A growth model for Islamic banking

As competition grows, incumbents must work harder to remain distinctive.

Article at a glance

Islamic banks have prospered, thanks to protected markets and increased demand for products that adhere to Sharia. But increased competition and other market changes will force Islamic banks to pay more attention to performance.

Along with getting the basics of banking right, Islamic banks—either pure plays or arms of conventional banks—must address specific problems linked to faithfulness to Sharia, in areas ranging from organization to branding.

Some structural obstacles related to treasury operations and scale may be overcome only through unprecedented cooperative efforts.

As customers realize that they no longer must choose between Sharia-compliant products and international standards of performance and service, Islamic banks that can deliver both will have an edge.
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A cursory glance at the Islamic banking industry shows that it is robust and profitable. In most countries with significant Islamic communities (Exhibit 1), financial institutions that cater to this segment are growing much faster than conventional banks, because of the strong demand among consumers for products and services that comply with Sharia, the Islamic legal code. The banks’ financial ratios, such as return on assets, can be as high as those of the best-performing conventional banks. But these successes are built largely on regulatory advantages and on a unique value proposition. Both are being eroded by the market entry of players that combine Islamic products with superior marketing and customer service skills. For incumbents to survive, they must not only bring their fundamental banking skills up to competitive levels but also overcome a handful of challenges specific to Islamic banks.

In general, Islamic banks are governed by Sharia, which, among other aspects, prohibits the use of interest or speculation (Exhibit 2). There are about 270 Islamic banks around the world (including subsidiaries of conventional banks), and together they hold assets estimated at more than $265 billion. Their holdings are growing by 15 percent a year, and although this amount represents just a small portion of the assets held by banks of any stripe, the potential for growth and for access to the Middle East and other desirable markets has attracted such banking giants as HSBC and UBS to Islamic finance. In addition, countries from Bahrain to Malaysia are racing to create Islamic banking hubs to serve the 1.2 billion Muslims around the world.

The door is opening
Most Islamic banks enjoy protected markets and other regulatory advantages, such as higher lending limits than conventional banks offer. In many countries, only pure-play Islamic banks are permitted to produce or sell most Sharia-compliant...
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products, leaving hybrids, which combine an Islamic unit and a conventional banking parent, out of the market. Furthermore, regulators in the past have limited the number of pure plays in a market to one or two, giving incumbents a national monopoly or duopoly. Such advantages have not only paved the way for above-average profits but also enabled these banks to reap the full benefit of the increased demand for Islamic banking products (Exhibit 3).

But the picture is mixed when you look at the average annual return on assets from 2000 to 2004 for 25 Islamic and conventional banks in seven countries with large Muslim populations.\(^2\) Al Rajhi Banking and Investment, a Saudi Islamic bank, was the best, with an average return on assets of more than 3 percent, while the worst were Islamic banks delivering 1 percent or less. In some countries Islamic banks do better than their local conventional rivals, but in others they perform much worse. Three factors in particular have an impact on the performance of Islamic institutions.

- **Market profile.** Customer characteristics, including average wealth and the demand for specific products (savings accounts and loans, for instance), as well as labor costs and competition all affect general profitability. In Qatar, for example, the high demand for and limited supply of loans for corporations and infrastructure projects have led to high corporate-lending margins, benefiting Islamic and conventional banks alike.

- **Business model.** As with conventional institutions, Islamic banks that focus on retail customers perform better, on average, than those that target only corporate banking. Al Rajhi and the Kuwait Finance House concentrate mainly on retail and small-business customers, which partly accounts for their above-average return on assets.

- **Demand for Islamic banking.** Consumers in different markets vary in their demand for Islamic banking products and the preferred source (pure play or hybrid), as does their tolerance for higher prices, lower performance, or poorer service as trade-offs for products that adhere to Sharia. In Saudi Arabia, for example, about three-fourths of consumer deposits and half of all bank deposits are in noninterest-bearing accounts, giving Saudi banks a cost advantage over their counterparts in other countries. By contrast, in the United Arab Emirates noninterest-bearing accounts do not exceed 25 percent of total deposits.

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\(^2\) Our research focused on banks in Bahrain, Jordan, Kuwait, Malaysia, Qatar, Saudi Arabia, and the United Arab Emirates.
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But conditions are changing quickly as governments relax their rules in order to build their domestic markets and to aid in the industry’s development. These moves have opened the door for hybrid banks offering Islamic and conventional products as well as for more pure-play Islamic banks. Institutions are entering these markets using a variety of strategies. HSBC and UBS have created separate brands for their Islamic offerings (Amanah and Noriba, respectively), while others, such as Maybank in Malaysia and Samba Financial in Saudi Arabia, have opened special branches that sell only Islamic banking products. In countries such as the United Arab Emirates, which maintains severe restrictions on hybrid models, banks have established discrete Islamic businesses with separate legal identities, management and governance, brands, and distribution channels. New banks are appearing, and incumbents are exploring expansion opportunities outside their home markets.

The pace of most of these developments has accelerated in the past year or so, and consumers now have many more options. In general, the service levels and product variety are superior in conventional banks, which traditionally faced more competition. As these banks bring their skills to the Islamic banking market, consumers will no longer face a stark choice between products that comply with Sharia and higher-quality service and product offerings.

To compete in this new environment, incumbent Islamic banks will have to follow the path taken by many conventional institutions. Vital steps include identifying and targeting the most valuable customer segments with differentiated and higher-quality offerings, increasing operational efficiency, and improving risk management. These measures are the bread and butter of good banking, but Islamic banks face challenges unfamiliar to their conventional counterparts.

Beyond Banking 101
Islamic banks that emerge from protected markets can borrow much from the traditional improvement programs of financial institutions. But as they seek...
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to boost performance and profitability in a much more competitive environment, they must still comply with Sharia. The need to follow Islamic law, both as an underlying principle and as a key differentiating factor in the market, complicates a bank’s organization and governance, branding, operations, and efforts to innovate. In addition, Islamic banks may have to band together to tackle structural problems that handicap the industry (see sidebar, “The industry’s structural hurdles”).

Organization and governance

Innovative products and services at Islamic banks must be approved by a Sharia committee, an independent panel of scholars appointed by the bank that issues fatwas\(^3\) on whether an offering abides by Islamic law. The Sharia committee exercises tremendous power by underpinning—or undermining—an institution’s credibility with the Islamic community.

But the need to secure approval from the Sharia committee adds an obstacle unlike any at conventional banks. Without a uniform interpretation of Islamic law, it is often difficult for banks to know whether their Sharia committee will approve a new product. In fact, nothing prevents a committee from reversing a previous decision and declaring that an offering is not compliant after it has been launched. Many Islamic banks struggle with committees that are overburdened, slow, and unpredictable.

Sharia committees should consist of Islamic scholars who are both respected in the religious community and knowledgeable enough about modern finance to evaluate new products and to communicate their opinions effectively. Scholars with both qualifications are rare, and the best—often serving on several committees—are overburdened.

Islamic banks should work to lessen this burden. Broadly speaking, a Sharia committee’s role can be divided into two areas: compliance and advisory. Since the committee’s central role is to judge a bank’s compliance with Islamic law, the task (which includes reviewing new products and services, issuing fatwas, and assessing a bank’s operation to ensure that it mirrors the design approved by fatwas) cannot be outsourced effectively.

The advisory function includes assisting managers with product development, working with customers to create deal structures that follow Sharia, handling external relations, and consulting on matters of general policy and strategy. Many of these duties could instead be assigned to in-house Sharia experts, allowing the committee to focus more on compliance issues. These in-house scholars should be experts in Islamic law and banking without necessarily having the religious credentials or public standing to qualify for the Sharia committee.

In addition to helping with product development, these internal experts would explain to the Sharia committee the merits and Islamic structures behind new products and interpret the fatwas for managers, who are then in a better position to address the committee’s concerns. They would also monitor the latest developments in Islamic banking around the world and tailor new ideas to meet the specific needs of the bank and its customers.

Branding

Too many Islamic banks take their brand position and credibility for granted, assuming that adhering to the tenets of Sharia will be sufficient. But as they face more competition from a variety of institutions that offer similar products, building a clear brand identity solely around Sharia compliance will become more difficult. Islamic banks need to understand and manage their brand image actively, thereby creating the perception of an “Islamic credibility advantage” over their competitors.

The first step is to understand the main factors that contribute to credibility in a given Islamic market, including whether a bank is a pure play or a hybrid, its history and pedigree, and the composition of its Sharia committee. Tangible attributes, such as the

\(^3\) Any ruling by a recognized authority on Islamic law.
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The industry’s structural hurdles

Islamic banks face many unique challenges, and most can be overcome by individual institutions. But the industry’s very nature poses two structural disadvantages that will be more difficult for banks working alone to address and may require outside support.

The lack of scale...

Scale is vital to driving down cost-income ratios, but by international standards—indeed, even by local standards in most cases—Islamic banks are well below optimal scale. In some countries, the total demand for Islamic banking may never be large enough to create a single bank with efficient scale, so national consolidation of existing Islamic banks is unlikely to be an answer. Merging with a conventional bank, even if the brands and infrastructure are kept separate, could jeopardize the credibility of the Islamic bank.

Cross-border expansion (including mergers and acquisitions) and the outsourcing of back-office functions are the remaining options. Even the most experienced conventional banks have struggled with the former, and most Islamic banks have very little skill or experience in such a risky undertaking. Third-party service providers for Islamic banks have yet to emerge, in part because of the language barrier and the complexity of Islamic products.

The differences in the structure of products across countries—or even from one bank to the next—add to the difficulties of cross-border expansion and back-office outsourcing.

...and liquidity

A second structural challenge for Islamic banks involves treasury. A liquid secondary market for Islamic fixed-income instruments doesn’t exist. Banks are forced to focus on shorter-term tools to ensure sufficient liquidity, a requirement that puts them at a disadvantage to conventional banks, both in exposure to market risk and in long-term returns on a bank’s investment portfolio. No bank has completely overcome this disadvantage, although some governments, in an effort to help Islamic financial institutions, have tried to create liquidity by issuing Sharia-compliant government bonds. Potentially, a third-party entity—perhaps developed and owned by a confederation of Islamic banks—could help solve both the scale and treasury challenges. Such an organization could be modeled after Bankers’ Bank (in the United States) or the Sparkasse (in Germany) which offer back-office and treasury services to all member institutions. The task would not be easy, and one of the primary challenges would be to build cooperative relationships between banks that are current or potential rivals in the Islamic market. But given the mounting competition from conventional institutions, Islamic banks may choose to stand together rather than suffer separately.

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number of Islamic banking branches, leadership in product innovation, or the segregation of Islamic funds from conventional activities, also come into play.

From this analysis, a bank should choose a specific brand position—conservative, innovative, or community advocate, for instance—and chart a course to reach and maintain that position. This effort, supported by strict Sharia compliance, audits, and reviews of all marketing communications, must be clearly understood and adhered to by all bank managers.

Maintaining a dialogue with the community to promote and defend a bank’s Islamic credibility is also important. A bank’s internal experts, or even members of its Sharia committee, could participate in conferences and other scholarly discussions, for example, or publish articles commenting on current Islamic issues. Newspapers in many Islamic countries have sections that discuss religious topics, so a bank can use this channel to explain how new financial products comply with Sharia.

Operational complexity

Products from Islamic banks are often more complex than those from conventional institutions. In the latter, a cash loan is simple: a customer borrows money at a fixed interest rate and with a prescribed set of installments and, if payments are overdue, faces accumulated interest and perhaps a late fee. The most popular Islamic alternative to the cash loan uses a tawarruq (literally, “monetization”) mechanism, in which a bank sells its customer a commodity (such as palladium) at a marked-up price to be paid over a predetermined time period. The customer then resells it for cash at the market’s current spot price. The bank’s profit comes from the difference between the purchase price of the commodity and the price agreed to by its customer, rather than from interest. Unlike a bank that makes a conventional cash loan, the bank can’t charge above the original amount if the customer makes late payments, because the additional fee would be considered interest.¹

The added complexity arises from the breadth of the transaction. The Islamic bank must maintain relationships with commodity brokers, take title of the goods temporarily, and shepherd each purchase and sale. The formal documentation is longer and more complex than it is for a conventional cash loan, and frontline employees and the bank’s advertising must explain exactly how the product works and show that it meets Sharia law. And finally, managing credit risk is more complex because the bank needs to estimate not only the expected losses from defaults on the loans but also the real cost to the bank of delayed payments, for which conventional, off-the-shelf risk-management tools aren’t useful. Complexities arise in a wide range of Islamic products, from savings accounts (which use a profit-sharing formula, rather than a fixed interest rate, to pay depositors) to takaful (meaning “mutual support”), a product (similar to life insurance) that works on a strict shared-risk system across policyholders.

Customers increasingly expect these products to perform as well as those from conventional banks and will not accept added complexity as an excuse for much higher costs or lower performance. To mitigate this additional complexity, Islamic banks need to pay greater attention to the three pillars of successful operations: cost containment, fast processing times, and low error rates. Islamic banks must manage these basics and understand customer needs in order to compete against conventional institutions.

Product innovation

In general, a product developed by a conventional bank can be copied by other conventional banks anywhere in the world. It’s not so easy for Islamic banks, however.

First, most conventional products employ some form of interest and so cannot be directly replicated

¹ Although banks are sometimes permitted to fine a customer for late payment, the proceeds must be donated to charity.
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by an Islamic bank; at a minimum, they require some level of reengineering. Further, the Sharia committee of one bank may reject an innovative product offered by another Islamic bank. In addition, with so few Islamic financial institutions in the world, only a relatively small number of people are developing new products that comply with Sharia.

Next, although innovation offers customers greater choice, a bank’s credibility within the Islamic community could be put at risk if its products and services were to draw criticism from Islamic scholars. Many banks prefer to avoid potentially controversial products, instead sticking to a basic portfolio and trying to appeal to the most conservative Islamic customers. Others try to adapt the product portfolio of conventional banks to Islamic structures.

But the more successful banks develop products that address customer needs. Saudi Arabia’s National Commercial Bank (NCB), the country’s largest, unveiled the first Islamic credit card, based on tawarruq, in 2003. The product fulfills the primary functions of a credit card—easy purchases and delayed payments—by using a series of commodity transactions. But many Islamic scholars disagree with tawarruq lending, especially in this context. So while NCB has strengthened its reputation as a leading innovator, it risked a backlash from some Islamic scholars who might consider this approach too close to traditional interest products. In the nearly two years since NCB launched its credit card, other Islamic banks have used a variety of approaches to offer their own Sharia-compliant versions (Exhibit 4). Rather than viewing the differences between a conventional credit card and its Islamic alternative as a weakness, some banks are highlighting the distinction to customers as an example of improved fairness and transparency.

Islamic banks that decide to innovate must also craft a program to ensure clear communications with customers. To guide consumers through the required voluminous documentation, for
instance, frontline staff should receive training to understand fully how the product functions as well as its implications.

Many Islamic banks have enjoyed strong financial performance in recent years. The growing demand for banking solutions that adhere to Sharia law presents an opportunity, but increasing competition raises new challenges: most Islamic banks must not only play catch-up with conventional rivals in product breadth and service quality but also overcome specific challenges linked to the Islamic code. If Islamic banks act now, they can maintain and strengthen their credibility within the community while closing the gap in conventional skills, thus benefiting from—as well as contributing to—the growth in demand for these products and services.

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