OLIVER WYMAN

Financial Services

The Next Chapter in Islamic Finance

Higher Rewards but Higher Risks

MMC
MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Contents

Introduction 1

Executive summary 3

The global emergence of Islamic finance 5

Wholesale banking: moving beyond vanilla financing 13

Retail banking: towards differentiated offerings and streamlined delivery 23

Conclusion 35

Appendix – What is Islamic finance? 36

Author: Mathieu Vasseux, Partner,
mathieu.vasseux@oliverwyman.com

Introduction

The next chapter in Islamic finance is a two-part examination of the Islamic finance market. It is aimed at helping decision makers in the financial services community decide where and how to compete in this promising and fast moving but opaque market. It is based on research conducted by Oliver Wyman combined with practical experience and insights derived from working with major financial institutions around the world.

In this first volume, *Higher rewards but higher risks*, we conduct a deep, quantitative, forward looking review of the global Islamic financial services market across segments and geographies. We focus on retail and wholesale banking, and provide insights on emerging trends and success factors within each segment.

In the second volume, *Redefining the operating model*, published later this year we will explore the key challenges in risk management, balance sheet management and IT and operations that incumbents and newcomers to this market will face as the business evolves.

Executive summary

Superior growth and economics

Islamic finance represents 1% of global assets. Surveys suggest that half of the 1.4 BN Muslims worldwide would opt for Islamic finance if given a competitive alternative to conventional services. The market has been growing at over 30% annually since 2000 and is set for continued strong growth. At the end of 2007, Islamic finance totalled $660 BN[1] of assets and $53 BN of revenues. Islamic finance profit pools total $15 BN and will increase more than two-fold to $32 BN over the next five years. We estimate that by 2012, Islamic assets will reach almost $1,600 BN with revenues of $120 BN.

The opportunity is commanding attention beyond Islamic incumbents, as witnessed by the spurt in Islamic start-ups and conventional players opening Islamic windows. Interest has spread beyond Islamic countries and leading financial centres like London are pushing to position themselves as major Islamic finance hubs.

Despite tremendous interest and phenomenal growth rates, most institutions are far from taking full advantage of that enormous growth. This partly stems from a lack of deep understanding of the opportunities that Islamic finance offers, and also because most financial institutions have not developed the required operational capabilities. This represents a major risk since success along these dimensions will distinguish the acquirers from the acquisition targets in the likely medium-term consolidation of the sector. What follows is a report of what has and has not worked in the realm of Islamic finance and how to succeed going forward.

Wholesale banking, moving beyond vanilla financing

Banks need to diversify their activities from what is mostly a real estate and vanilla lending play, to offer a comprehensive service suite including advanced treasury services, innovative asset management, balance sheet management and securitisation services. This will allow them to address the needs of underserved market segments such as Islamic financial institutions, corporates, sovereign wealth

1 All $ denominated figures in this report are quoted in US Dollars

funds and private wealth clients. Wholesale banking is the biggest market for Islamic finance with over $420 BN of assets and revenues of $28 BN. Wholesale assets have been growing at 34% annually and we estimate that by 2012, total assets will reach $1 TR with revenues of more than $60 BN.

Retail banking, towards differentiated offerings and streamlined delivery

Islamic retail banking is very profitable thanks to access to cheap deposits and high-margin financing activities. It has a significant upside given strong demographics and rising product penetration. However, most banks have an undifferentiated product offering, poor client servicing and sales efficiency problems. Success in this market will require developing differentiated and segmented offerings, streamlining product development to boost innovation and designing efficient processes. In addition, care must be taken in adapting marketing and the consumer proposition to Shariah imperatives and rethinking current business models. The market has $175 BN of assets and $20 BN of revenues. With an annual asset growth of 22% going forward, by 2012 total assets should reach over $470 BN with revenues of $50 BN.

The global emergence of Islamic finance

Introduction

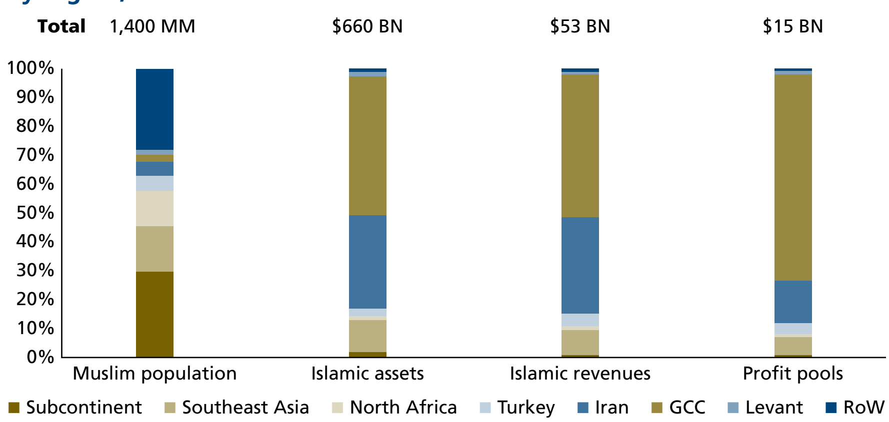
This section provides a global market overview of Islamic finance. It explores growth dynamics, key profit pools and the ongoing shift towards pure-play Islamic finance. It ends with an overview of the untapped market of Muslim minorities.

A large market with superior growth rates

As early as the 8th century, financiers in the Islamic world (known as *sarrafs*) developed what was then a sophisticated financial services system. They fostered economic development across Muslim lands by performing financial intermediation, operating an international payment system and offering advanced trade products such as letters of credit and promissory notes. Centuries later, European bankers built upon the expertise of the *sarrafs* to develop similar products. Having inspired Western finance, Islamic finance itself then declined in relative global significance. However, over the past few decades it has re-emerged as a powerful force globally.

While Southeast Asia was an early adopter, the GCC and Iran are now the largest markets. They account for 80% of global Islamic finance assets but only comprise 6% of the global Muslim population.

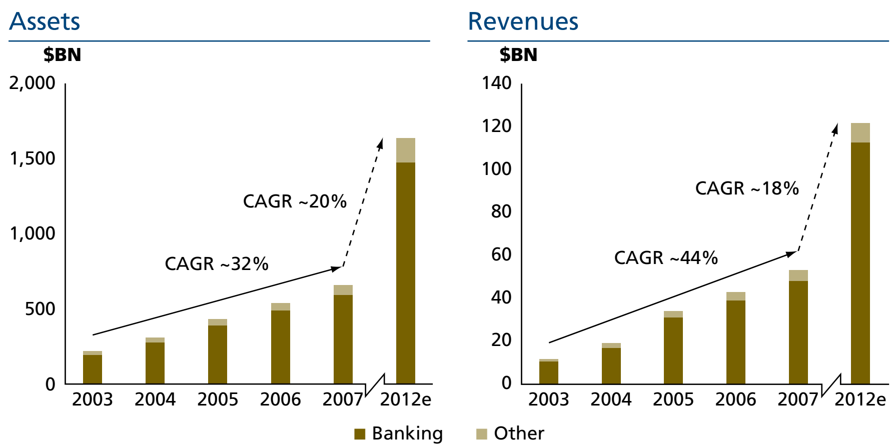
Muslim population, Islamic assets, revenues and profit pool breakdown by region, 2007



Source: Bankscope, CIA Fact Book and Oliver Wyman analysis
Regional breakdown as follows:
Levant: Israel, Jordan, Lebanon, Palestine, Syria
GCC: Qatar, Bahrain, Kuwait, UAE, Saudi Arabia, Oman
North Africa: Algeria, Egypt, Libya, Mauritania, Morocco, Tunisia, Sudan
Southeast Asia: Cambodia, Laos, Thailand, Vietnam, Philippines, Brunei, East Timor, Indonesia, Malaysia, Singapore
Subcontinent: India, Pakistan, Bangladesh, Bhutan, Nepal

Islamic finance is a very attractive market, with superior growth and profitability. It has been experiencing stellar asset growth of over 30% since the beginning of the decade, moving from niche to mainstream. Competition from numerous new entrants has not dented economic returns as revenue growth has been running ahead of asset growth with a CAGR of 44% over the past five years.

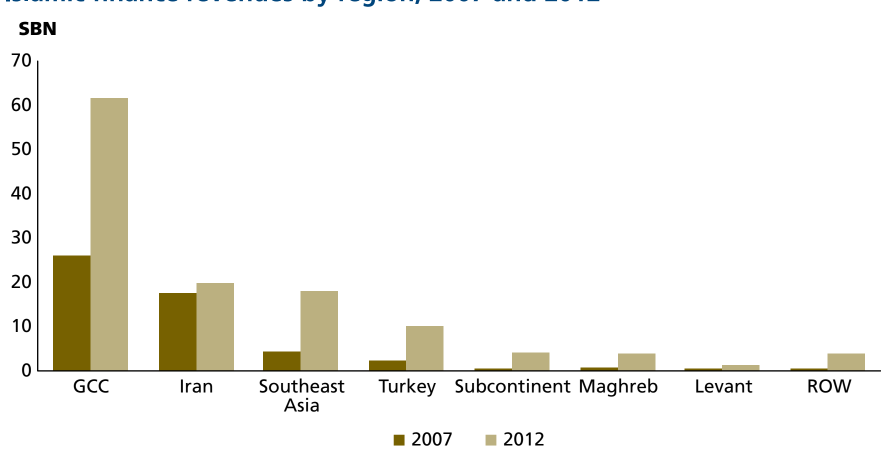
Islamic finance



Source: Bankscope, annual reports and Oliver Wyman analysis

While the GCC accounts for the majority of the growth in absolute terms, Southeast Asia, North Africa, Turkey and the Subcontinent also present major growth opportunities.

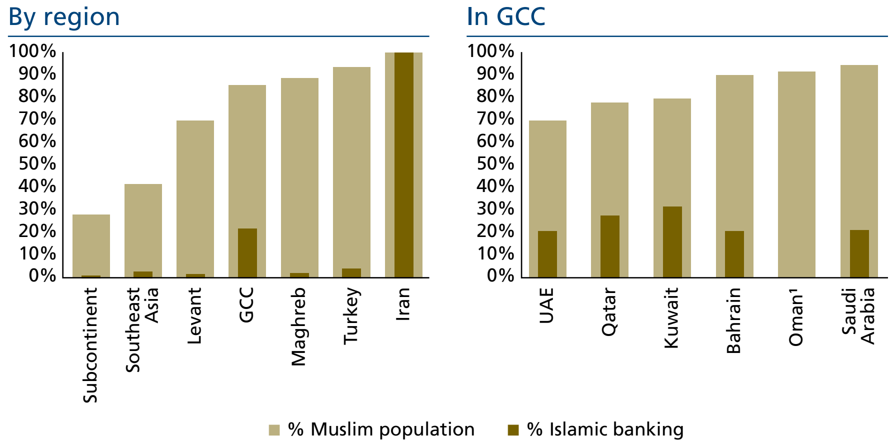
Islamic finance revenues by region, 2007 and 2012



Source: Bankscope, Oliver Wyman analysis

Recent surveys suggest that given the choice, one in two Muslims would opt for Islamic finance alternatives. Furthermore, with penetration rates of only 2-4% in many markets, there is plenty of room to sustain the explosive growth currently being experienced in countries like Pakistan and Turkey.

Islamic banking penetration



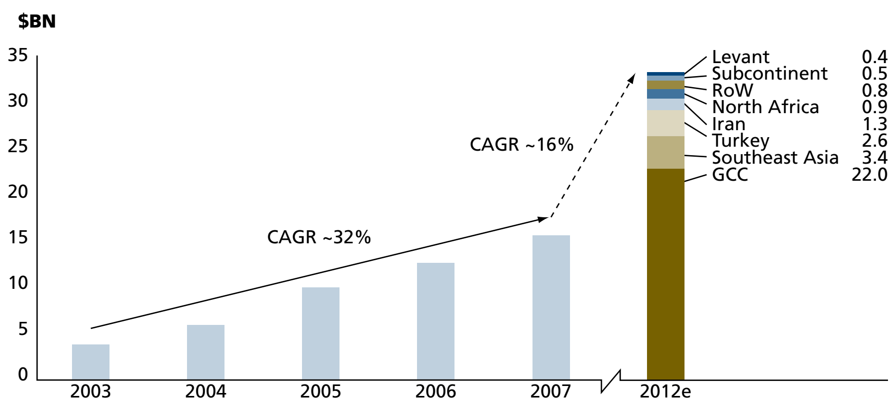
Source: Bankscope, CIA Fact Book and Oliver Wyman analysis

1 Although Islamic finance is not officially allowed by the Central Bank of Oman, some international banks offer it locally without branding it as Islamic

Deep profit pools and attractive economics

Islamic finance profit pools total $15 BN and will increase more than two-fold to $32 BN profit over the next five years.

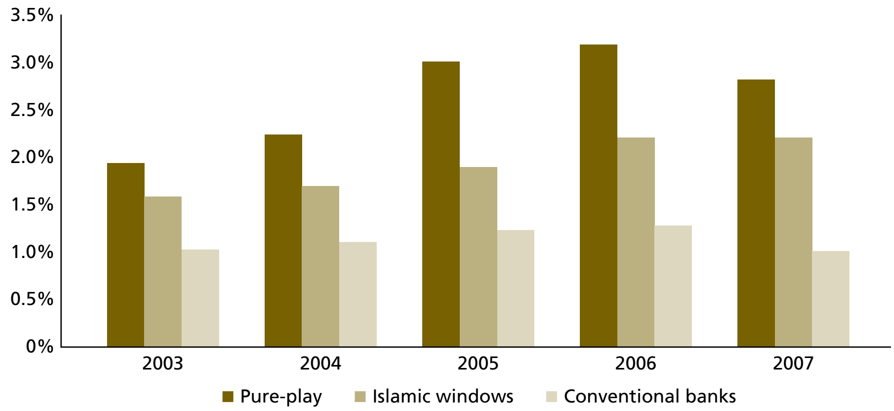
Profit pool growth
Islamic finance profit before tax



Source: Bankscope and Oliver Wyman analysis

Islamic finance also commands superior economics driven by rapidly rising demand and large pools of “free” (non-profit bearing) deposits. In the first instance, religious motivation means that customer price sensitivity has much less importance. In the medium term, competition is likely to put margins under pressure.

Return on assets (RoA)

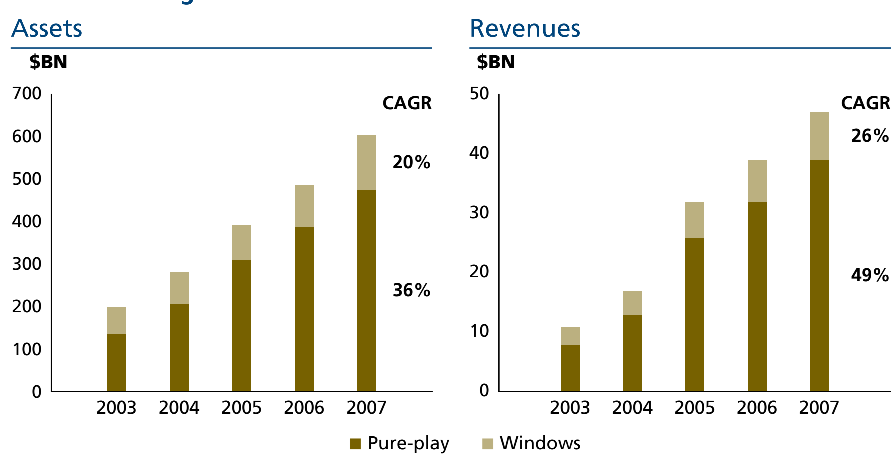


Source: Bankscope and Oliver Wyman analysis
RoA ratios are partially distorted by accounting treatment of profit sharing

The shift towards pure-play Islamic finance

There is a growing customer demand for pure-play Islamic banking over Islamic windows setup by conventional players. Banks with Islamic windows commingle Islamic and conventional activities, which raises customer concerns about their Shariah compliance. In any case, pure-play Islamic banks have outgrown Islamic windows with asset growth of 36% versus 20% respectively since 2002.

Islamic banking



Source: Bankscope and Oliver Wyman analysis

Recognising this underlying trend, many players have decided to respond to market demands through:

- Large pure-play Islamic start-ups with initial capital of between $1 BN and $4 BN
- Conversion of major conventional banks to Islamic finance-only banks
- Moving from Islamic windows to separate subsidiaries

	GCC	Southeast Asia	Other regions
Islamic windows → Islamic subsidiaries	Badr Emirates Islamic Bank First Gulf Bank Shamil Bank SABB	RHB Islamic Bank CIMB Islamic AFFIN Islamic Standard Chartered EONCAP Islamic Bank AmIslamic Bank Alliance Bank	Arab Banking Corporation HSBC Amanah ABN AMRO Shariah Compliant Solutions Citi
Conventional banks → Islamic banks	Bank Aljazira Sharjah Islamic Bank Dubai Bank Investment Dar Kuwait International Bank	The Bank of Khyber Bank Muamalat Bank Rakyat BankIFI	Kuveyt Turk Albaraka Turk Kauthar Bank Meezan Bank
New Islamic banks	NOOR Islamic Bank Albaraka Banking Group Alinma Bank Masraf Al Rayan Ajman Bank	Kuwait Finance House The Islamic Bank of Asia Bank Islam Asian Finance Bank	Jaiz International Syria International Islamic Bank Cham Bank Islamic Bank of Yemen Lebanese Islamic Bank

Source: Oliver Wyman analysis

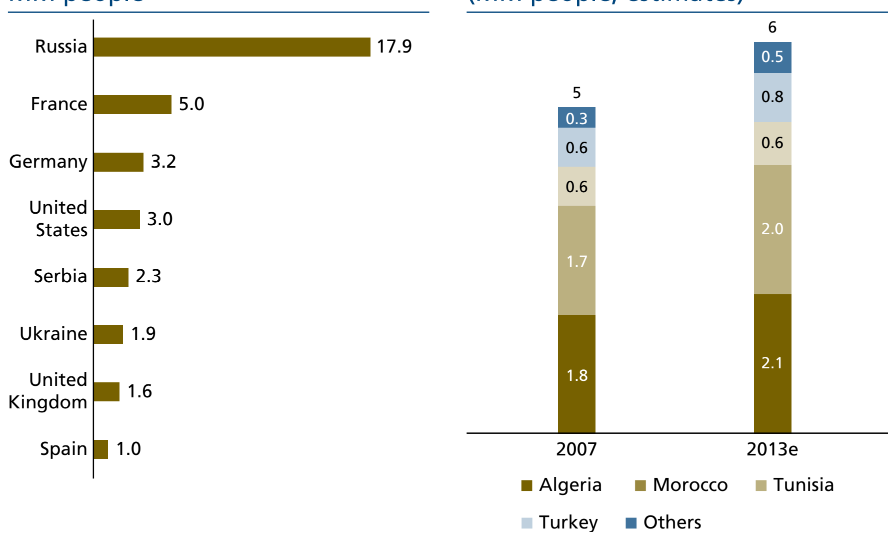
Targeting underserved Muslim communities abroad

To date, the main focus of Islamic finance has been on Muslim countries in the Middle East, and Southeast Asia. However, this may overlook a significant potential, especially in countries with large Muslim minorities. Developed countries with strong Muslim communities imply both richer customers and higher penetration of financial services.

Muslim population

MM people

In France by origin (MM people, estimates)



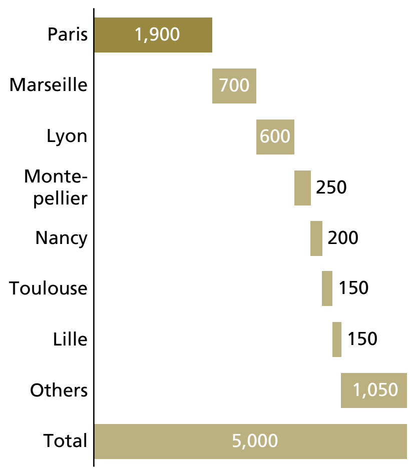
Source: CIA Fact Book, INSEE, August 2006, 2004-2005 census, Oliver Wyman analysis

France is a good example of an untapped opportunity. It has the largest Muslim community in the Western world and has strong demographic potential. On average, compared to the native French population, Muslim immigrants have higher birth rates of 2.5 compared to 1.65.

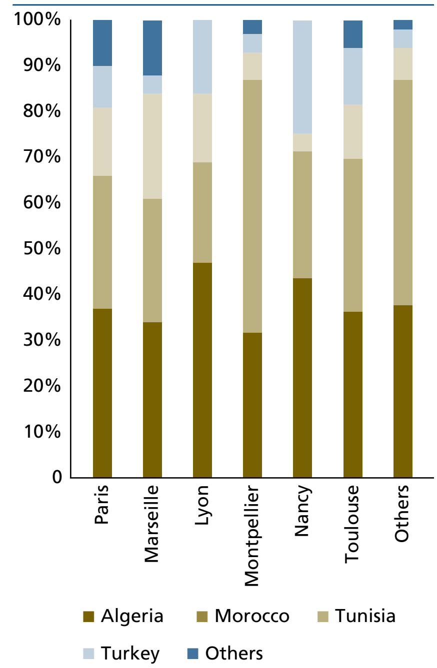
The Muslim population is geographically concentrated in a few major cities which makes them easy to target through a compact branch network and allows efficient community marketing and referral programs.

French Muslim population

By city of residence (estimates, in thousands)



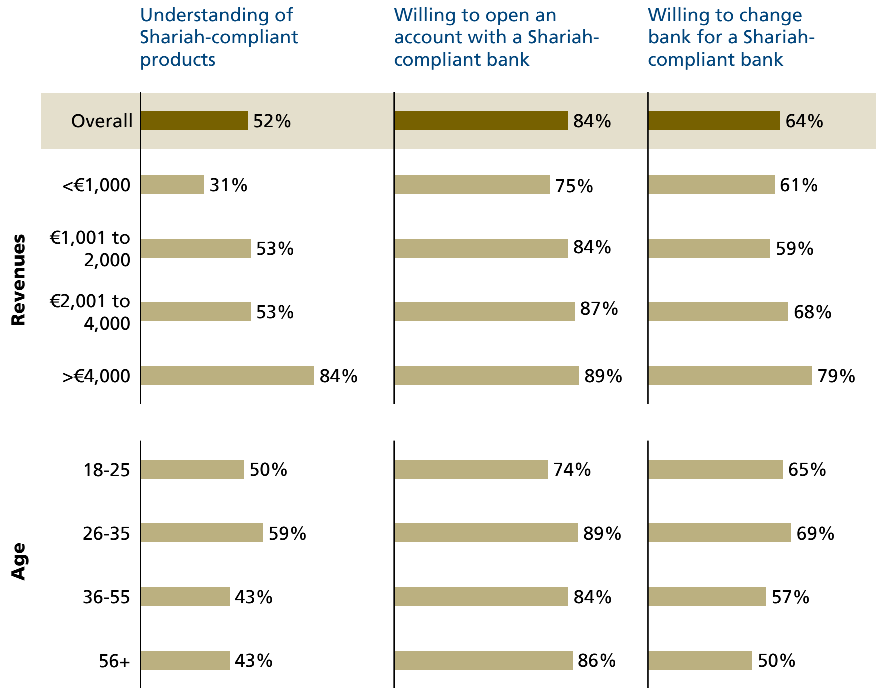
Origin by city of residence (estimates)



Source: INSEE, 1999 census, Oliver Wyman analysis

There is strong interest for Islamic finance in France with nearly two-thirds of French Muslims declaring a willingness to change to a Shariah-compliant bank.

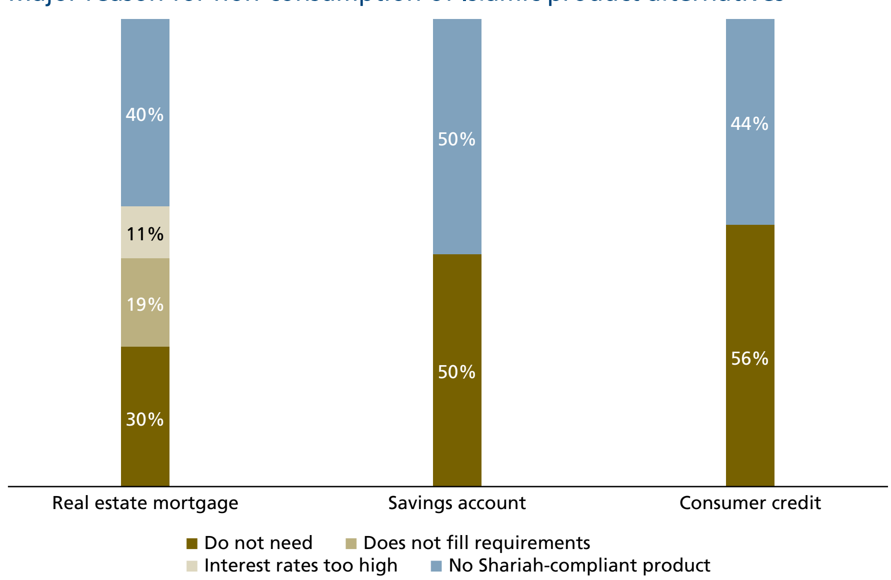
French Muslim interest in Islamic finance



Source: Market interviews, Oliver Wyman analysis

There are huge untapped markets in the retail space for instance, where most French Muslims keep their savings in current accounts to avoid Riba and avoid consumer credit and mortgages.

Impact of non-Shariah compliance on consumption in France
Major reason for non-consumption of Islamic product alternatives



Source: Market interviews, Oliver Wyman analysis

Wholesale banking: moving beyond vanilla financing

Introduction

This section provides a global market overview of Islamic wholesale banking and its dynamics. It then explores opportunities in the most sophisticated and promising segments across treasury, structured products, asset management and securitisation.

Growing larger and more sophisticated

Until the 1970s, Islamic banking was mostly focussed on the retail market. The emergence of wholesale banking and the associated product innovation is a more recent development.

Developments in the Islamic finance industry

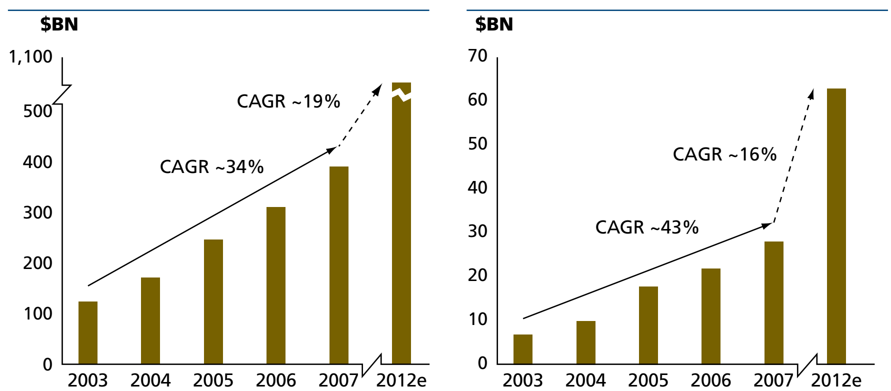
Prior to 1970	1970s	1980s	1990s	Today
▪ Mostly retail banking	▪ Commercial banking	▪ Project finance & syndication	▪ Equity funds ▪ Leasing	▪ Advanced treasury services ▪ Balance sheet management ▪ Innovative asset management

Source: Oliver Wyman analysis

Islamic wholesale banking is now the largest segment in Islamic finance and assets have been growing at a pace of 34% per annum since 2003.

Islamic wholesale banking

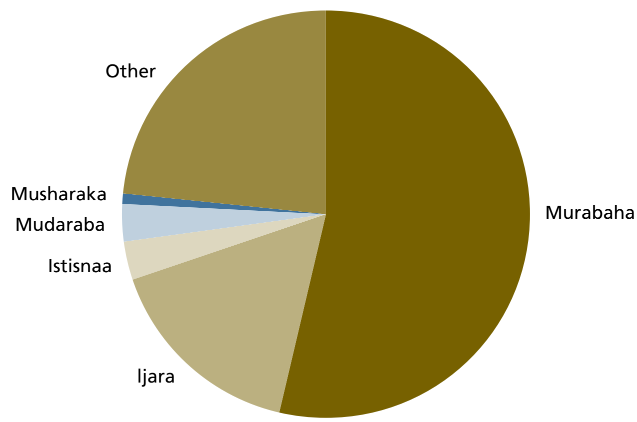
Assets | Revenues



Source: Bankscope and Oliver Wyman analysis

One of the factors limiting the development of this sector is the prevailing focus on vanilla and real estate financing. This is the result of a long-standing bias toward simple products that use mostly Murabaha and Ijara structures, both of which offer more predictable returns, and have similar profiles to conventional products. Furthermore, they do not bear the challenges in terms of governance, profit calculation and allocation of more complex structures, like Musharaka and Mudaraba, which allow for more advanced financing offerings such as private equity.

Asset breakdown for a sample of leading Islamic banks (excluding fixed assets and cash)



Source: Annual reports, Zawya and Oliver Wyman analysis

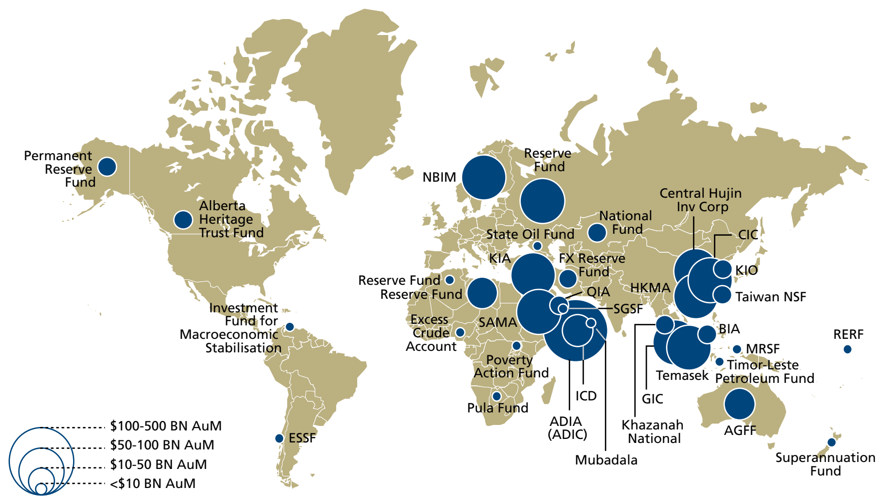
Islamic banks should strive to enlarge their offering in wholesale banking with a broad range of services that include treasury and structured products, securitisation and innovative asset management offerings.

These services should be targeted at the following four customer segments, where strong potential exists:

- **Local financial institution:** The prevailing mismatches in Islamic institutions' balance sheets provide a strong underlying demand for Islamic derivatives and structured products. However, local financial institutions often lack expertise in structuring such products, and thus they are potential clients for larger banks that can acquire or develop the skills necessary to do so. There is also a dire need for innovative offerings in securitisation, treasury services and other asset management products where duration and risk/reward options are currently limited
- **Private/Family wealth:** In the private/family wealth segment, there is a clear lack of structures that allow for alternative investment. The development of specialised alternative offerings in the form of Islamic funds will, without a doubt, prove successful

- **Corporate customers:** Corporate customers in Muslim countries have shown a strong interest in Islamic offerings. However, they require a broader range of available products and services than currently offered. Therefore, major opportunities lie in the development of acquisition finance, project finance, Sukuk issuance and real estate offerings via Real Estate Investment Trusts (REITs)
- **Sovereign wealth funds:** These funds are currently looking for ways to develop and diversify the local Islamic banking sector, and are interested in long term investment products. A private equity offering including advisory services and benchmark investment products is a major opportunity in this segment

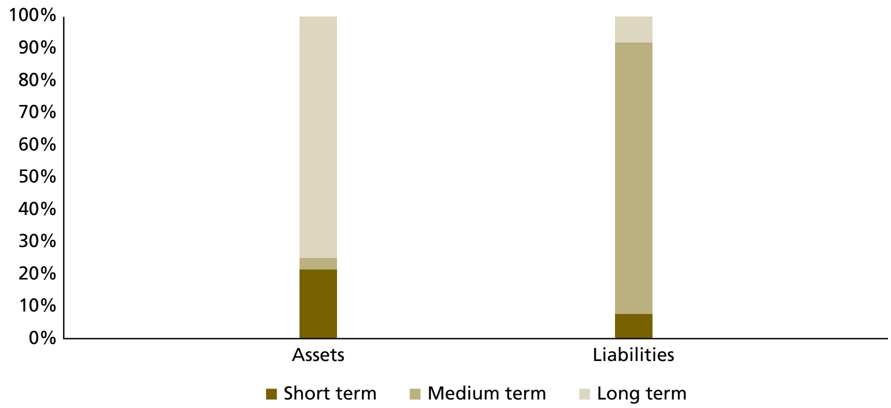
Sovereign wealth funds are concentrated in Islamic financial markets



Building advanced treasury services and structured products

Responding to a growing demand from Islamic financial institutions and corporates, new derivatives and other balance sheet management services have been pioneered over the past few years, with Malaysia leading the way. The most promising products include cross currency swaps, profit rate swaps and forward rate agreements. Many of these innovative structures are spreading quickly, especially in the Gulf, for instance Deutsche Bank recently closed an Islamic Profit Rate Collar structure with Dubai Islamic Bank. This transaction was worth over $500 MM in notional value and, to date, is the largest deal involving such a structure.

Leading Islamic banks' balance sheet breakdown 2007



Sample of 20 leading Islamic banks

Note: Asset/liability tenure defined as follows: Short term – 0 to 3 months; Medium term – 3+ months to 2 years; Long term – 2+ years and beyond

Source: Annual reports, Zawya, Oliver Wyman analysis

The potential for these products is not limited to balance sheet management since they can be bundled with project and trade finance. The core opportunity comes from developing products to manage profit rate risks and FX risks using fixed-floating profit swaps and currency swaps.

Profit rate swaps rely mostly on the double Murabaha approach. Although straight-forward FX contracts are not permissible, there are several alternative solutions, which all have their respective challenges:

- Back-to-back Qard Al-Hasan (benevolent loans) in different currencies to lock in a current FX rate. These agreements have to be separate and cannot be conditional upon each other, which results in significant credit risk beyond the usual counterparty risk
- Dual commodity Murabaha contracts in separate currencies with deferred payment
- Waad (promise) where the party looking to hedge provides a unilateral binding undertaking to buy currency from a third party at a given price in the future. The third party is not under any obligation to act on the transaction when the offer to purchase is submitted, resulting in significant counterparty risk

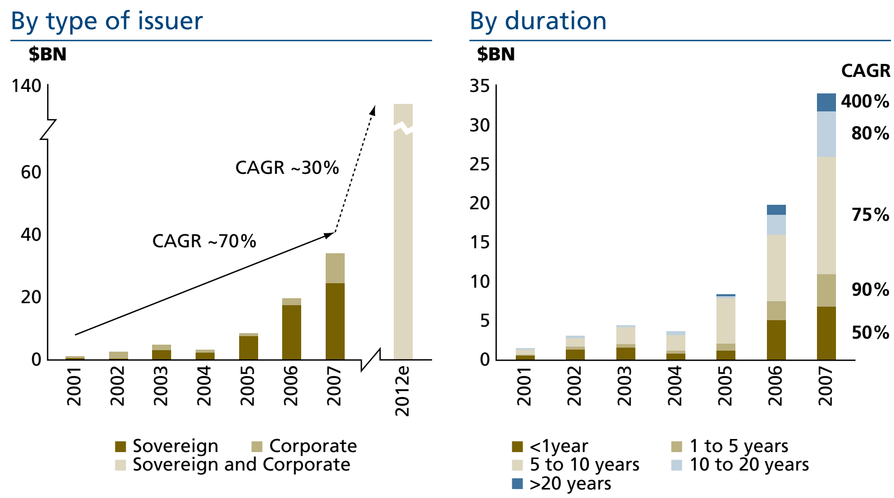
Further development should move towards credit risk mitigation by way of Islamic credit default swaps and the development of options under the Arbun structure.

Developing securitisation capabilities

Most Islamic banks have large balance sheet mismatches, which are difficult to bridge given the lack of long duration liabilities. Advanced securitisation and balance sheet management tools are not only the first steps to addressing this challenge internally, but will also have broad appeal to less sophisticated institutions.

Despite the recent difficulties faced in the global securitisation markets, Islamic securitisation has strong long term potential driven by the trend towards financial disintermediation and the need for securities with tailored underlying assets and maturities. Currently, at the early stages of Islamic securitisation, the two most successful products are Sukuk and Islamic REITs.

Global Sukuk issuance

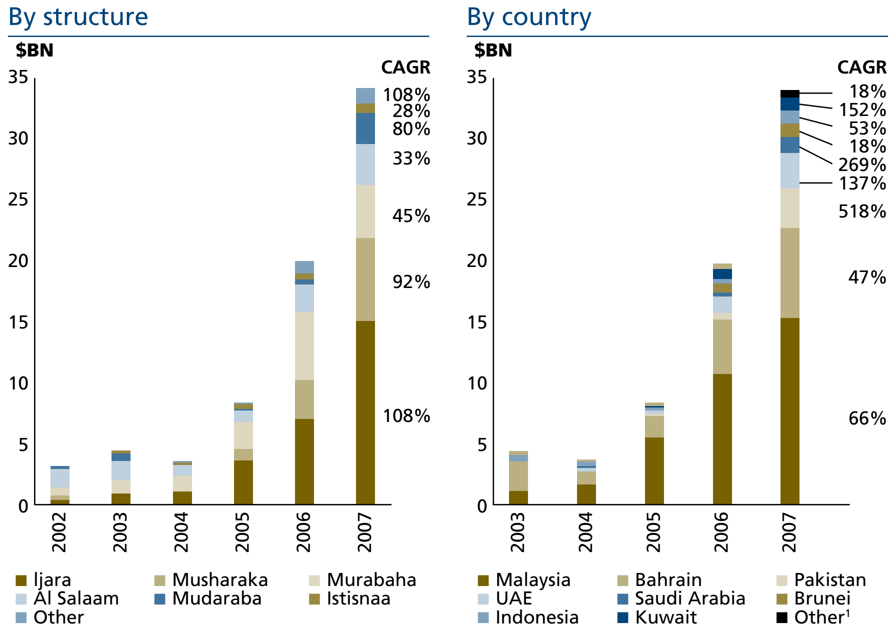


Source: Zawya and Oliver Wyman analysis

Sukuk are often mislabelled as being Islamic bonds. They are, in fact, a securitisation technique and are often used to create securities with periodic payment structures. Sukuk are either based on asset securitisation, often through asset sale, lease and buy-back schemes (e.g. Ijara Sukuk) or partnership structures (e.g. Mudaraba and Musharaka Sukuk). The former employs a true-sale model through which cash flows and the underlying assets or their usufruct are securitised together.

The Sukuk market has experienced dramatic growth over recent years, especially for longer duration Sukuk. The market is expected to reach $130 BN within the next five years.

Sukuk issuance



Source: Zawya and Oliver Wyman analysis

1 "Other" includes Germany, Qatar, Sudan, United Kingdom, and the United States

The development of the Sukuk market will continue, both for corporates, where large issuances are becoming more common especially in UAE, and for sovereigns, as governments try to diversify their funding sources. Indeed, the German state of Saxony-Anhalt issued a €100 MM Sukuk and the United Kingdom, China and Japan plan to launch issuances in the near future.

Major Sukuk issuances in 2007

Issuer	Country	Amount ($MM)
Aldar Properties	United Arab Emirates	2,530
DP World	United Arab Emirates	1,500
Dubai International Financial Center	United Arab Emirates	1,250
Dana Gas	United Arab Emirates	1,000
Dar Al Arkan	Saudi Arabia	1,000
Khazanah Nasional	Malaysia	850
Nakheel	United Arab Emirates	750
Dubai Islamic Bank	United Arab Emirates	750
Dar Al Arkan	Saudi Arabia	600
National Industries Group	Kuwait	475

Source: Standard & Poor's, Zawya

Success in the Sukuk market will be driven by the ability of issuers to improve the liquidity of their issuances and guarantee a strong secondary market by addressing the following challenges:

Improving liquidity and secondary market for Sukuk

- **Structuring** – Structure products to ensure international Shariah compliance and tradability
- **Investor education** – Educate investors on their ability to trade the Sukuk
- **Rating** – Adopt a systematic approach to ensure that issuance is rated to maximise liquidity

Source: Oliver Wyman analysis

Recently, leading Shariah scholars criticised Sukuk issuances featuring a guaranteed buy-back clause as contravening Shariah. This led to a massive reduction in issuance volumes in late 2007 and early 2008, especially for Musharaka and Mudaraba Sukuk. This illustrates the importance of true Shariah compliance for a sustainable business model, to avoid reputation risk and Shariah risk, as well as a sudden loss of business formerly supporting a significant cost base. Product developers are now assessing how to restructure Sukuk to be more acceptable and we believe that Sukuk will be more equity-like in the future.

Islamic REITs are another area for development and are gaining popularity especially in Dubai and Malaysia. They allow Islamic institutions to diversify their real estate dominated balance sheets, provide developers with an alternative source of funding for projects and make an attractive addition to the Islamic asset management product suite.

Expanding into innovative asset management

The 1990s saw the emergence of Islamic funds, where all selected investments in a portfolio are carefully screened to guarantee strict adherence to Shariah. There are now more than 350 Islamic funds worldwide that comply with norms developed by prominent scholars to guarantee Shariah compliance.

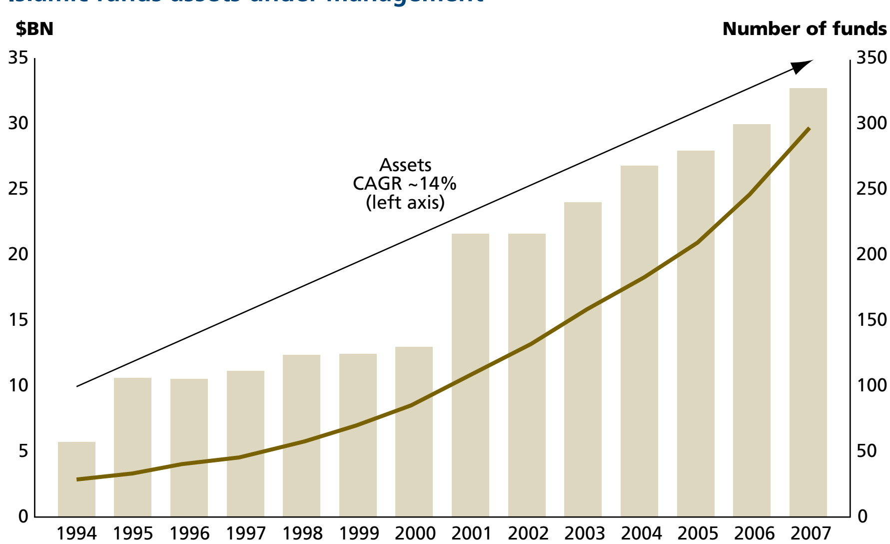
Example of screening criteria

Sector-related restrictions	Financial restrictions	Instruments
▪ Investments are excluded in the following businesses: – Companies producing or selling alcohol, tobacco or pork products (including hotels, restaurants) – Weapons and defence industry – Entertainment sector: casinos, gambling equipment, music, cable TV operators, cinema operators, etc. – Pornographic industry – Biotechnology industry – Conventional financial services (banks, insurance) and financial institutions which invest in prohibited businesses	▪ Companies are evaluated to assess resemblance to conventional financial services, as measured by balance sheet ratios – Debt to equity ratio in excess of 33% – Debt to assets ratio in excess of 30% – Interest income exceeds 5% of gross revenues – Cash and interest bearing securities are more than 33% of total market capitalisation – Receivables equal to or greater than 45% of total assets	▪ The fund does not invest in interest-bearing instruments or in instruments involving Gharar (uncertainty) ▪ No use of futures, options, swaps, short sales or other instruments involving payment or receipt of interest

Source: Oliver Wyman analysis

The Islamic asset management industry has grown at 14% per year and now represents $34 BN in assets. As most Islamic banks offer profit-sharing savings and investment accounts, a large part of Islamic finance institutions' deposits could be reclassified as quasi-asset management. However, this section only focuses on Islamic funds.

Islamic funds assets under management



Source: Bloomberg

Islamic asset management has become more sophisticated over the past few years but is still far from providing the same investment opportunities as conventional asset management, in terms of duration, risk/reward, sector exposure and diversification. There is a sizeable opportunity for

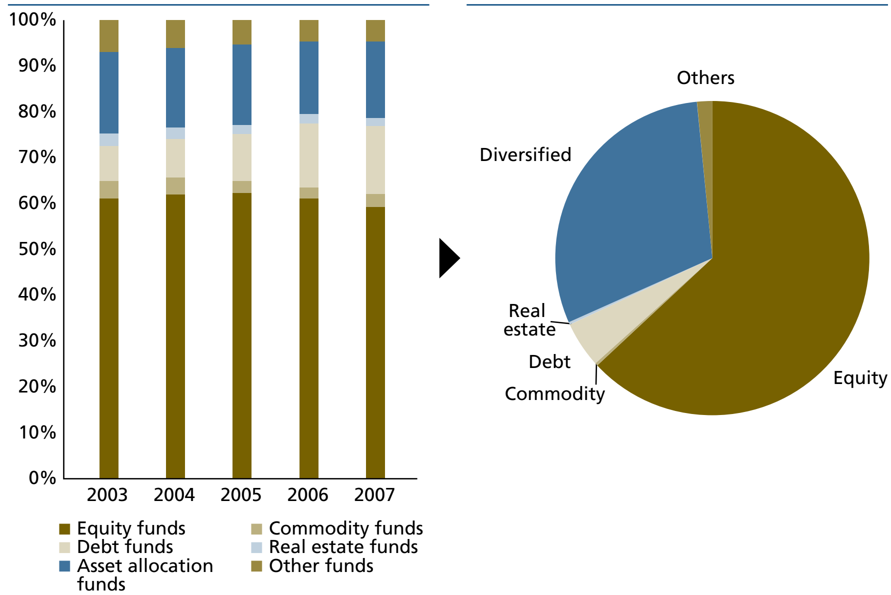
Islamic institutions to expand into new alternative asset management offerings. The following activities present the biggest opportunities:

- Passive offerings based on carefully crafted index/tracker funds
- Commodity funds
- Private equity funds
- Islamic hedge funds

Islamic funds breakdown

Number of funds

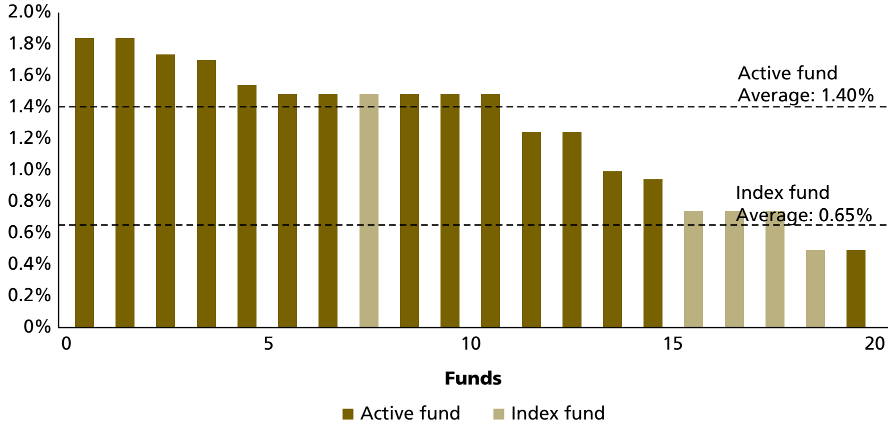
2007 assets under management



Source: Bloomberg

The development of index/tracker funds is an underlying trend in asset management as investors become wiser and more reluctant to pay high fees for mixed alpha-beta strategies. This trend is also true in Islamic asset management. The growth of index funds has been underpinned by the launch of several Islamic indexes by prominent providers over the past few years. The first was the Dow Jones Islamic Market Index, launched in 1999, quickly followed by the FTSE Global Islamic Index Series the same year. In 2006, Standard & Poor's launched the S&P Shariah indices. There has been a multiplication of benchmarked funds, undercutting active asset managers' fees by up to 75% and passive funds will continue to experience strong growth prospects.

Management fees of major Islamic funds



Source: Bloomberg

Commodity funds are particularly suited to Islamic asset management because commodities are often the underlying assets, enabling various financing transactions to be performed in accordance with Shariah. They are, therefore, an area of natural product expansion, especially in light of the recent increase in institutional investors' appetite for commodity funds. Moreover, many Muslim countries boast large commodity reserves which they can leverage to capture the downstream financial services revenues.

Private equity and venture capital investments, predominantly based on Musharaka structures, are also a natural fit for Islamic banking, since they involve the profit and loss sharing model praised by prominent scholars. The ongoing trend for privatisation in developing Muslim countries provides a strong underlying market. Islamic private equity is still nascent: it accounts for only $2 BN of assets under management in MENA[2], but is growing at over 50% per year.

The Islamic hedge fund industry is still embryonic due to the complexity of creating funds that comply with Shariah principles. Conventional long/short strategies are not possible in an Islamic framework and there are strong restrictions in the selection of acceptable investments. However, significant developments are expected in the next few years given the strong appetite among institutional Islamic investors and private wealth customers. Some hedge fund managers have successfully adapted conventional strategies by using Islamic structures such as Salam and Arbun contracts. Agile players, such as Alfanar US Equity Hedge Fund (Permal) and Al-Khawarizmi Market Neutral Fund (The International Investor), have been successful in this field. A new wave of Islamic hedge-funds are now in the making, many within the Dubai Multi Commodities Centre using the Al Safi platform, aiming to capture this major gap in the alternative asset management offering for Islamic investors.

2 MENA: Middle East and North Africa

Retail banking: towards differentiated offerings and streamlined delivery

Introduction

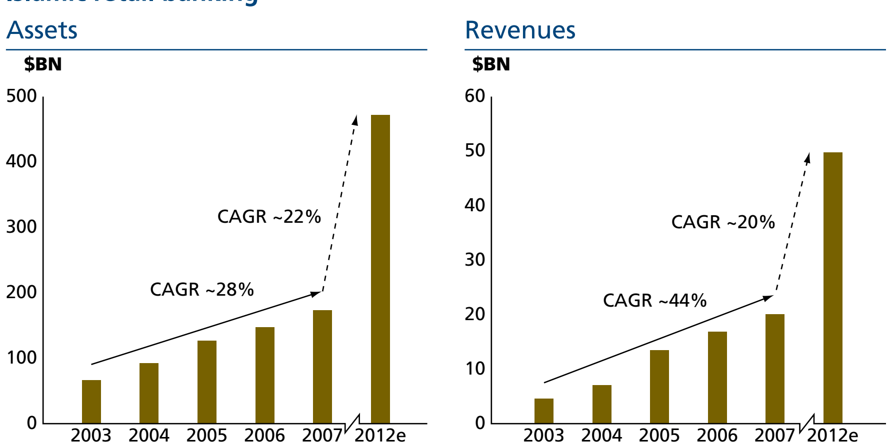
This section provides an overview of the relatively immature but quickly growing Islamic retail banking market. Given market momentum, banks should focus their business models on growth through distribution. However, the ban on Riba, the need to deal in assets, the involvement of a Shariah Board in product development and the prohibition of discrimination of customer types result in four specific challenges, which must be addressed in order to reach operational excellence:

- Developing a differentiated but non-discriminating offering
- Improving product development to address Islamic product structuring constraints
- Enhancing processes and product delivery to improve service and sales efficiency
- Adapting marketing and customer proposition to Shariah principles

Strong growth fundamentals and superior economics

Islamic retail banking is a very attractive market given its strong growth, long term market potential and superior economics. Islamic retail banking assets have been growing at over 25% per year since the beginning of the decade.

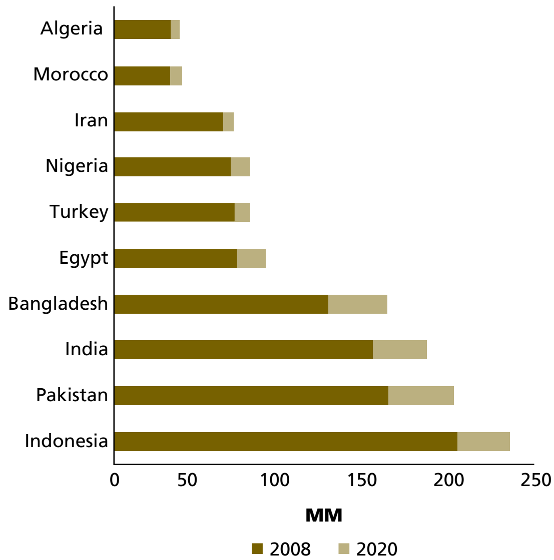
Islamic retail banking



Source: Bankscope and Oliver Wyman analysis

The market is set to expand further since nearly 50% of Muslims would opt for Islamic retail banking if given a competitive and high-quality alternative to conventional banking. This is underpinned by the strong demographics of major Muslim countries. By 2020 the population of the top 10 Muslim countries will grow by nearly 200 MM, with over half of the population still under age 25. As this new generation enters adulthood, the retail customer base is set to double in the same period.

Top ten largest Muslim populations



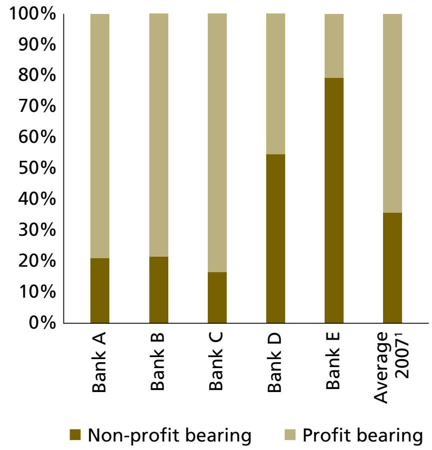
Country	Median age
Nigeria	18.7
Pakistan	21.2
Bangladesh	22.8
Egypt	24.5
Morocco	24.7
India	25.1
Algeria	26.0
Iran	26.4
Indonesia	27.2
Turkey	29.0
United States	36.7
United Kingdom	39.9

Source: CIA Fact Book and Oliver Wyman analysis

Islamic retail banking is a very profitable business, which enjoys superior economics. This is fuelled by inexpensive customer deposits and limited price sensitivity from customers as illustrated by the healthy retail lending margins. In many banks, as much as half of customer deposits do not bear any profit. Moreover, pricing is often opaque: financing cost is mostly communicated as a lump sum or as a percentage of financing facility rather than an APR. This makes comparisons with conventional competitors difficult.

Islamic banks' deposit breakdown

Total deposit volumes



1 Sample of 20 leading Islamic banks

Sample GCC Islamic retail lending margins

Loan terms of one to five years

Given strong growth and the barrier to entry imposed by Shariah-compliance, Islamic retail banking is still relatively under-competed, but as leading players engage in international expansion, competitive pressures are growing rapidly even in new markets like Pakistan.

Increasing competition, Pakistan case study

2003	2004	2005	2006	2007
Meezan Bank	**Meezan Bank**	**Meezan Bank**	**Meezan Bank**	**Meezan Bank**
Al Baraka	**Al Baraka**	**Al Baraka**	**Al Baraka**	**Al Baraka**
MCB	MCB	MCB	MCB	MCB
	Alfalah	Alfalah	Alfalah	Alfalah
		Standard Chartered	Standard Chartered	Standard Chartered
		Bank Al Habib	Bank Al Habib	Bank Al Habib
		Habib Ag Zurich	Habib Ag Zurich	Habib Ag Zurich
		Metropolitan	Metropolitan	Metropolitan
		Bank of Khyber	Bank of Khyber	Bank of Khyber
			Soneri Bank	Soneri Bank
			Habib Bank	HBL
				Bank Islam
				DIB
				Emirates International Group
				NBP
				ABN AMRO
				UBL
				Askari
				PICCIC
				Crescent
				First Dawood Islamic

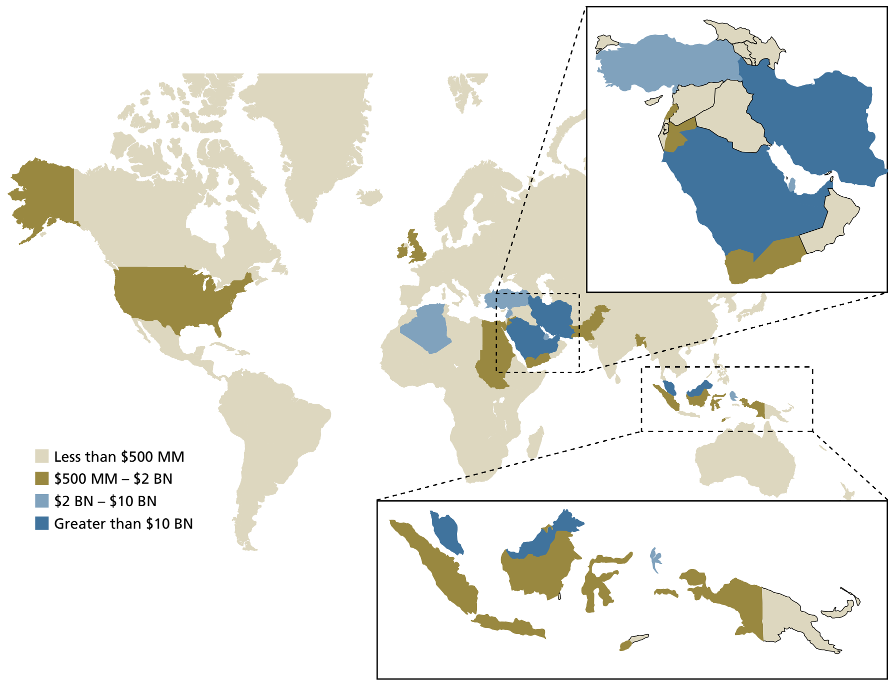
At year-end 2007:
6 Pure player Islamic banks
15 Islamic Banking Divisions or Windows

Source: IFSB Report 2006 and Standard Chartered, 2008

Differences in maturity levels of regional markets translate into specific challenges and opportunities

Islamic retail banking is mostly concentrated in Iran, GCC and Southeast Asia which have been the early adopters of modern Islamic finance.

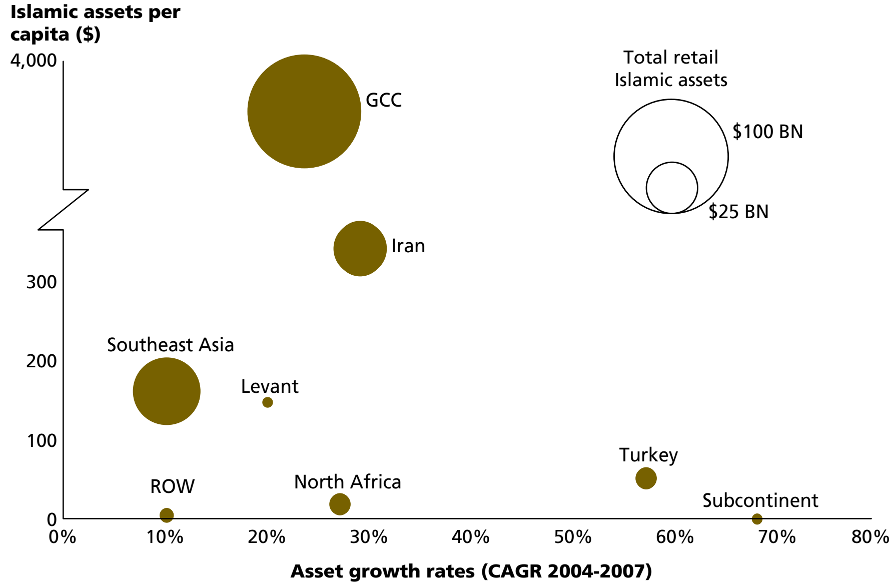
Global Islamic retail banking assets 2007



Source: Bankscope, CIA Fact Book and Oliver Wyman analysis

Within mainstream markets, Iran and the GCC are maintaining steady growth, whereas Southeast Asia is slowing down, driven by the relatively slower growth of the Malaysian market. The Subcontinent, North Africa and Turkey are very attractive markets, with large populations, strong demographics, modest but rising banking penetration and a widespread appeal for Islamic retail banking.

Islamic retail asset growth and size per capita by region, 2004-2007



Source: Bankscope, CIA Fact Book and Oliver Wyman analysis

Islamic retail banking markets are very diverse in nature due to their social, economic and historical specificities. However, it is possible to categorise them based on their development, level of sophistication and competition into the following three categories:

Identifying the opportunity by market category

Category	Market highlights	Attractiveness	Challenges
1. **Core markets** (Saudi, UAE, Kuwait, Qatar, Bahrain)	▪ Highly-penetrated markets ▪ High disposable income ▪ Solid appetite for products	▪ Sizeable revenue pool ▪ Small – medium sized markets requiring limited upfront investment ▪ Foundation for innovation and expansion	▪ Product innovation ▪ National incumbents' distribution and client franchise ▪ Strong service required
2. **Immediate adjacencies** (Turkey, India, Pakistan, Egypt, Indonesia)	▪ Populous markets (young and growing) ▪ Lower-income clients ▪ Typically lower Islamic banking penetration	▪ Large retail customer base ▪ Early entry should provide first-mover advantage in fast-growing markets	▪ Competition from conventional incumbents ▪ Developing a distribution either requires a significant investment or a partnership
3. **Strategic bets** (Albania, Azerbaijan, Kazakhstan, Tunisia…)	▪ Medium-sized populations ▪ High share of Muslim population	▪ Longer-term prospects and proximity to Europe ▪ Relative low current penetration of Islamic banking services	▪ Limited bankable population ▪ Limited scope for economies of scale

Source: Oliver Wyman analysis

Rethinking existing business models

Within the most developed markets, leading players are trying to differentiate themselves through specialised business models, which are still emerging given the market is still in its infancy. Three main models currently compete in the Islamic retail banking arena, with different challenges and growth prospects.

Main Retail banking business models

Islamic windows	Pure-play Islamic banks	Monolines
▪ Conventional banks with an Islamic banking unit ▪ Strong performance but slower growth potential (~15%) ▪ Commingling Islamic and conventional activities limits appeal to customer ▪ Tendency to segregate activity in Islamic branches or to convert the window into a ring-fenced subsidiary	▪ Full fledged Islamic banks offering umbrella of retail services ▪ Either converted from conventional banks or Islamic at inception ▪ High growth (~30%) and superior profitability ▪ Focus on expanding distribution network, either organically or through distribution partnerships	▪ Specialised institutions focused on one main product (e.g. home financing) ▪ Out-performing all other models ▪ Success partly driven by booming Islamic mortgage and Islamic car leasing markets ▪ Continued international expansion through partnerships

Source: Oliver Wyman analysis

While performance has been clearly skewed across these business models, the underlying market growth is so strong that even Islamic windows have benefited.

Although they have not been fully explored, the following potential business models all have strong prospects going forward:

- Third-party distribution specialist: focusing on consumer finance and distributing through retailers (e.g. white goods, car dealers). It is well suited to Islamic finance, which is asset based and allows lower distribution costs from capturing the customer at the point of sale
- Mortgage specialists: demographics are particularly strong in key Islamic finance markets and housing demand is buoyant. Most Islamic banks lack a good mortgage offering, therefore leveraging these networks to push a well-designed product will allow rapid growth and international expansion
- Deposit specialist: asset gathering is still underdeveloped and most Islamic banks rely on a passive depositor base. Actively-managed deposit accounts with attractive profit-sharing will benefit from increasing customer sophistication. Collecting deposits can be accomplished through e-channels or a postbank partnership to minimise costs

Execution excellence is the ticket to success

A. Developing a differentiated but non-discriminating offering

Over the last decade, the main focus of most Islamic retail banks has been to adapt conventional products and replicate leading Islamic banks' offerings. Although they have aimed to offer a complete set of services comparable to their conventional competitors, less than half of Islamic banks offer more than six retail banking products and only about 15% offer more than 10 products, which is far fewer than the product range offered outside Islamic banking. Most advanced institutions have launched new initiatives, such as Islamic credit cards, Tawarruq-based cash loans and Islamic overdrafts. By providing a "one-stop shop" solution for retail banking needs, these institutions have removed one of the barriers for new customers switching to Islamic banking. Yet a bigger prize awaits those that can move from a comprehensive offering to a differentiated and segmented one. This would not only create a competitive advantage in the battle for new customers, but also allow them to exploit the full economic potential of their existing customer base.

The key challenge lies in the prohibition of discrimination. The kind of differentiated pricing that is common in conventional retail banking is often contrary to the Shariah principle, which forbids discrimination of customers based on wealth. For instance when determining the profit rate on a given Mudaraba deposit product, the share of profits must be the same for customers with accounts of $1 K and $1 MM. Banks should, therefore, develop variants of their core products, tailor them to each customer segment, and market them selectively to the respective target segments.

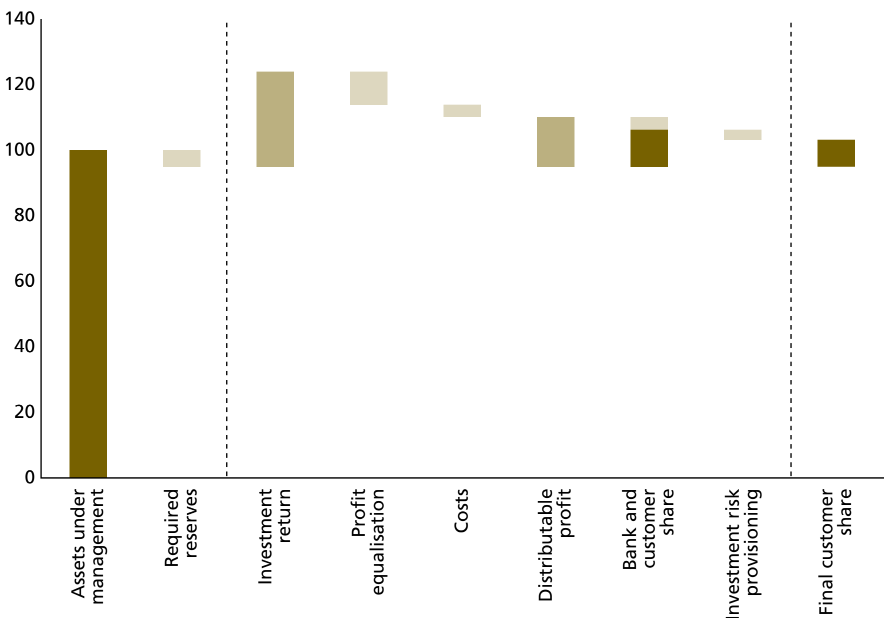
Currently, only one in five Islamic retail banks have developed segmented and differentiated offerings and, in most cases, its segmentation is very basic. Unsurprisingly, the most advanced institutions in this respect are the Islamic windows of conventional retail banks, such as HSBC, who are able to draw on their segmentation and marketing experience in Western markets and apply it to their Islamic activities.

B. Improving product development to address Islamic product structuring constraints

All Islamic products require requiring approval from the banks' Shariah board, a panel of renowned Islamic scholars that validate the new product's adherence to Islamic law. This approval process is time consuming, and the limited availability of leading scholars often results in significant delays – some banks require as long as three months to obtain the approval for a new product. Streamlining this process is essential to reduce time to market and improve efficiency.

Adherence to Shariah involves a more complex product development process and results in challenges for product innovation. Significant product structuring is required to overcome the prohibition of interest, as illustrated by the example of the flow of funds on a simple profit-sharing deposit product, like an Islamic savings or term account.

Value analysis of a typical savings customer using profit sharing products
(100 = customer assets)



Source: Oliver Wyman analysis

This results in lengthy product contracts, which require standardisation and streamlining to improve customer friendliness. Some Islamic banks have contracts as long as 40 pages for a simple profit-sharing current account.

Creating an in-house Shariah audit department acting as a relay for an overstretched Shariah board often results in faster product approval. Moreover, this department can leverage their Shariah expertise to assist the product development team with new product design.

Another practical step is to set up a clear product approval process with well-delineated responsibilities for the major product types. Very often, the lack of clearly defined rules of engagement and processes results in unnecessary delays.

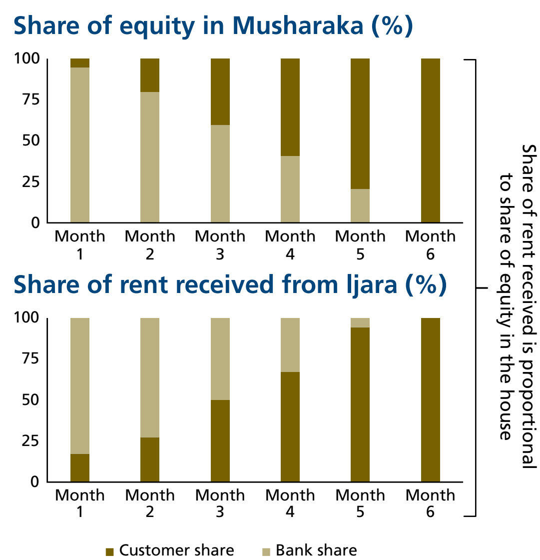
C. Enhancing processes and product delivery to improve service and sales efficiency

Prevailing structures and processes through which Shariah-compliant products are offered often lead to increased complexity. This arises both on the contractual side, with multiple independent contracts underpinning a single product, and on the transactional side, where a cascade of transactions is often required to serve a simple customer need. Lending products are particularly prone to process complexity since most of them require the bank to physically purchase an asset before selling or leasing it to the customer.

For instance, comparing a conventional amortising loan with its Islamic equivalent based on Diminishing Musharaka and Ijara, illustrates the additional complexity of the Islamic products.

Diminishing Musharaka home finance

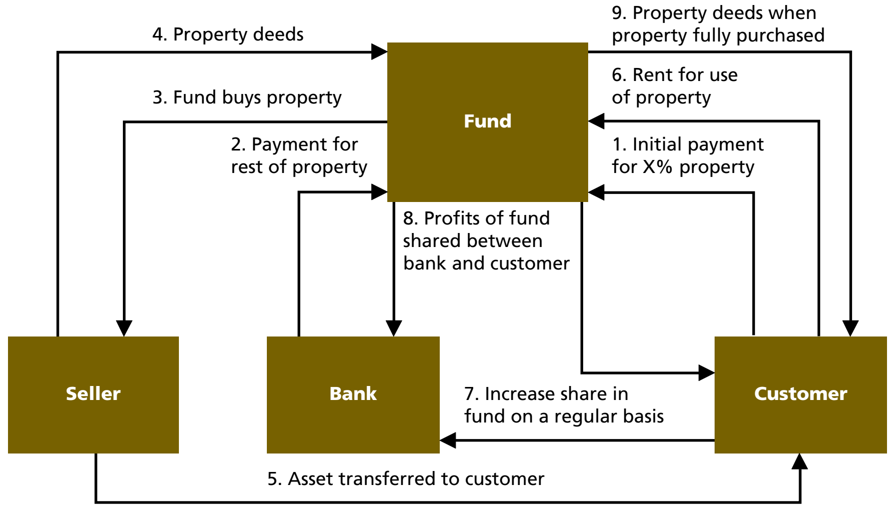
- The bank and client jointly purchase the house and the ownership is split between the two parties
- The customer purchases the bank's share of the house in increments over a specified period
- During the financing period, the bank leases its share to the customer, who in return pays rent for its use
- Over time, the customer's share of the asset increases until they take sole ownership of the asset
- This structure allows for a conventional amortisation schedule, where the proportion of profit to capital repayment reduces over time



Source: Oliver Wyman analysis

The number of transactions is dramatically higher, as well as the number of required interactions with the client. For instance, the bank would buy and audit the asset on behalf of the customer before reselling it to him.

Example Islamic loan process – Diminishing Musharaka with Ijara



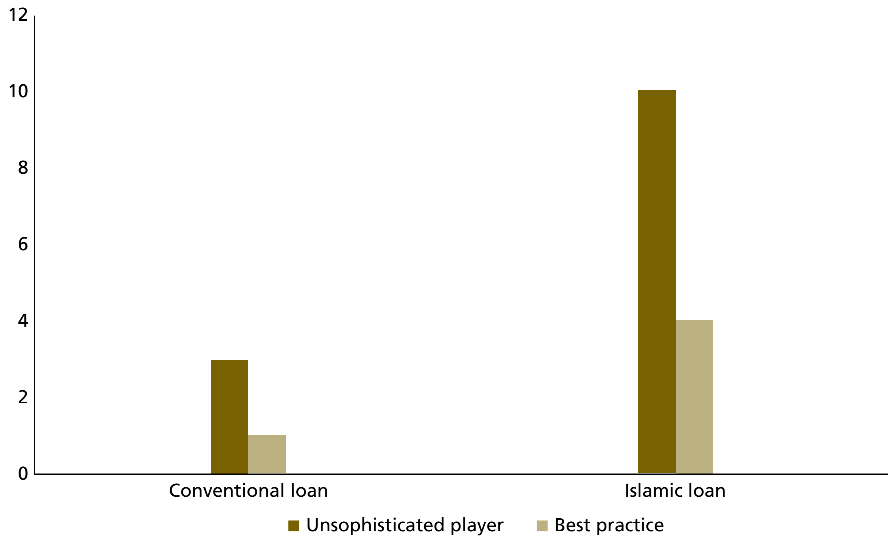
Source: Oliver Wyman analysis

This additional complexity is unfortunate for many reasons:

- It slows product delivery, with lead times up to three weeks. This leaves plenty of time for customers to change their mind or switch to competitors, especially if they have urgent financing needs
- It inflates commercial costs per product sold and reduces sales efficiency, as the front-office is often swamped by the paper-work and process
- It increases fulfilment risk with multiple independent transactions, increasing the chance of the transaction stalling or falling through altogether
- It discourages customers for whom a transparent and simple offering is important. Some Islamic product structures create uncertainty regarding the accountability of each party to the transaction

Islamic institutions must improve product structures and better manage their processes to minimise complexity. It is possible to reduce the number of required interactions with customers and limit complexity by streamlining contracts and redesigning processes. Best-practice products and processes reduce the number of customer interactions for a single transaction by up to 50%.

Number of interactions required to extend a loan



Source: Oliver Wyman analysis

D. Adapting marketing and customer proposition to Shariah principles

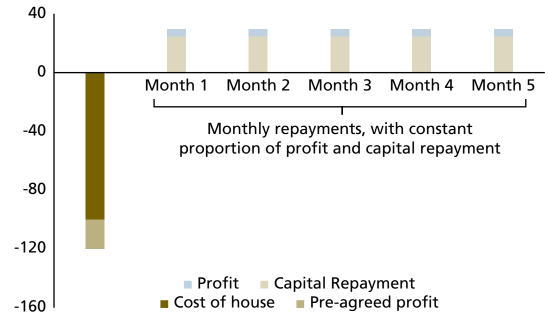
The prohibition of interest and the complexity of Islamic structures is a significant challenge for product marketing. Retail banking is a commoditised business where banks compete mostly on price and service quality.

It is difficult to communicate price in an Islamic environment. On the asset side with a Murabaha lending transaction for instance, the bank buys the asset and sells it to the customer at a mark up. The resulting profit dictates the profit rate of the transaction and can be communicated as the overall cost of financing. Nonetheless, it is still difficult to compare it with the interest rate on its conventional equivalent. Moreover, when banks' pricing models benchmark against the equivalent interest rate, it raises suspicion about the Shariah compliance of the transaction. On the liability side, the absence of interest results in profit-sharing deposit accounts, where the customer has no certainty about the expected returns since it is based on the bank's performance. A bank can overcome this by stating their profit track-record on a specific account, even though there is no guarantee that past performance will be repeated. It is also difficult to explain product structures, which are often cumbersome and difficult to understand.

Murabaha financing

- Bank buys the goods and sells to the customer at cost plus a previously agreed profit
- Customer takes possession of the goods at the beginning of the contract
- Customer repays bank in fixed periodic instalments (or one lump sum at the end of the duration)
- Customer has to pay back the full amount of pre-agreed profit in the event of early payment

Cash flow in Murahaba ($)



Source: Oliver Wyman analysis

A potential solution is for the bank to simplify the communication of product features and customer benefits while highlighting the bank's Shariah compliance credentials. Communication around the bank's social involvement, Shariah board pedigree, the ethical principles underpinning product structures and risk-sharing between the bank and the customer is more efficient than trying to explain the intricacies of a Diminishing Musharaka.

There are still significant opportunities for the use of advanced marketing techniques. An interesting development is the rise of an Islamic alternative to cash-back cards, with charity-linked incentives. For example, Islamic banks have recently been promoting credit and debit cards for which transactional usage translates into donations made to a charity of the client's choice under a Shariah-compliant scheme. It promotes increased usage which, beyond benefiting the charity and serving the client's religious aims, benefits the bank by promoting customer retention, positioning itself as the salary account bank and increasing point of sale commission volumes.

Conclusion

Islamic finance is both a significant economic opportunity as well as a structural change for many financial systems and institutions. A solid underlying demand drives the growth of Islamic finance and will continue to do so. While some are still relatively underdeveloped, many financial institutions are looking to expand their Islamic activities.

With so many players planning to compete in this arena, only the best prepared will succeed and endure the maturation and consolidation phases. Success will come to players who target the most attractive business segments, and who can create efficient business models around the inherent complexities of Islamic finance. Effective models must also address challenges pertaining to risk management, balance sheet management, IT and operations as a priority. We will explore those in *Redefining the operating model*, the second of our two-part examination of the Islamic finance market.

Those who quickly differentiate themselves and move towards developing the next generation of Islamic financial services will win the big prizes in this booming market.

Appendix – What is Islamic finance?

Islamic financial services are governed by the principles of Islamic ethics as dictated by the Shariah (Islamic law). The most significant of these is the prohibition of Riba (*increase*) which bans interest from Islamic transactions. The underlying principle for the ban on Riba is that any profit must be accompanied by liability and risk, thus giving both sides an incentive to cooperate fully.

Islamic finance, therefore, relies on transactions that involve trading and leasing of tangible assets for a profit, or setting-up financing partnerships that share both risks and rewards in a venture. Secondary norms include a prohibition on excessive Gharar (*uncertainty or deceit*) and the limitation to Halal (*permissible*) activities, which excludes, for example, business related to pork, alcohol, gambling or pornography.

Debt based contracts	Fee based contracts	Participatory contracts
■ Customer undertakes a debt obligation to the bank backed by an asset e.g. – Murabaha – Salam – Istisnaa	■ Bank charges a fixed fee in exchange for a service provided to the customer e.g. – Wakala – Ijara – Wadia	■ Bank and customer co-invest in a partnership agreement e.g. – Mudarabah – Musharaka – Diminishing Musharaka

Source: Oliver Wyman analysis

Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, organisational transformation, and leadership development.

OLIVER WYMAN

For more information please contact the marketing department by email at marketing.fs@oliverwyman.com or by phone at one of the following locations:

Middle East	Europe	Asia Pacific	North America
+971 4 425 7000	+44 20 7333 8333	+65 6510 9700	+1 212 541 8100