitability. Although Islamic banks have generally outperformed conventional banks in terms of growth over the past decades, they have not consistently outperformed them in terms of profitability. For example, several small Islamic banks in the GCC have been struggling for years to turn profitable; others have been badly affected by the regional economic crisis (see sidebar: Challenges in Islamic Banking). More importantly, some major Islamic banks, notably in the GCC, have witnessed declining profit margins over the past five years.[2]

To sustain profitable growth, a more sophisticated leveraging of the Islamic banking potential—much of whose potential has not yet been exploited—is required. Strategically, this means that Islamic banks, which so far often purely emulate a conventional bank's offering, need to revisit their positioning. Operationally, they need to seek greater efficiency across the value chain.

Challenges in Islamic Banking

Given the slowing growth and decreasing profitability of Islamic banking, we looked at some of the main challenges facing the industry.

Size. **Many Islamic banks are considerably smaller than their conventional competitors in their domestic markets. Moreover, even the biggest Islamic banks are typically small compared to international conventional competitors. There is no Islamic Citibank or Islamic Goldman Sachs—that is, no global pure-play Islamic banking leader with a broad or specialized business model.**

Competition. **The number of Islamic banks and financial services firms is growing even as market growth slows down. For example, the only new banking licenses in the United Arab Emirates issued in recent years were for Islamic banks; meanwhile, conventional banks continue to launch Islamic windows.[3] As a result, merely being Sharia compliant is not a major differentiator.**

Standardization and regulation. **Standardization and regulation present ongoing challenges for Islamic banks. Different interpretations of the acceptability of various products from a Sharia perspective makes standardization difficult. For example, the same Islamic financial instrument can be rejected by one Sharia board and approved by another, as the Sharia rulings of these boards are based on their understanding of the underlying Sharia principles. Moreover, historically, there have been marked differences in product acceptance between Southeast Asia and the Middle East. There is a converging trend now, as Bank Negara, Malaysia's central bank, discourages the sale of Islamic banking products that are deemed unacceptable in the GCC to increase industry standardization. Regulation issues also stem from some countries' lack of specific Islamic banking rules.**

Cost structure. **Despite strong growth, most Islamic banks have not been consistently profitable, particularly since the global financial crisis. Structural factors are partly to blame as Islamic products are typically more complex than conventional products, which add development and manufacturing costs. Bank-specific weaknesses, such as risk management and operational effectiveness, also play a role.**

[1] It is widely held that customers fall into three categories. The first two include "Islamic bank loyalists" and "conventional bank loyalists", both with clear-cut preferences. The third and largest category is "floating mass"—in some estimates about 60 to 70 percent. They typically make their banking decisions based on pricing and service quality, and will require an Islamic offering to be at least on par with a conventional one.

[2] While profitability may not be a key driver for some Islamic banks, it certainly remains important for most.

[3] Qatar is a notable exception, as the central bank has ordered Islamic windows to be closed.

A Market Overview

Islamic banking—financial activity consistent with Sharia, or Islamic law—has become a material part of the global financial services industry, growing rapidly in both size and stature. Total Islamic assets are estimated around $1,200 billion in 2010. Islamic banking assets make up around 90 percent of this, while outstanding Islamic sukuk and Islamic investment funds comprise the rest.

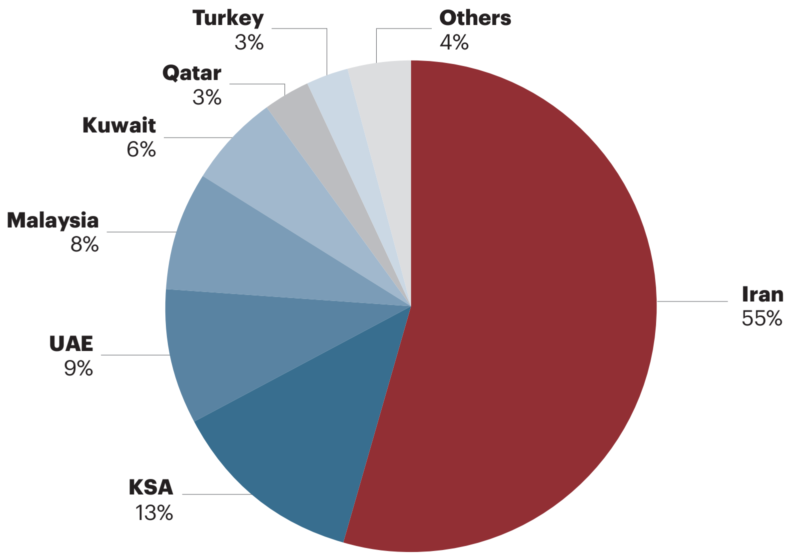
The major geographic markets are Iran, the Kingdom of Saudi Arabia, the United Arab Emirates, Malaysia, Kuwait, Qatar and Turkey (see figure A). Over the past several years, Islamic banking has seen double-digit growth rates. For example, the compound annual growth rate between 2006 and 2010 has been 21 percent in the Kingdom of Saudi Arabia and 24 percent in Malaysia.

In terms of Islamic banking penetration (that is, Islamic banking assets as percent of total banking assets), markets can be broadly categorized into three clusters: established, emerging and untapped (see figure B on page 5). The established cluster of Islamic banking activity is the Middle East and South East Asia, with some of the world's most active markets such as Kuwait, the Kingdom of Saudi Arabia, the United Arab Emirates and Malaysia. Emerging markets such as Pakistan and Indonesia have vast Muslim populations and offer significant growth prospects. Large yet untapped markets such as India offer great potential to daring investors. To date, there are no major initiatives undertaken to promote Islamic banking, and if tackled strategically, markets such as India present a vast opportunity for expansion.

There are three main types of players in the Islamic banking industry: full-fledged Islamic banks, Islamic windows of conventional banks, and Islamic finance companies. Full-fledged Islamic banks are either fully independent entities or subsidiaries of conventional banks, holding banking licenses. Islamic windows are secluded Islamic banking departments within conventional banks. Islamic finance companies focus on supplying Sharia-compliant financing products such as auto and home finance, and are not allowed to take deposits.

Figure A
Islamic banking has become a material part of the global financial services industry

Islamic banking assets breakdown
(100% = ~$1,100 billion)



Source: A.T. Kearney analysis

Figure B
Islamic banking markets can be broadly categorized into three clusters

Islamic banking markets

Examples

	Established				Emerging			Untapped	
	Kuwait	KSA	UAE	Malaysia	Pakistan	Turkey	Indonesia	India	China
Muslim population (Million, 2010)	3	27	6	17	175	73	209	162	22
GDP per capita ($, 2010)	40,517	23,201	59,533	15,022	2,516	13,150	4,250	3,408	7,544
Islamic assets ($ billion, 2010)	62	142	94	86	6	28	10	-	-
Islamic assets as % of total assets	40%	38%	22%	17%	7%	5%	3%	-	-

Source: A.T. Kearney analysis

Niche Market or Head-on? Consider the Implications

Fundamentally, Islamic banks have two strategic choices—exploit the Islamic banking niche or compete head-on against conventional banks.[4] Before moving along either path, or considering a blend of both strategies, we suggest looking at the implications of each.

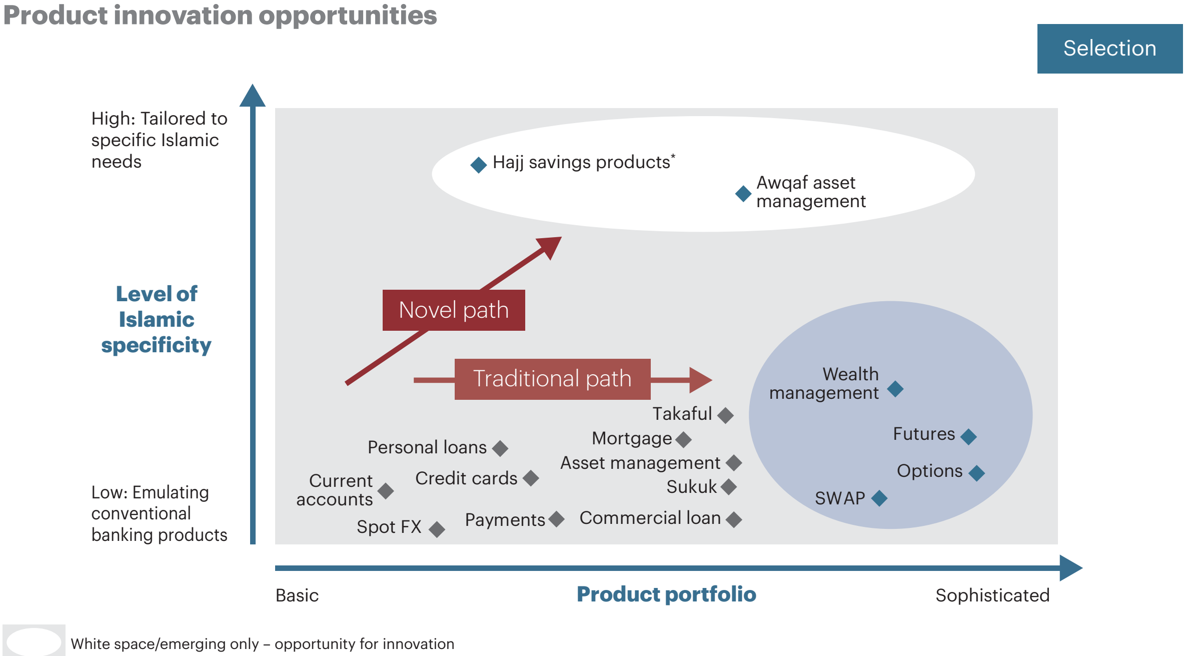
Exploiting the niche. Fully exploiting the Islamic banking niche means targeting customer segments that care most deeply about Sharia compliance in their financial dealings as well as offering products and services that meet not only general financing but also Muslim-specific customer needs. While Islamic banking products for basic banking abound (for example, auto finance and credit cards), and while there is still "white space" in some more sophisticated areas (for example, asset management and wealth management), such products tailored to Muslim-specific needs provide a platform for true differentiation (see figure 2 on page 6).

In retail banking, target customer segments may include religious conservatives, muftis, awqaf employees, or employees of ministries of Islamic affairs. One good example of a Muslim-specific retail banking product is financing for the pilgrimage to Mecca. This is highly relevant even for customers who generally place less importance on Sharia compliance in their financial dealings. Such products exist already in some parts of the Islamic world, for example, Tabung Haji Banking in Malaysia and Brunei. In private banking, target segments may include owners of halal industry companies. Providing specialized advice to high-net-worth individuals planning an awqaf set-up could represent a highly specialized, differentiated service in this segment. In corporate banking, target segments may include Islamic charities as well as the halal industry. A niche Islamic banking service for this segment will include asset management for awqaf, or expertise on providing Islamic financing in Western countries to companies acquired by Sharia-compliant private-equity firms. In institutional banking,

[4] Regarding the first choice, the Islamic banking niche, assets rarely surpass 30 percent of total market share, and as such, Islamic banking is still a niche market even in the GCC and Malaysia. A notable exception is retail banking in the Kingdom of Saudi Arabia, where Islamic banking has a much larger share and has effectively grown out of the niche.

Figure 2

While Islamic basic banking products abound there is still white space in some areas



*Tabung Haji is a notable exception.
Sources: Company websites, A.T Kearney project experience

other financial establishments may be targeted for the provision of pure-play Islamic banking expertise to support the development of their Islamic finance offering.[5]

Fully exploiting the Islamic banking niche also requires pricing considerations. As target customer segments will be less prone to accepting conventional bank offerings, products can be priced more expensively than conventional products, as long as prices remain competitive among competing Islamic offers. It also requires a reflection of Muslim values and heritage throughout the entire marketing portfolio, including brand name, corporate slogan, product names, and media and advertising campaigns.

Preserving a personal relationship is important in reaching Islamic banking "loyalists," which means providing brick-and-mortar branches where sales staff can meet customers face-to-face. However, less traditional ways to reach customers via alternative channels, such as phone banking, should also be explored. Beyond this, corporate social responsibility, such as supporting local Muslim communities and creating new Islamic charities, will appeal strongly to Islamic banking customers.

Some international banks have Islamic footprints in many countries, such as HSBC Amanah, and some Islamic banking groups domiciled in the GCC have a remarkable geographic coverage. However, most focus on one country, signaling geographic expansion as a clear growth

[5] Muftis are Islamic scholars. Awqaf are religious endowments in Islamic law. Halal industry companies in the true meaning of the term are companies selling halal products. In a broader sense, they include industries selling products which draw on the Muslim identity. For more information, see "Addressing the Muslim Market" at www.atkearney.com.

opportunity for niche-focused banks—the market is under-served in many markets outside of the GCC and Malaysia. Potential opportunities include Muslim-majority emerging markets such as Indonesia and Iraq, and wealthy, Muslim-minority developed markets such as Germany and France. Co-operative ventures might be the best entry strategy in these latter countries.

The market gaps are many and varied. Opportunities to better meet Muslim-specific client needs with dedicated banking products aligned with Islamic core values are under-developed and present attractive platforms for profitable growth for players willing to exploit the niche.

Competing head-on with conventional banks. It is a fact that many Islamic banks are competing head-on against their conventional peers. However, not all may realize that a head-on strategy has fundamentally different implications than a strategy of exploiting the Islamic banking niche. Competing against conventional banks means attracting customers who place less importance on Sharia compliance in their financial dealings, and more importance on competitive products and efficient services vis-à-vis the banking market at large.

Three elements are key to targeting the right customer segments. First, identification of customer segments least open to Islamic banking (for exclusion). Second, identification of segments with needs not fully met in a Sharia-compliant manner (to address shortfalls). And third, identification of segments open to ethical banking (to tap into a wider audience of both Muslims and non-Muslims).

As competition intensifies, Islamic banks **will have to adopt more sophisticated, customer-centric sales approaches.**

Successfully attracting these customers requires meeting a broader set of customer needs, while remaining on par with conventional banks in terms of ease of use and pricing. To achieve this, product innovation is paramount both in terms of broadening offerings using existing Islamic structures, as well as developing new Islamic structures. Banking services and products for small- and medium-sized enterprises, which are still only emerging in Islamic banking, and ethical banking products such as funds focused on investments in sustainable energy, provide an opportunity to broaden the offering. New Islamic banking product structures not easily replicated in a Sharia-compliant manner include hedge funds—an alternative asset class for high net worth individuals —and derivatives for corporate clients. While some Islamic banks offer Islamic derivative products, such products are not generally accepted as Sharia compliant (see sidebar: Islamic Derivatives: Moving the Frontier on page 8).

When competing against their conventional peers, Islamic banks typically are at a scale disadvantage, as they are often smaller in size (see figure 3 on page 9). In retail banking for example, the disadvantage is most significant in the size and range of the branch network. To compete successfully, head-on with conventional banks, particular focus on two areas is required. Firstly, Islamic banks should explore the use of alternative channels such as online banking and phone banking to gain market share. It will be important to use them much more as a sales channel rather than the current service focus. Secondly, the use of different branch models should be explored, depending on target segments' needs, ranging from light, kiosk-style sales outlets focusing on retail mass customers to full-service branches covering all customer segments. Alternative branch

Islamic Derivatives: Moving the Frontier

Derivatives are highly disputed in Islamic finance. Some industry officials condemn them as inherently incompatible with the principles of Sharia. They believe two parties' deferment of obligations to a future date is tantamount to a debt exchange without an underlying asset transfer, implying the possibility of gharar—prohibited transactions associated with speculation. This is a main reason why derivatives have not yet gained universal appeal in the Islamic world, particularly in the Gulf states.

Some leaders within the Islamic financial services industry, however, recognize the need for managing risks and the potential benefits of derivatives for hedging purposes. For example, Bank Negara Malaysia has long advocated introducing derivatives in Islamic banking, saying that with an adequate legal, regulatory, and corporate governance framework they could improve the Islamic financial system. The bank launched the first global Islamic derivative master agreement to document Islamic derivative transactions in 2007. A Malaysian bank also created the world's first Islamic derivative product (an Islamic profit-rate swap) in 2005.

Another major milestone for Islamic derivatives was the Tahawwut Master Agreement, launched in early 2010 by the International Islamic Financial Market, a Bahrain-based global standardization body for the Islamic capital and money markets, and the International Swaps and Derivatives Association. The multiproduct agreement, including murabaha (cost plus financing with known cost of underlying asset at the time of entering arrangement), musawama (cost plus financing with unknown cost of underlying asset at the time of entering arrangement), and wa'ad (unilateral pledge) products set terms upon which parties can enter risk management arrangements for hedging transactions, standardizing structures, and documentation. If widely adopted, the new standards could boost the Islamic derivatives market.

Currently, Malaysian banks and major international banks are driving Islamic derivative offerings. The most widespread are profit-rate swaps, cross-currency swaps, cross-currency profit-rate swaps, forward-rate agreements, and equity-linked structured products. Contrary to conventional derivatives, Islamic derivatives cannot be traded, as they are intended for hedging purposes only, and not as speculative investments.

models have the additional advantage of potentially reducing capital investments, operating costs and set-up times, and are particularly powerful if coupled with alternative channels.

A modern, customer-centric image that emphasizes ethical values and social or environmental efforts will reach the widest audience of both Muslim and non-Muslim customers. Alongside this is the need for education programs on Islamic banking products and structures.

In deciding to compete head-on with conventional banks, a first step is to build a strong domestic base before expanding internationally. Domestic mergers and acquisitions (M&A) can offer attractive opportunities to achieve scale-related synergies from larger operations. Strategic M&As allow Islamic banks to compete more effectively with the larger conventional banks by expanding branch networks, taking advantage of operational synergies, and expanding their financial clout.

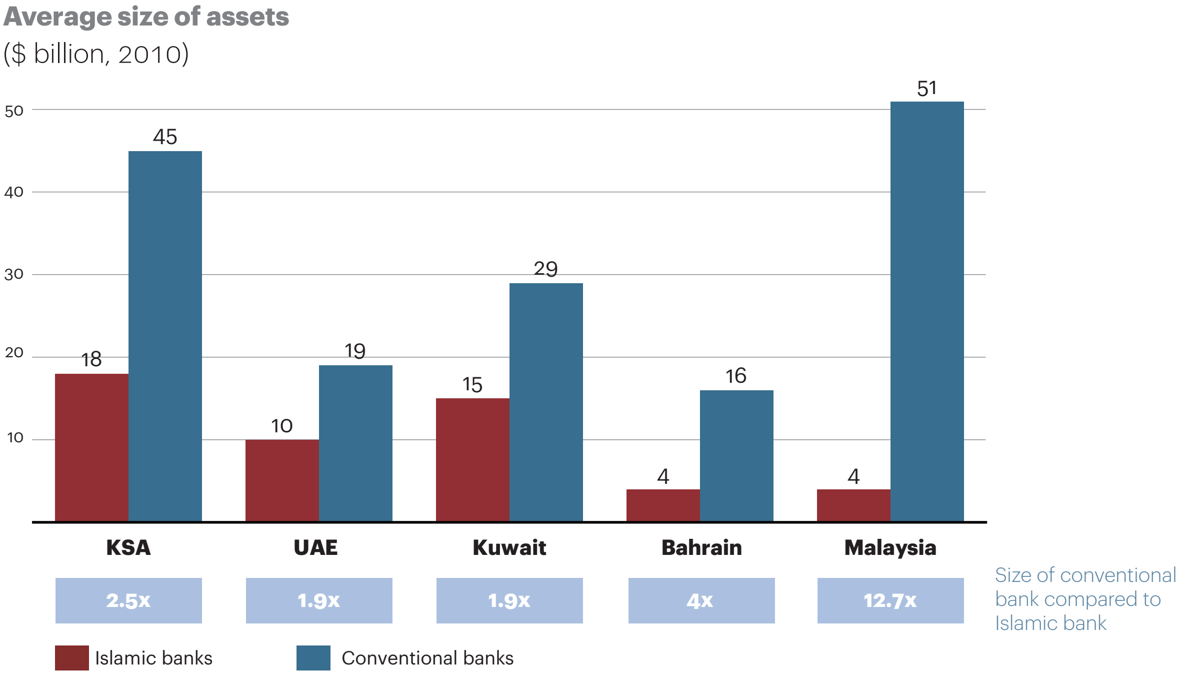
Opportunities to Improve Productivity

Whatever strategic positioning an Islamic bank chooses, it will typically need to seek greater efficiency across the value chain. As with other GCC banks, key areas include sales effectiveness, operational efficiency, and performance management.

Customer focus. The number of banking products and revenue per customer in the GCC remains relatively low compared to developed markets. For banks to increase their share of wallet, customer satisfaction is key, yet studies show that GCC banks generally do not seem to consider customer satisfaction a priority. Based on our research, we see three main areas for improving customer focus.

- **Staff.** Salespeople often are poorly prepared and have little understanding of the products they are selling. This is even more pronounced in Islamic banking, where customers may require additional explanations of Sharia-compliant product structures. There is a need to improve responsiveness, as customers do not receive a callback within the promised time, if at all.
- **Information**. When customers do not receive important information about a product before purchase—for example, discovering extra charges after a sale—this typically results in severe, lasting damage to brand loyalty.
- **Touch points.** Customers often have limited call-center or website service options and are repeatedly referred from one department to another. Few Islamic banks have a multi-channel view of the customer.

Figure 3
Compared to conventional peers, most Islamic banks suffer a size disadvantage



Note: Islamic assets of conventional banks are included within the size of "conventional banks" as they are simply another product offering by the conventional bank.
Sources: Country central bank websites; A.T. Kearney analysis

Improving customer service begins with a framework in which the brand promise is aligned with every aspect of the organization—its people, culture, performance metrics, processes and infrastructure. As competition intensifies, it is imperative for Islamic banks to adopt a more sophisticated, customer-centric sales approach. A reorganization of the sales force from a product focus to a customer segment focus, improvement of sales techniques and skills, and installing an improved multi-channel offering through channel cooperation and organizational integration will keep costs down and promote customer satisfaction. Maintaining a single view of the customer across all channels is paramount.

Operational efficiency. Many bank processes in the GCC are still manual, involving a multitude of documents and layers upon layers of decision makers. This can be particularly cumbersome in Islamic banking as an asset transfer is often involved. Redesigned processes can yield significant efficiency improvements, in some cases reducing resource requirements by 50 percent. While automation is important, it is not always required, particularly given the low labor costs in the GCC. Targeted IT investments are important, as is aligning the entire organization on strategy and streamlining the structure, which can significantly improve efficiency.

Improving customer service begins with aligning the brand promise with every **aspect of the organization—its people, culture, performance metrics, processes, and infrastructure.**

Outsourcing and offshoring provide options for centralizing business processes, improving service levels, and increasing control. Although it is a relatively new concept in the GCC, several regional banks have successfully outsourced less complex functions to India and Egypt.

A structured approach to procurement—analyzing spending and identifying savings for both strategic and operational costs—can reduce costs by up to 30 percent in some categories.

Performance management. Monitoring and properly rewarding high achievers is key to improving performance levels. Rewards can be in the form of financial compensation, career progression, or acknowledgements such as tried and tested "employee of the month" awards. A properly structured incentive system can become a powerful tool for retaining staff, particularly important in Islamic banking given the general shortage of skilled resources. The key is linking rewards directly to performance measures—pre-defined at the employee level—to ensure that hard-won improvements are sustained.

Banking on the Future

Growth over the past several years continues to generate optimism for the future of Islamic banking. But as competition ramps up, and early warning signs show growth slowing down, Islamic financial institutions have plenty of work to do. Whether the strategy is to focus on niche positioning, compete with conventional banks head-on, or a blend of both, sustaining growth will require most Islamic banks to achieve greater efficiency across the value chain.

Islamic banks that take the time now to consider strategic choices and address operational fundamentals will be in a stronger position to capture untapped market opportunities and master the changing dynamics of their industry.

Authors

Cyril Garbois,
partner, Middle East
cyril.garbois@atkearney.com

Cyril Gourp,
principal, Middle East
cyril.gourp@atkearney.com

Dr. Alexander von Pock,
principal, Middle East
alexander.von.pock@atkearney.com

Mukund Bhatnagar,
manager, Middle East
mukund.bhatnagar@atkearney.com

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