



Developments in the Islamic Finance Landscape

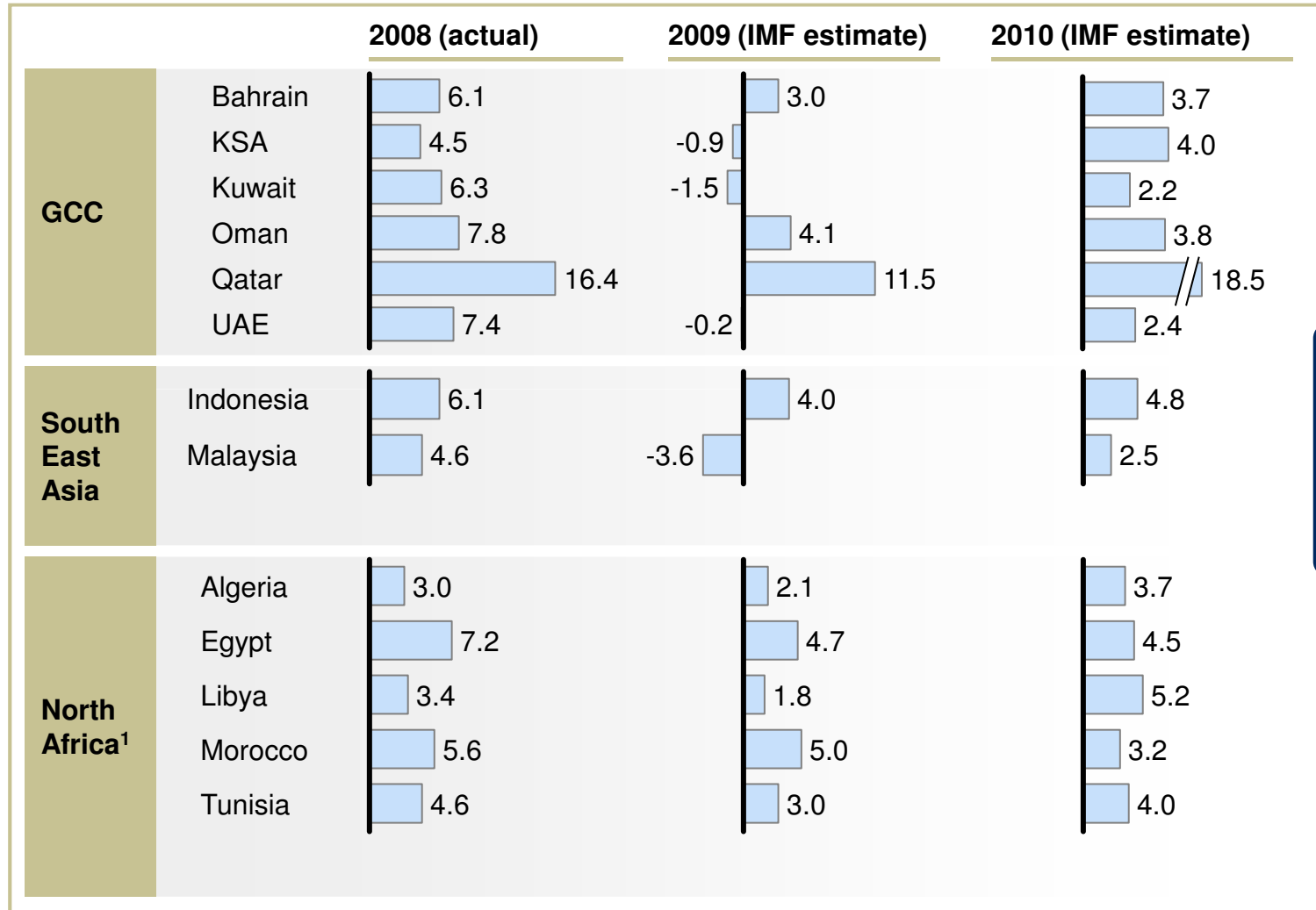
2009-2010
World Islamic Banking Conference
Bahrain, December 6-8, 2009

The crisis has clearly impacted 2009 growth in large markets for Islamic finance

ESTIMATES

SELECTED MARKETS

Real GDP growth
Percent



Both GCC and East Asia have positive outlook for 2010 after significant declines in 2009

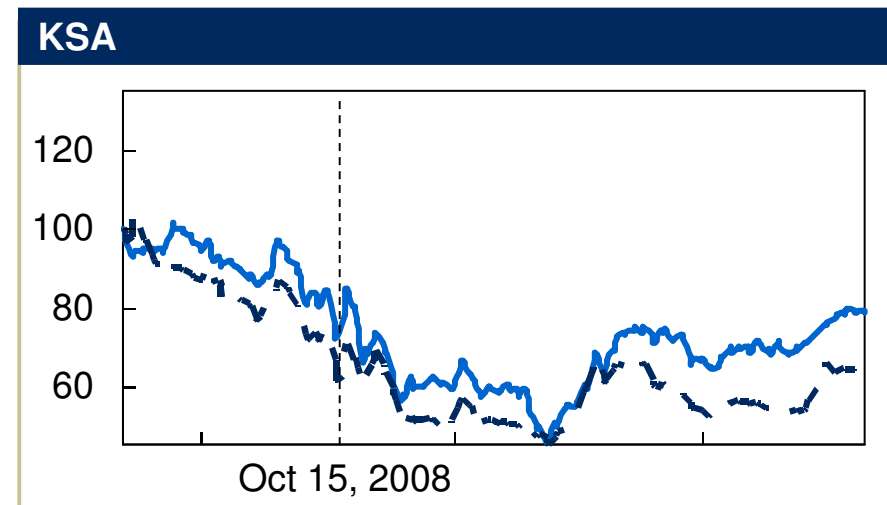
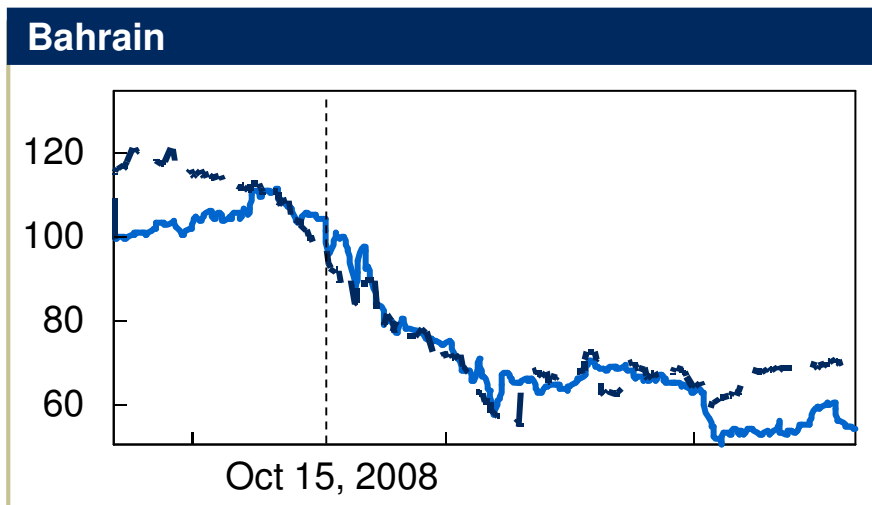
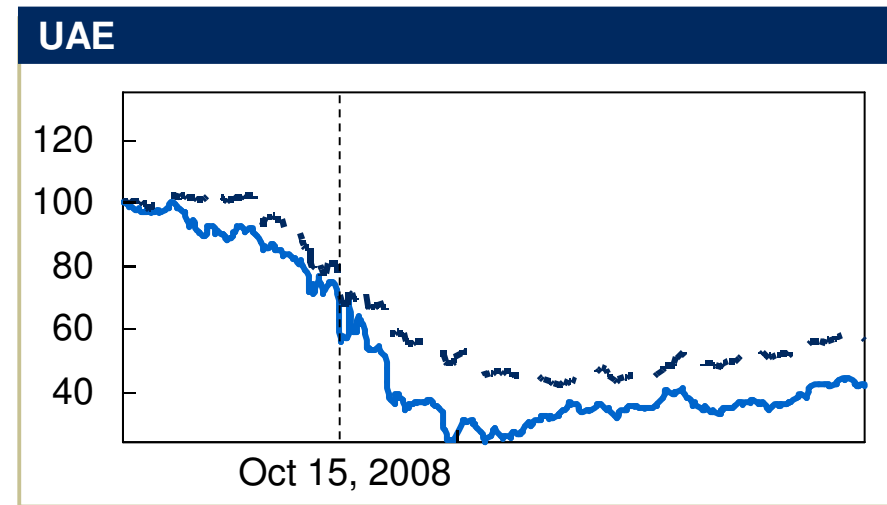
¹ Covered in detail in North Africa section of report
Source: IMF World Economic Outlook Database, October 2009; McKinsey

Moves in the stock market performance of Islamic banks have generally mirrored the trend of conventional banks

— Islamic banks
- - Conventional banks

Total market value

Starting point indexed at 100; May 2008 - Oct 2009



Asset growth has led to an increase in Islamic banking penetration in key markets

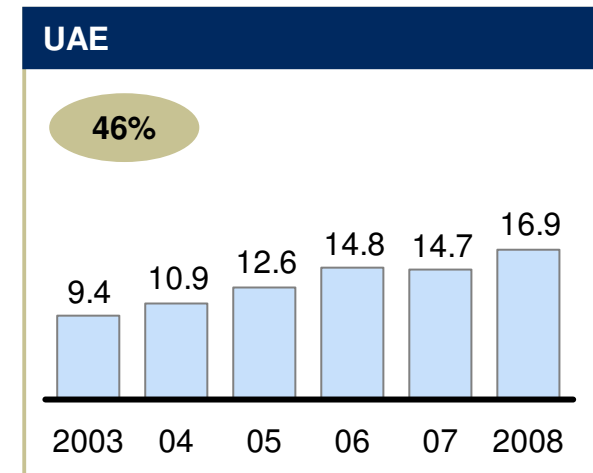
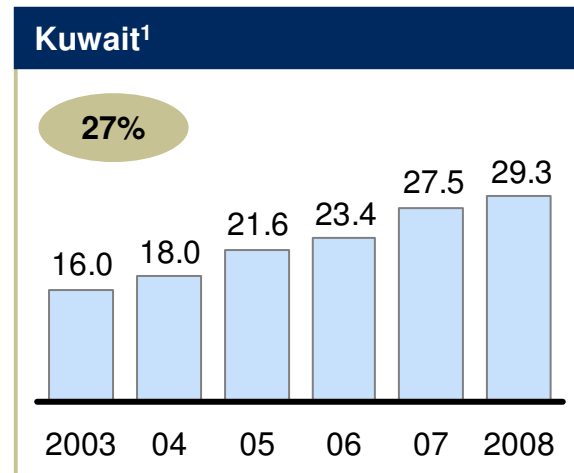
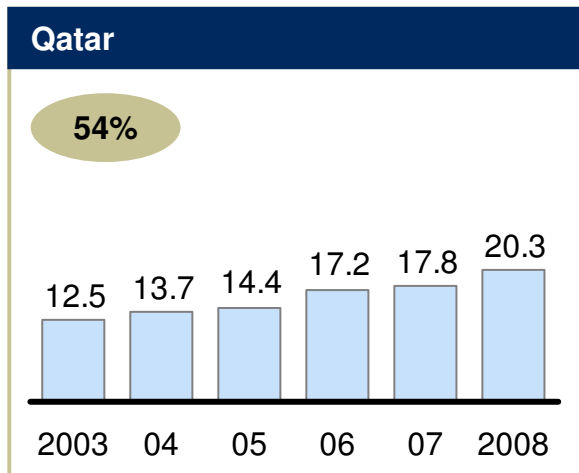
Islamic assets as part of total banking assets

Percent

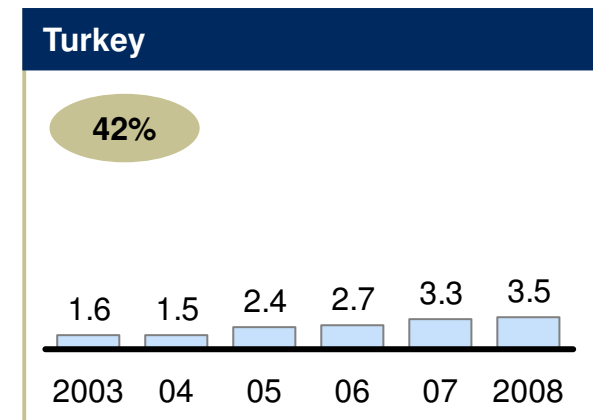
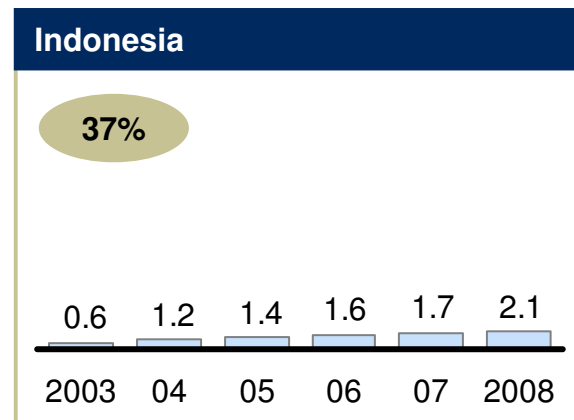
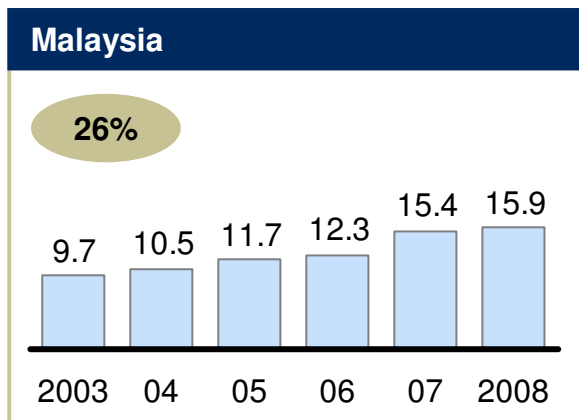
GCC markets

SELECTED MARKETS

X Growth in Islamic asset base, CAGR (2003-08)



Other markets



¹ Excluding one bank

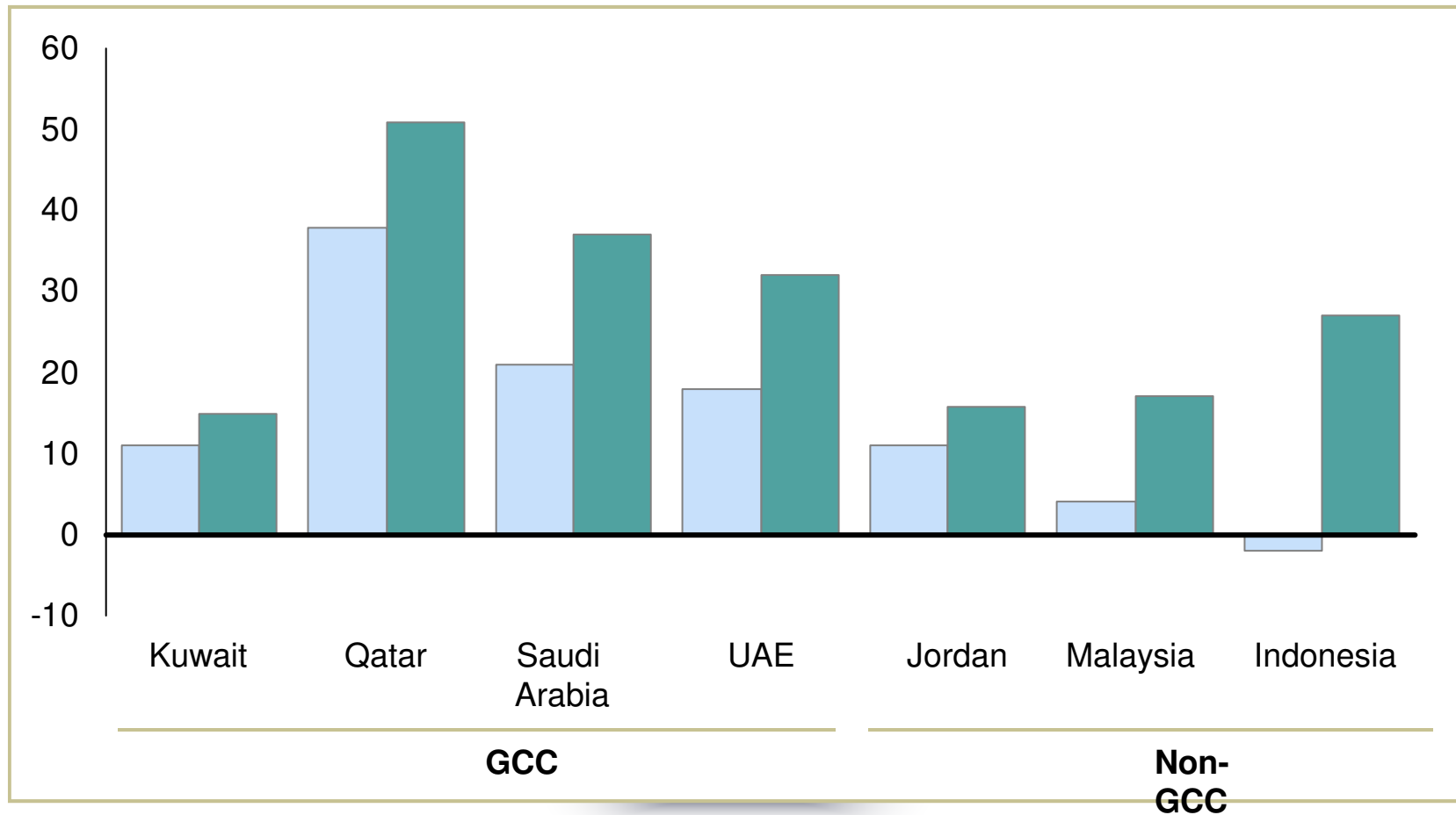
Source: Central banks; bank annual reports; Capital Intelligence reports; Zawya; McKinsey

During 2008, Islamic banks continued to experience robust asset growth and out-performed conventional banks

Asset growth 2007–08¹, %

■ Total Banking Sector
■ Islamic Banks

SELECTED MARKETS



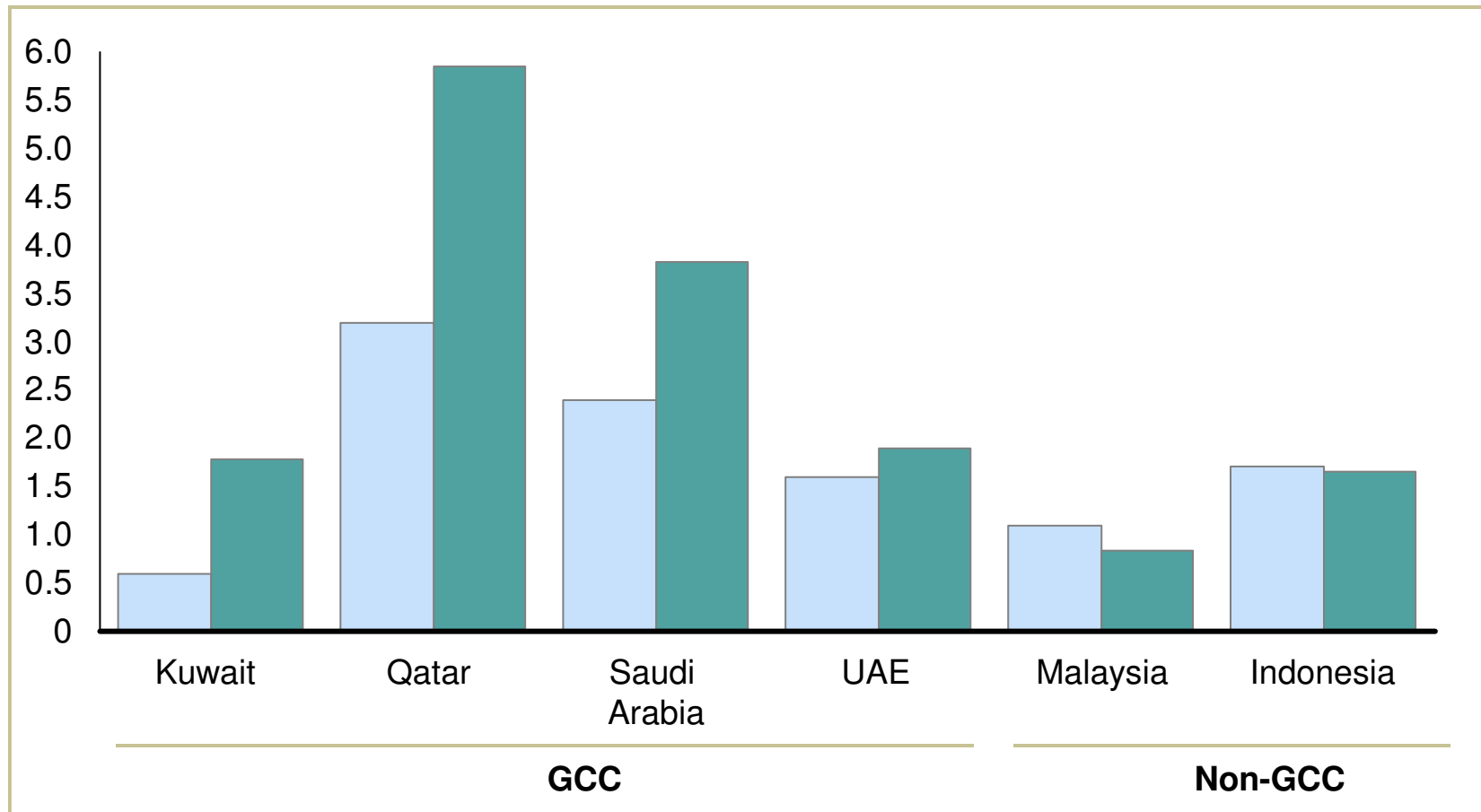
1 Islamic banks' data covers all the major Islamic banks in each country
 Source: Central banks; bank annual reports; Bankscope; Zawya ; McKinsey

Reported profitability remained generally higher for Islamic banks especially in the GCC region

■ Total Banking Sector
■ Total Islamic Banks

Return on Average Assets for Top 5 banks versus Islamic banks¹
 Percent , 2008

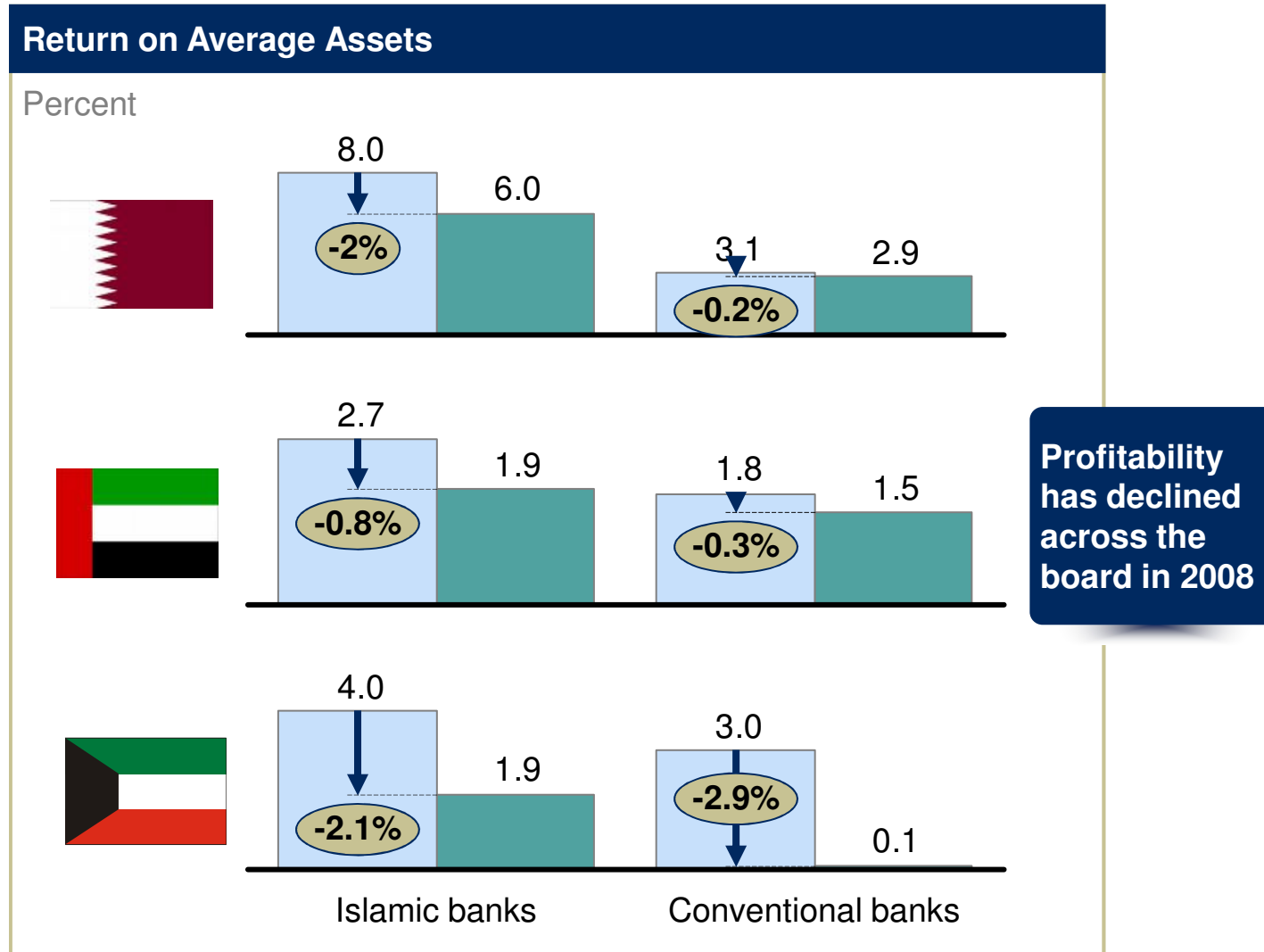
SELECTED MARKETS



¹ Top 3 Islamic banks by assets considered for all countries except the UAE (top 5) Malaysia and Indonesia (top 4).
 Source: Central banks; annual reports; Bankscope; McKinsey

However, profitability compared to 2007 has significantly declined, and more so for Islamic banks in some countries

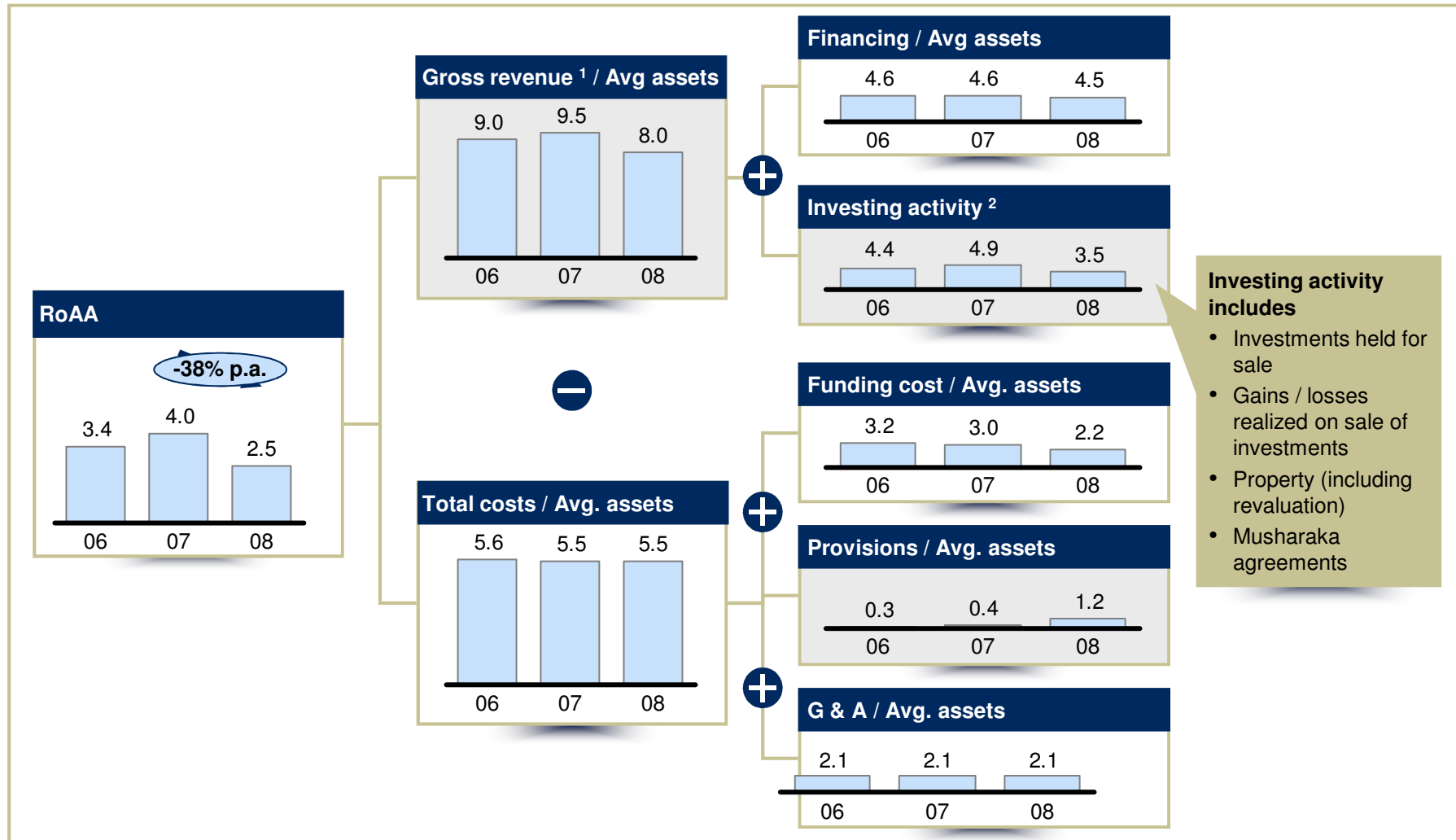
2007
2008



Note: Kuwait data for 2008 disproportionately affected by one bank
Source: Annual reports of top 3 banks (Islamic and conventional) by assets in each country; McKinsey

Decline in profitability of Islamic banks was primarily driven by a decline in revenues from investing activities and an increase in provisions

Aggregate profitability of top 3 Islamic banks in Kuwait, Qatar, UAE and Bahrain, %



1 Gross revenue for Kuwait, UAE and Qatar; Bahrain revenues net of payouts to depositors

2 Investing activity includes musharaka agreements, investments held for sale, gains / losses realized on sale of investments, property (incl. revaluation)

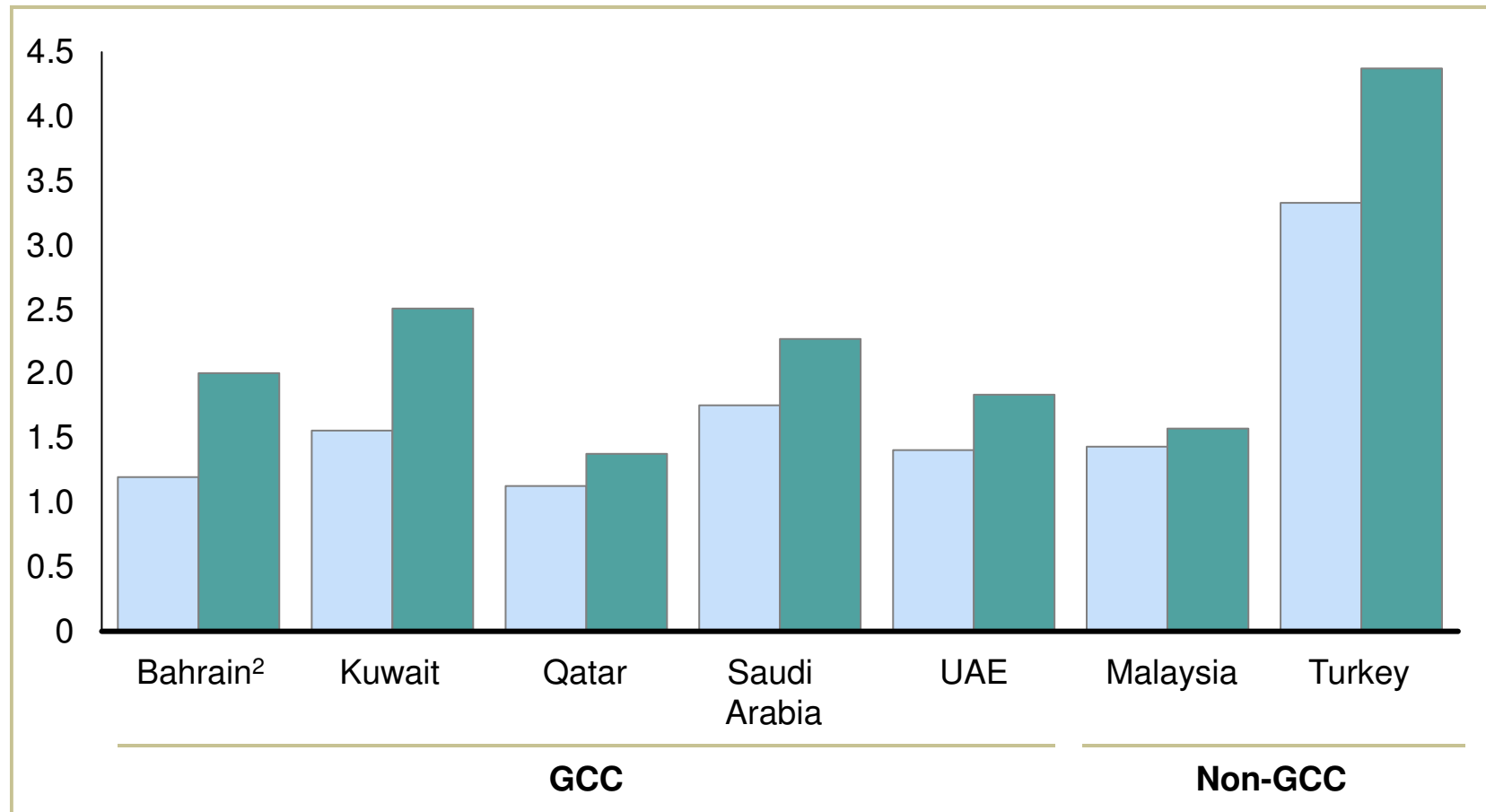
Source: Annual reports; McKinsey

Higher operating costs versus conventional banks also exerted pressure on Islamic banks' profitability

Operating costs as a % of average assets¹
2008, Percent

■ Total Banking Sector
■ Total Islamic Banks

SELECTED MARKETS



1 Top 3 Islamic banks by assets considered for all countries except the UAE, Malaysia and Indonesia (top 5).

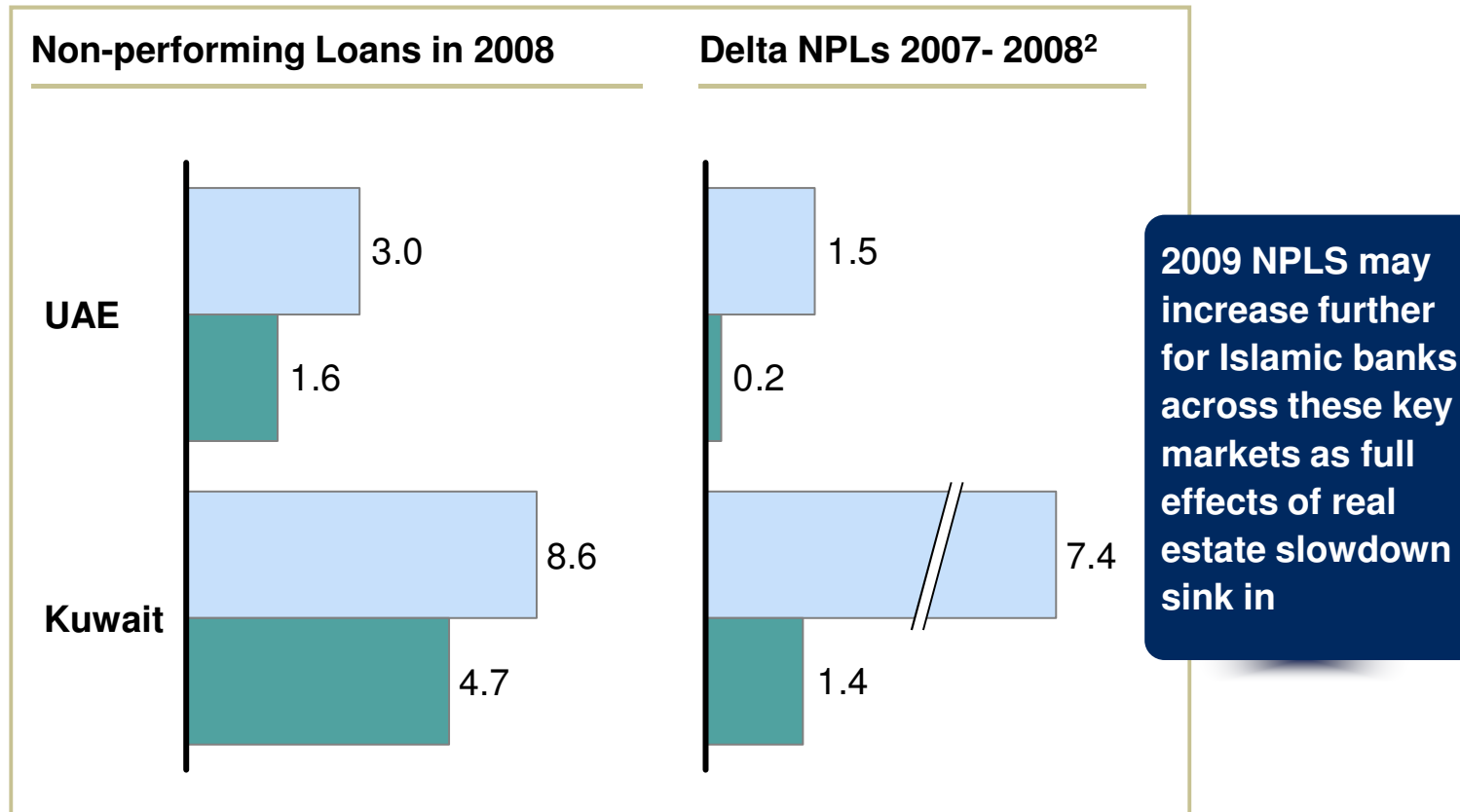
2 For Bahrain, only onshore banks considered.

Source: Central banks; annual reports; Bankscope; McKinsey

Some Islamic banks had a higher NPL ratio in 2008 across key markets

NPLs / Gross loans¹, Delta NPLs
Percent

Islamic
Conventional



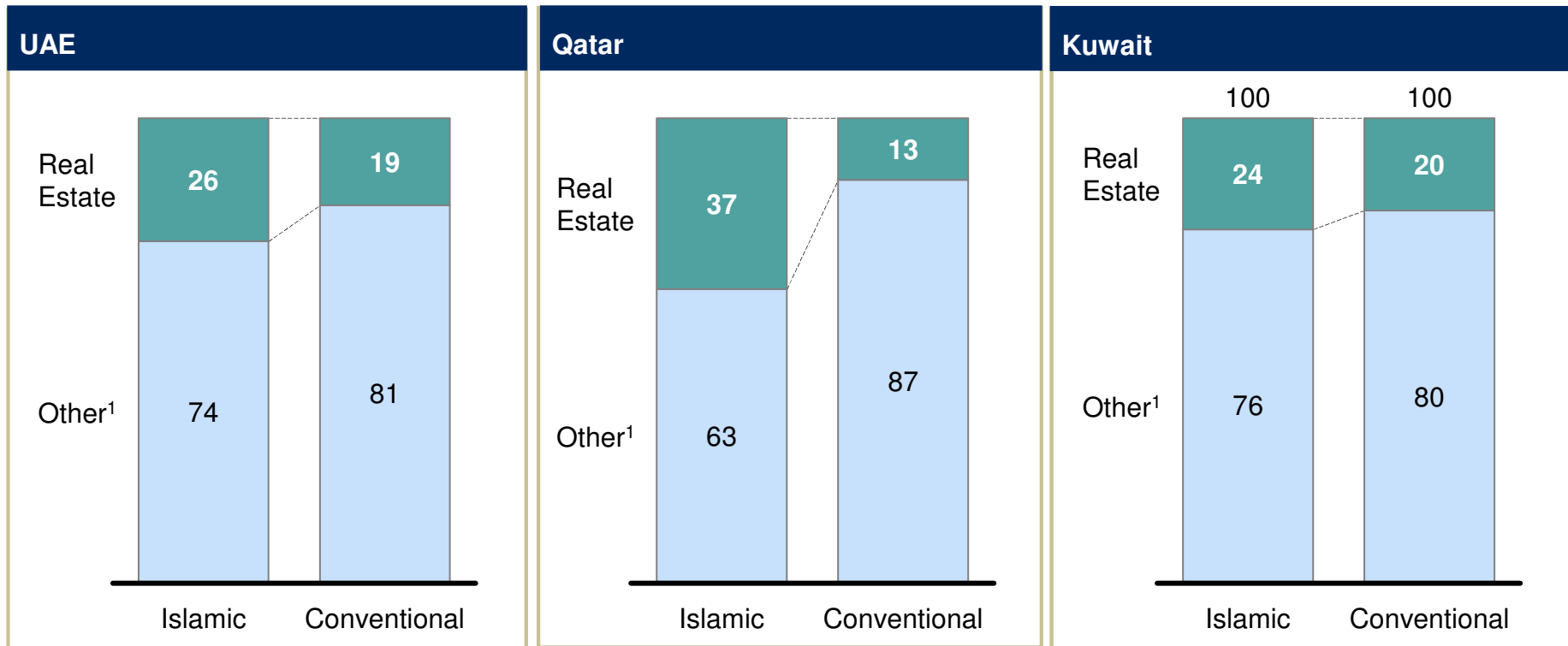
2009 NPLS may increase further for Islamic banks across these key markets as full effects of real estate slowdown sink in

1 Top 3 Islamic and conventional banks by assets in each country
 2 Calculated as (end of year NPL – beginning of year NPL + write offs) / Total assets
 Source: Annual Reports; McKinsey

Islamic banks also continue to have a high proportion of real estate assets

SELECTED MARKETS

Breakdown of Islamic banking assets by sector and type of financing*
%, Dec 2008



Islamic banks continue to have a significantly higher proportion of assets deployed in real estate and construction activity

* Top 3 Islamic banks (except Qatar where top 2 are considered) versus top 3 conventional banks. Loans and advances of banks have been considered in all cases except one Islamic and one conventional bank in Kuwait, where total assets have been considered

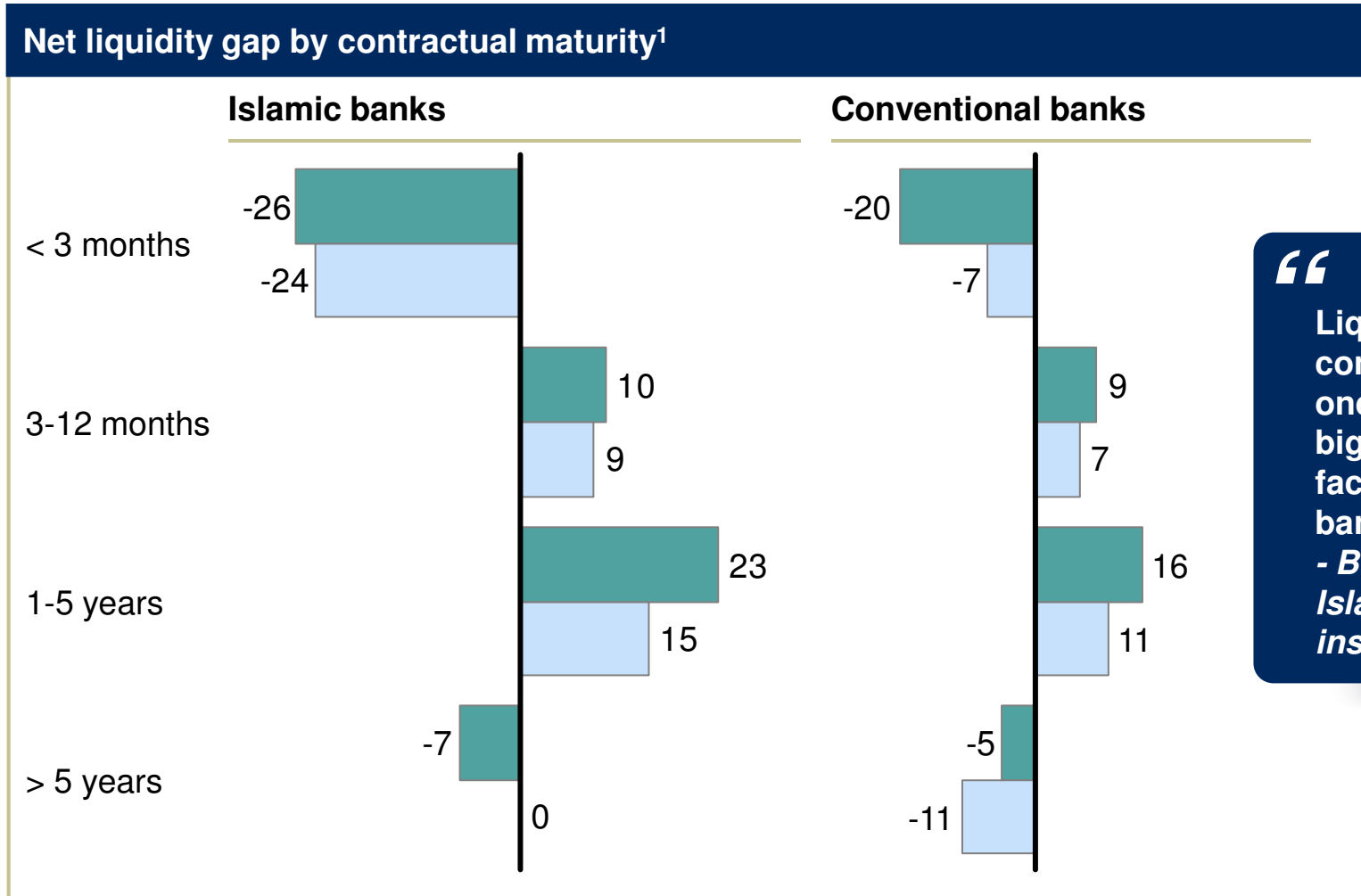
¹ Other includes retail, corporate and government assets

Source: Annual reports; McKinsey

On the liquidity front, Islamic banks have a more pronounced maturity mismatch than conventional banks . . .

2008
2007

Percent of total assets

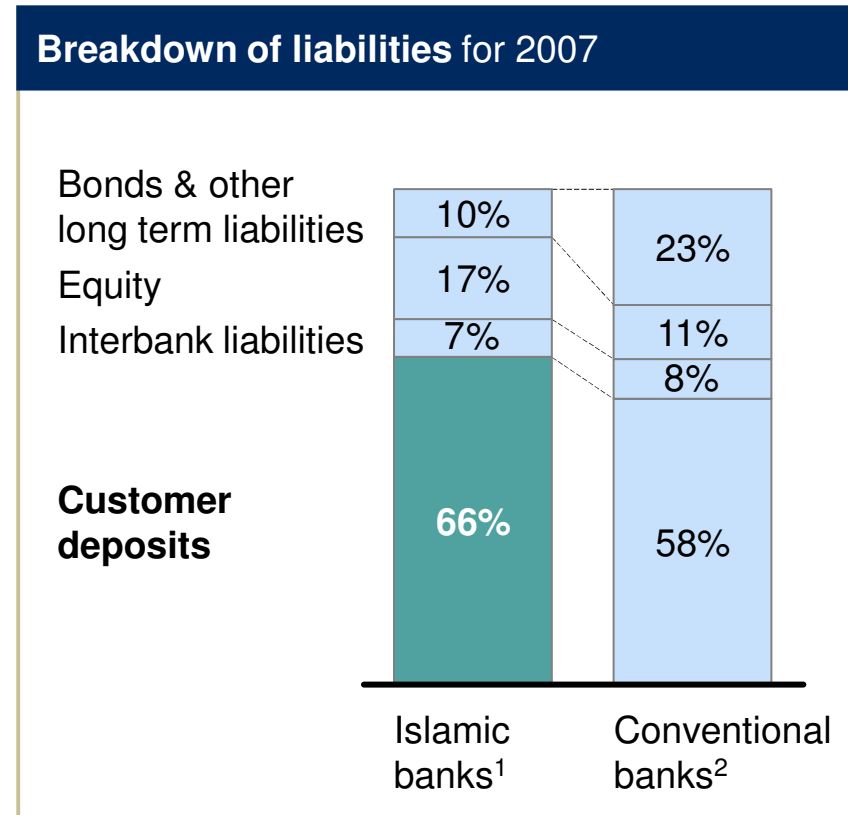
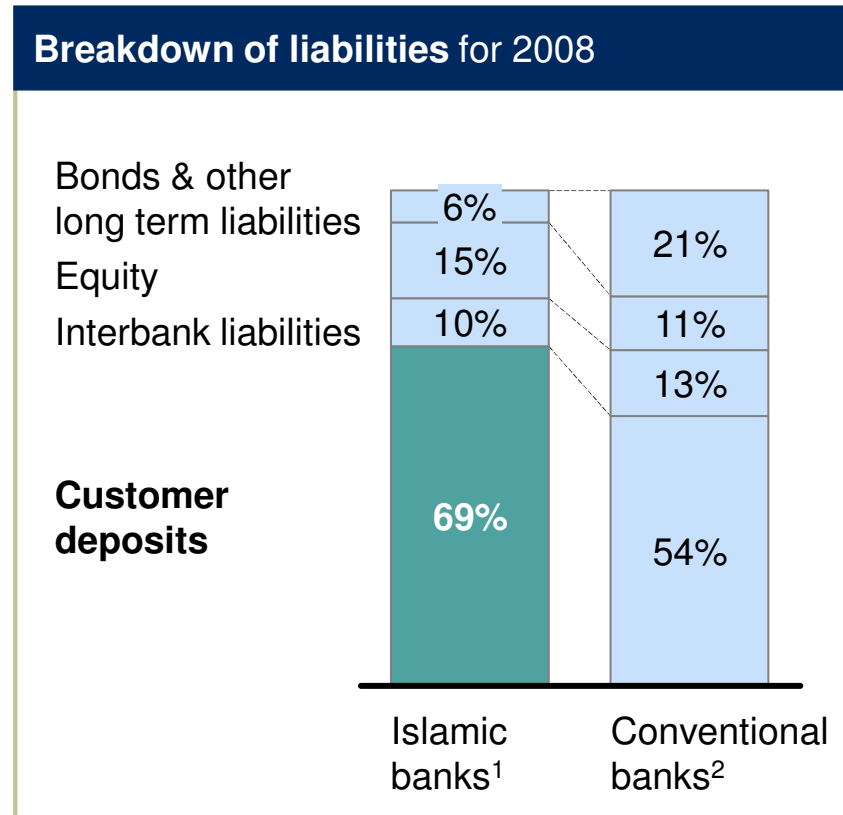


“
Liquidity continues to be one of the single biggest challenges faced by Islamic banks”
- Board member, Islamic banking institution

¹ From a sample of 7 each of the largest conventional and Islamic banks (by assets) in the GCC
Source: Bank annual reports; McKinsey

... however Islamic banks source more funds from deposits

Consolidated commercial bank balance sheets across the GCC
Percent

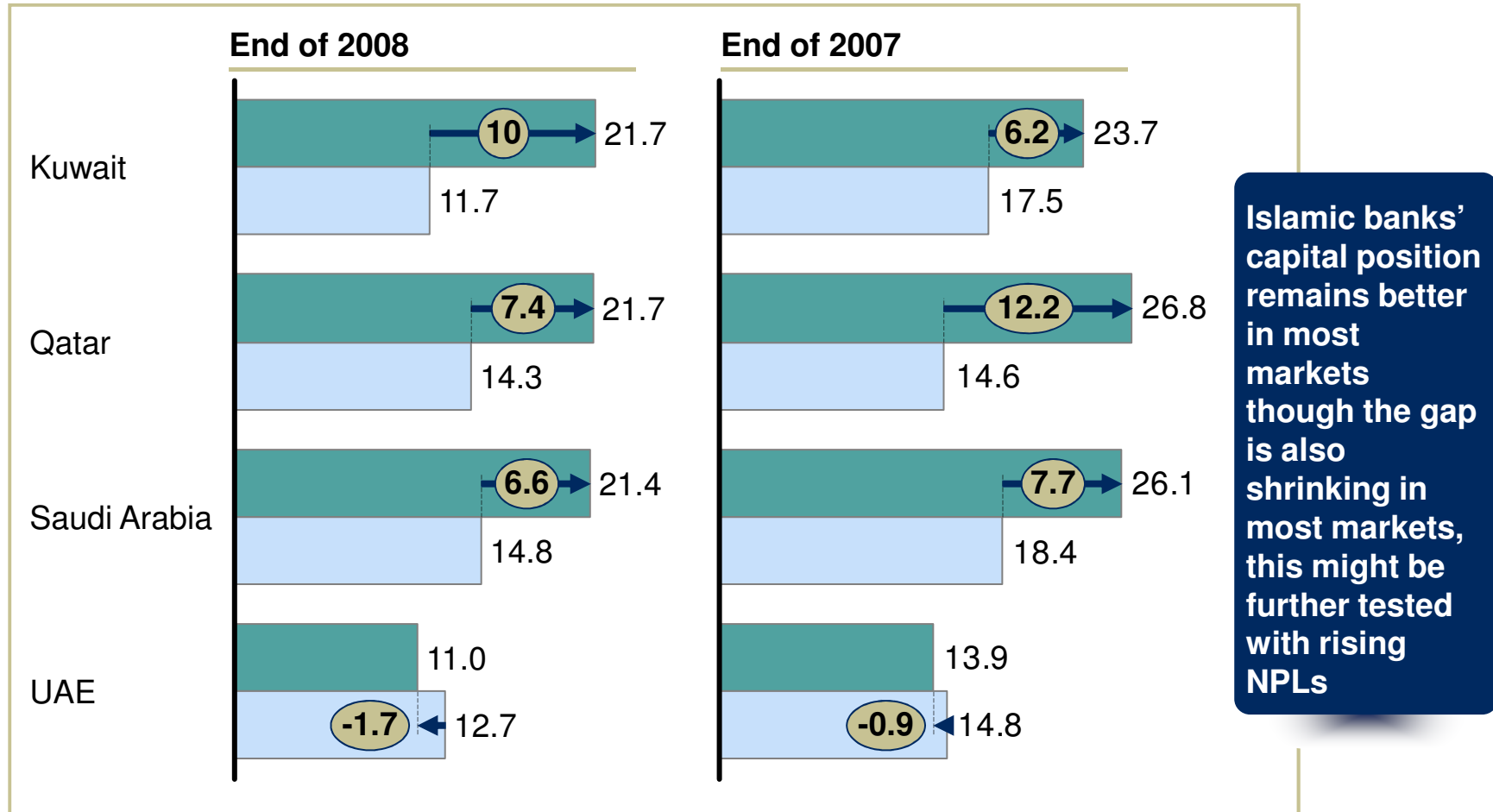


1 Includes all pure Islamic banks in the UAE, KSA, Kuwait and Qatar
 2 Includes all conventional banks in the UAE, KSA, Kuwait and Qatar
 Source: Central banks; annual reports; McKinsey

Islamic banks' reported capital positions remain strong but could be tested

■ Islamic banks
■ Conventional banks

Capital Adequacy Ratio, Percent¹



Islamic banks' capital position remains better in most markets though the gap is also shrinking in most markets, this might be further tested with rising NPLs

¹ Weighted average of top 3 Islamic banks for each country; top 4 conventional banks for Qatar, Kuwait and KSA, top 5 for UAE
Source: Annual reports; McKinsey

There are four priority areas which Islamic banks should focus on going forward

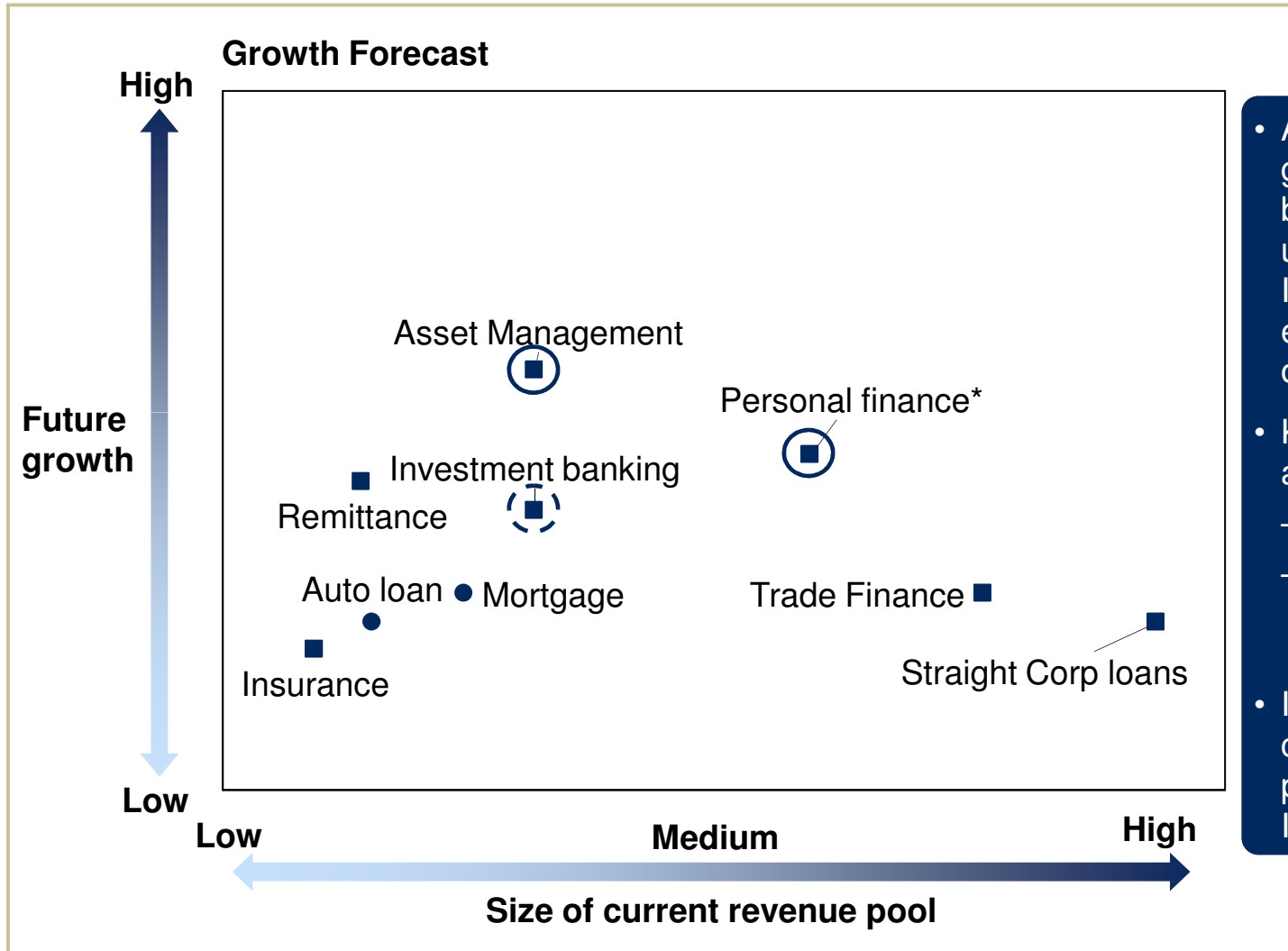
Priority area	Potential actions for Islamic banks
1 Enhanced and diversified business mix	<ul style="list-style-type: none"> • Change business mix in product areas where Islamic banks have not been traditionally focused or where there is growth potential such as <ul style="list-style-type: none"> – Fee-based businesses such as Investment banking and capital markets – Credit cards – Islamic Investment management (as an upcoming growth area)
2 Risk management	<ul style="list-style-type: none"> • Upgrade risk management systems and capabilities in anticipation of required capability to manage in crisis environments, i.e. focus on <ul style="list-style-type: none"> – Credit risk as an important area of focus given high real estate concentration and potential for increased non-performing loans in end 2009 – Liquidity risk¹ via improved sources of funding, new hedging tools and enhanced infrastructure. Critical to manage liquidity in light of limited sources of funding for Islamic banks (MTNs, government credit lines etc)
3 Efficiency in operations	<ul style="list-style-type: none"> • Make efforts to lower cost of operation and improve service quality in order to improve competitiveness
4 Explore global growth options	<ul style="list-style-type: none"> • Well positioned Islamic banks can consider international growth opportunities in countries with <ul style="list-style-type: none"> – Sufficient target population and strong un-met demand – Feasible market entry based on competitive environment and regulatory climate

1 Covered in detail in the liquidity chapter of the report
Source: McKinsey

1 Islamic banks need to reconsider their business mix in light of ESTIMATES growth opportunities

Revenue pools for banks across GCC

○ Typically underpenetrated by some Islamic banks ◌ Area of future growth



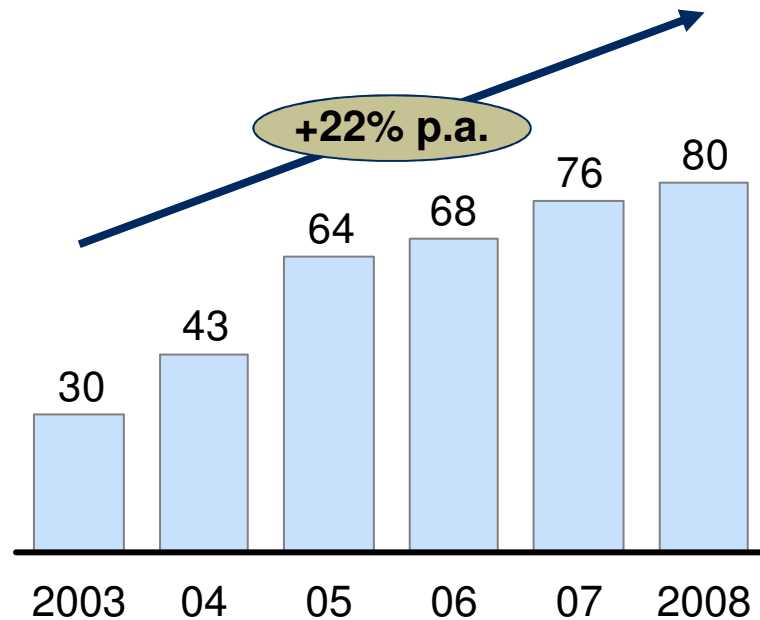
- A number of high growth areas have been traditionally underpenetrated by Islamic banks, for either commercial or offering reasons
- Key examples of these are:
 - Asset management
 - Personal finance (Credit cards and personal loans)
- Investment banking can also be an area of potential growth for Islamic banks

* Personal loans and credit cards
Source: McKinsey

1 Personal finance products have sustained a strong growth momentum in the GCC over the last few years

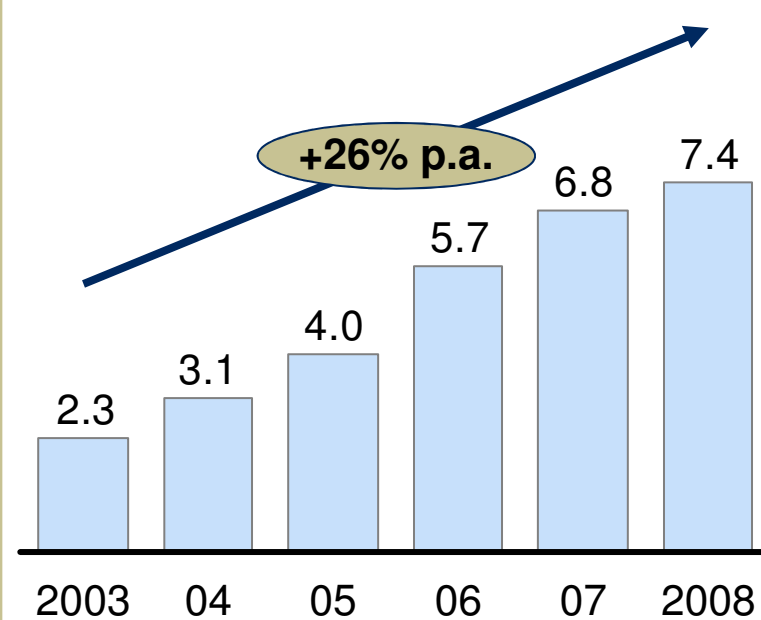
Personal loans¹ volumes GCC

2003-08²,
USD bn



Credit card volumes GCC

2003-08²,
USD bn

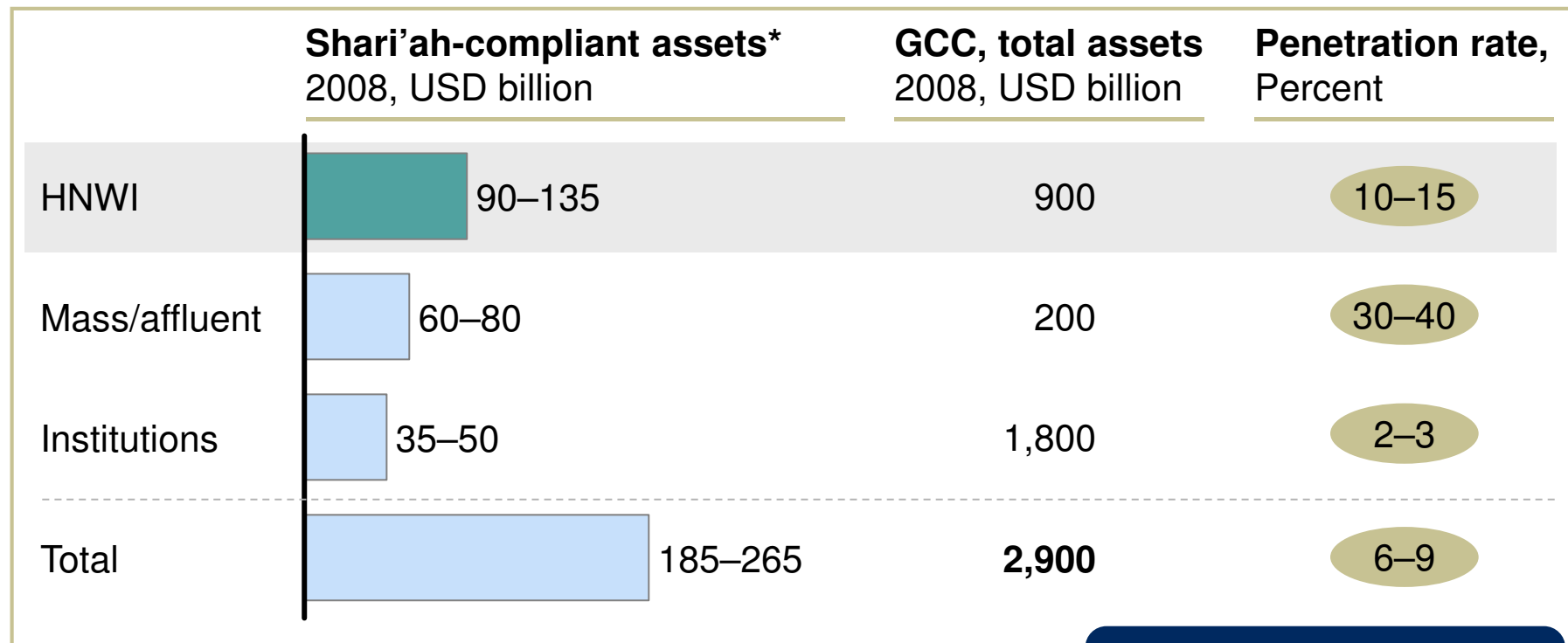


1 For Kuwait includes finance for buying securities

2 Forecast data for 2008

Source: Lafferty Group

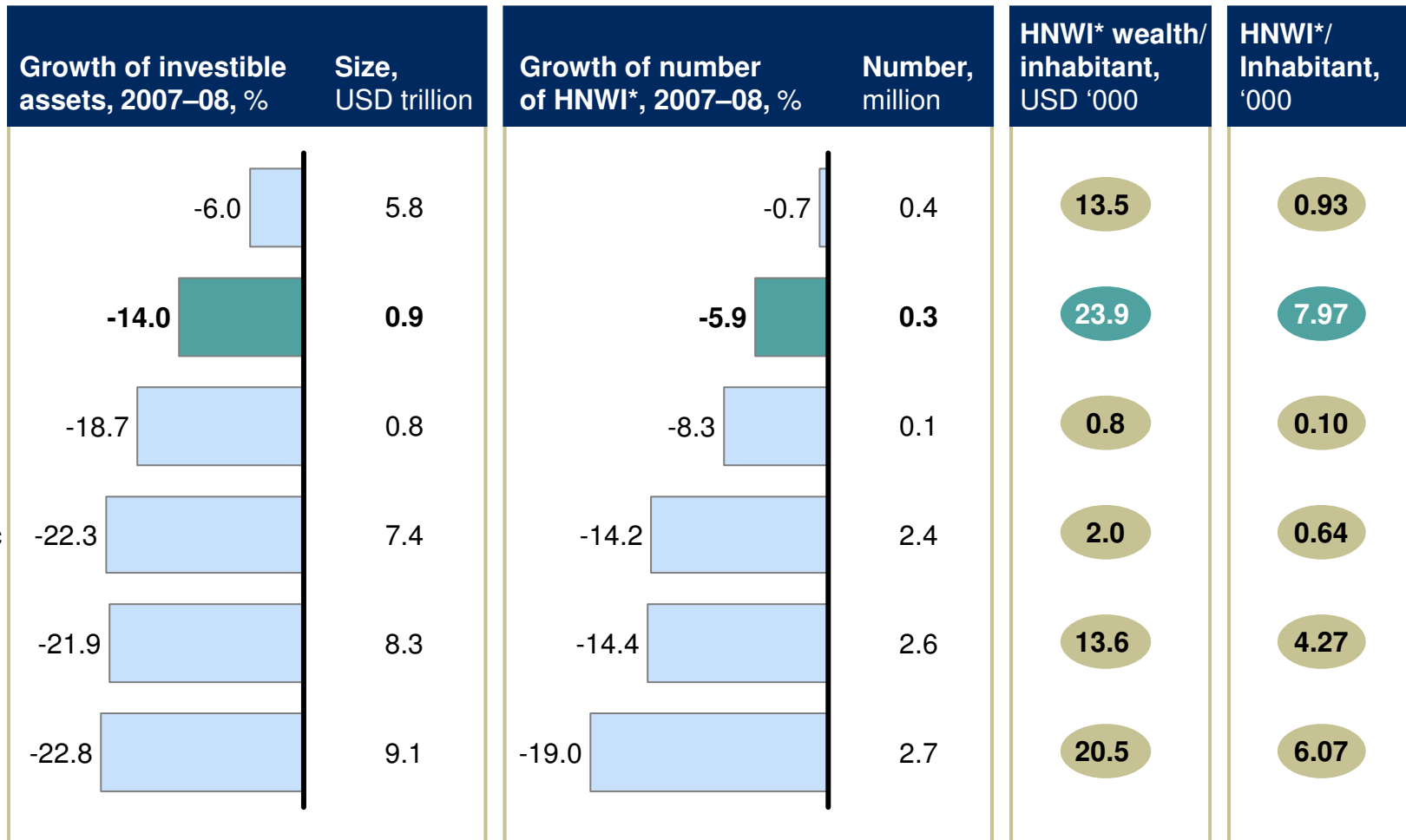
1 A significant opportunity exists in shariah compliant asset management given demand from individuals



Our model indicates 30% higher growth rates for Islamic assets compared to conventional

* Shari'ah-compliant investments made with Islamic motive
Source: McKinsey

1 The wealth of GCC high net worth individuals decreased from 2007 to 2008, but less than in other geographies



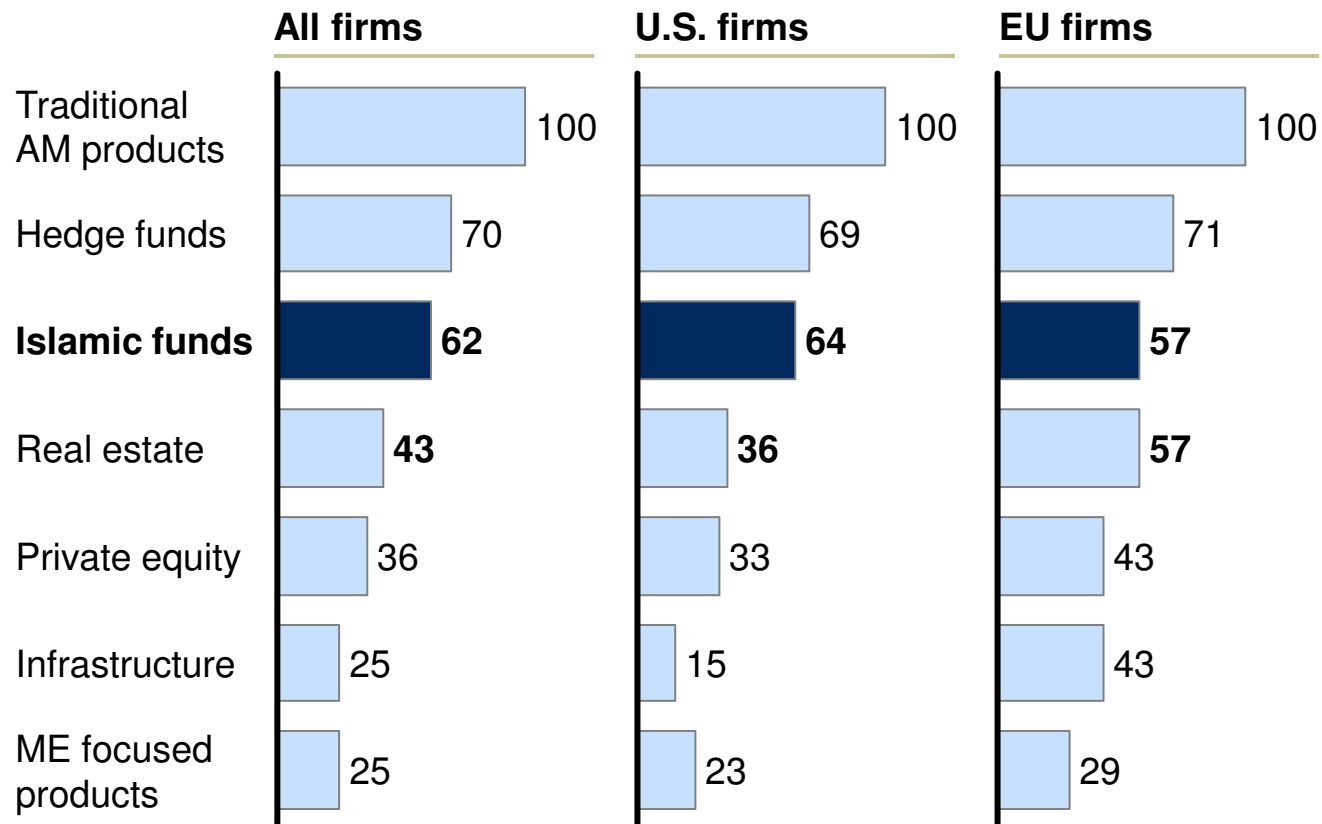
* HNWI = High net worth individuals; having wealth > \$1 million

Source: McKinsey Islamic wealth model, World Wealth Report 2008; Global Insight

1 Islamic funds are an increasing priority for fund managers

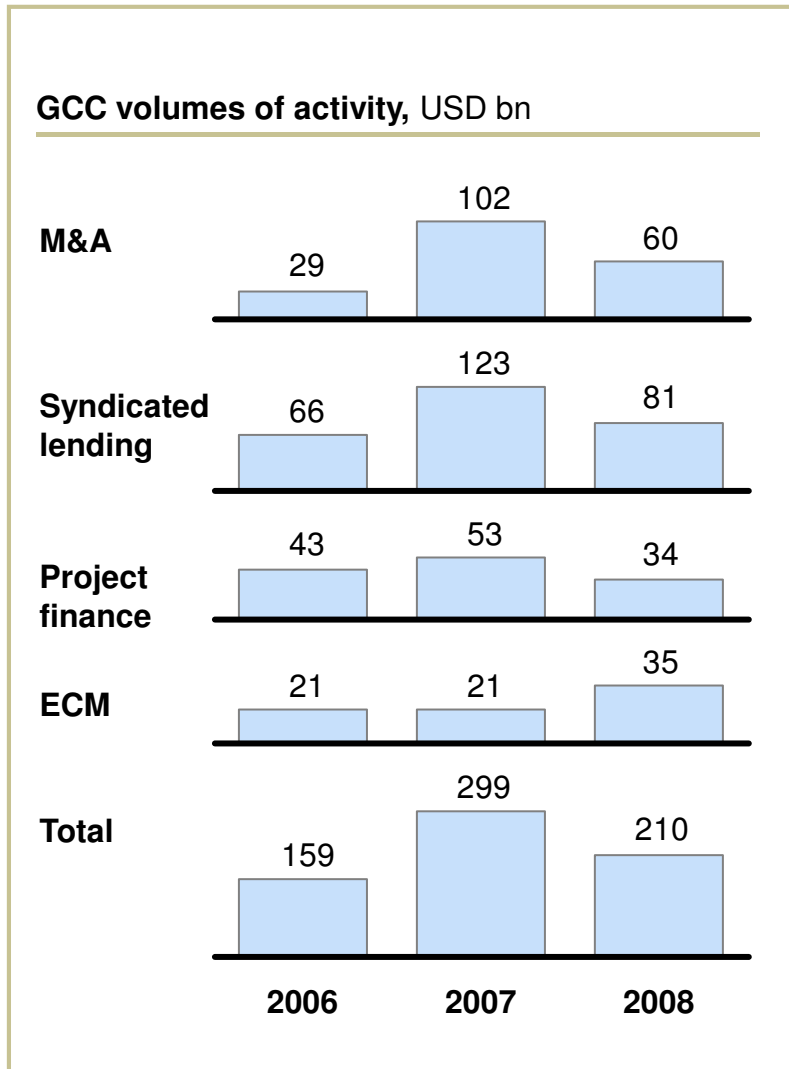
Survey conducted among CEOs of AM funds, % of respondents who "agree" or "strongly agree"

Question: What kind of products does your firm offer, or plan to offer in the next 2-3 years, in the Middle East?



Discussed in detail in the investment management section of the report

1 Islamic banks have had limited presence in leading investment banking and capital markets activity



League tables* for deals 2006–08

	ECM	M&A ²	Synd. Lending
1	No Islamic bank in top five	No Islamic bank in top ten	No Islamic bank in top ten
4			
5			
Islamic Bank			
7			
9			
10			

1 Based on deal values being equally apportioned between all participants

2 Includes cross border M&A

Source: Dealogic, Projectware; McKinsey

2 Islamic banks must consider a few critical questions around risk management...

- I Is my institution resilient enough to cope with an unprecedented down cycle?
- II Is my corporate business prepared well enough to avoid excessive losses and navigate through the anticipated down cycle?
- III Have we developed the skills and capabilities to manage risks associated with our fast growing and increasingly complex retail business?
- IV Whom in my institution has the confidence to know how much we could possibly lose through our investments and trading positions?
- V What is my institution's plan to handle the real estate slowdown?

THANK YOU

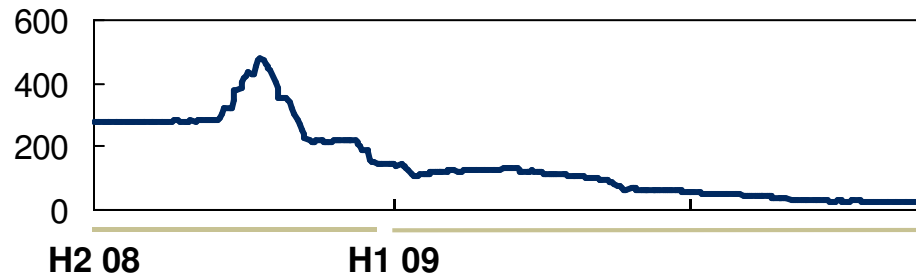
Executive summary

- **The 2008-2009 economic crisis has impacted banks globally, with large markets for Islamic finance no exception**
 - Global banks suffered \$700 billion in losses in 2008
 - GCC economies have also felt the crunch, with little or no growth in 2009
 - Equity markets have also seen steep declines in spite of a partial recovery in 2009
 - Banks in the GCC have faced challenging times, with scarce liquidity, a rising perception of risk, and the ever-present reality of credit defaults
- **Since 2008, Islamic banks have not been immune from the crisis**
 - Islamic banking penetration is up in key markets with Islamic banks outperforming in asset growth
 - However both market values and profitability of Islamic banks have come under pressure, narrowing the gap with conventional peers
 - Revenues have declined significantly from 2008, particularly driven by a drop in income from investing activity
 - A number of Islamic banks have been harder hit by NPLs than conventional peers and continue to face the risk from real estate concentrations even as their operational efficiency continues to lag conventional peers
 - Liquidity continues to be a significant constraint for Islamic banks. While Islamic banks maintain their market share of deposits, it will be subject to increased competition in the “war for deposits”
- **In the aftermath of the crisis, Islamic banks must now determine their future course of action by exploring four important areas**
 - **Enhancing and diversifying their business mix**, by tapping into new growth business lines, such as personal finance, asset management and various areas of investment banking, where some Islamic banks have been less focused in the past
 - **Improving risk management**, in order to mitigate challenges on both credit and liquidity fronts, through upgrade of risk management capabilities and skills
 - **Lowering cost of operation and improving service quality**, to maintain competitiveness for an increasingly demanding market
 - **Exploring international growth opportunities**, especially where excess capital is available and can be better deployed in under-penetrated markets

The financial crisis has had a significant impact on national economies and banks

The financial crisis has been challenging for economies and banks throughout the world

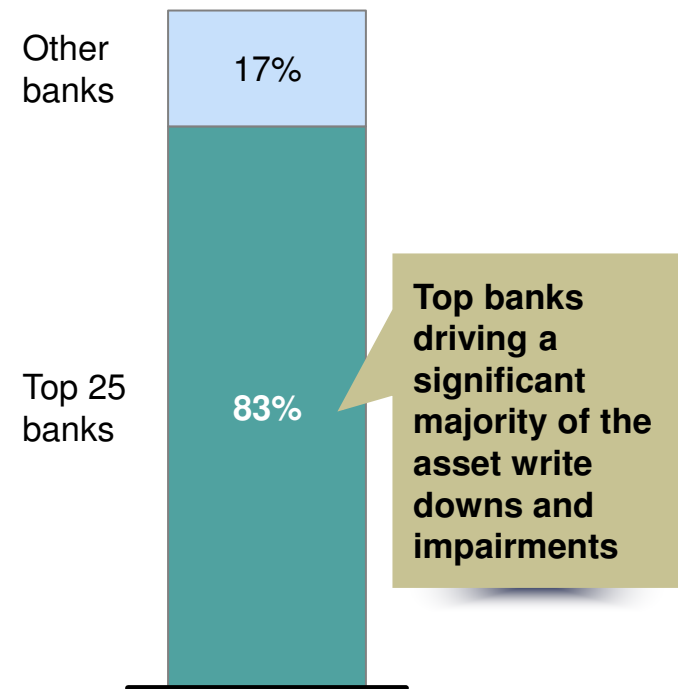
LIBOR USD 3 month Treasuries spread, bps



- **Lehman Brothers** files for bankruptcy
- **Merrill Lynch** acquired by BofA
- **AIG** bailout by Fed worth \$700B U.S.
- **WaMU** acquired by Wells Fargo
- **Fortis** partly nationalized
- **HBOS** taken over by Lloyds TSB
- Crisis spreads and deepens in Europe
- **90+ banks collapse** in US alone
- **Barclays, RBS** lose substantial market value
- **Citigroup** announces plans to split into two
- **General Motors** files for bankruptcy
- **Ireland, Portugal, and Spain** all have sovereign credit ratings downgraded

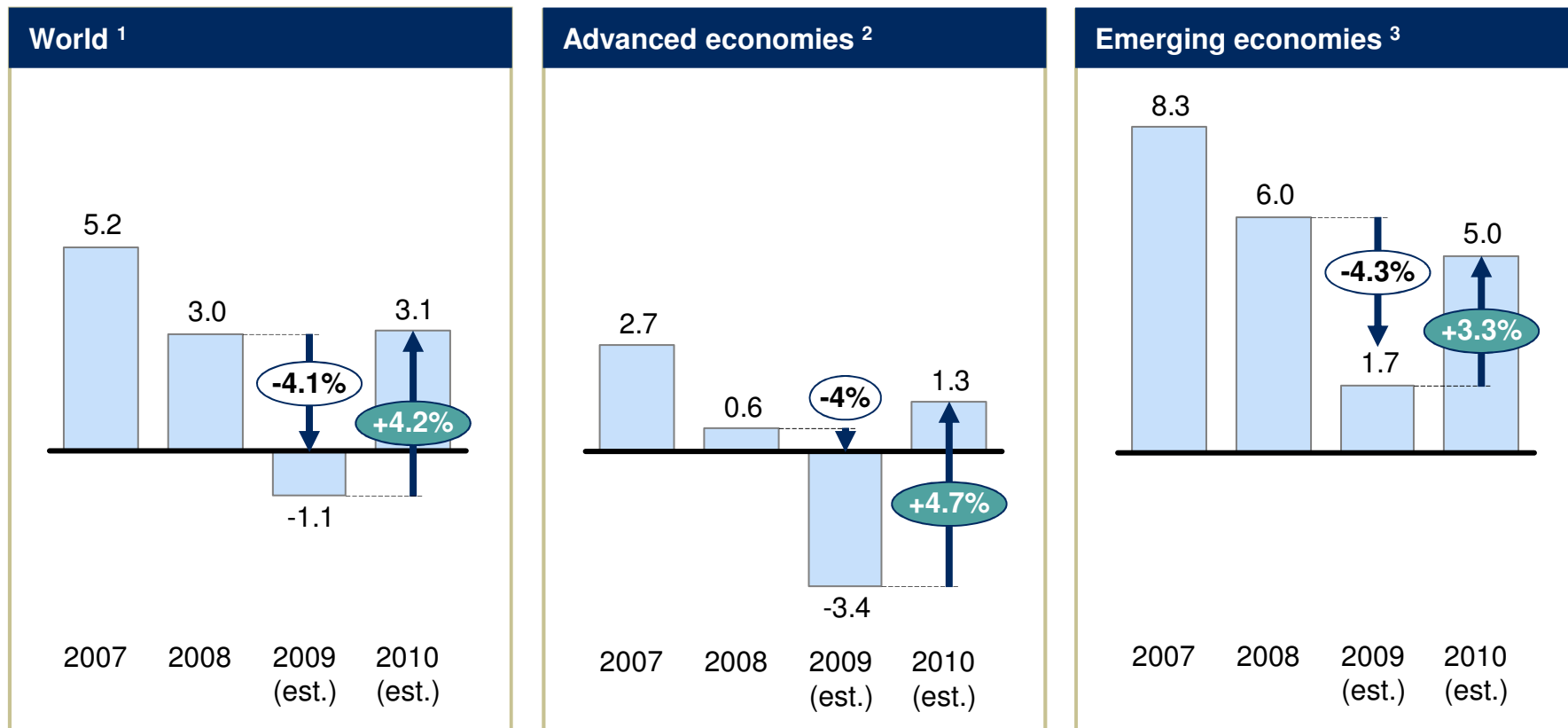
hit particularly hard

Credit crisis write-downs/impairments
Percent, as of Dec 2008



The crisis has impacted worldwide growth though some forecasts for 2010 are more optimistic

GDP growth at constant prices – IMF World Economic Outlook
Percent



1 182 countries (world)

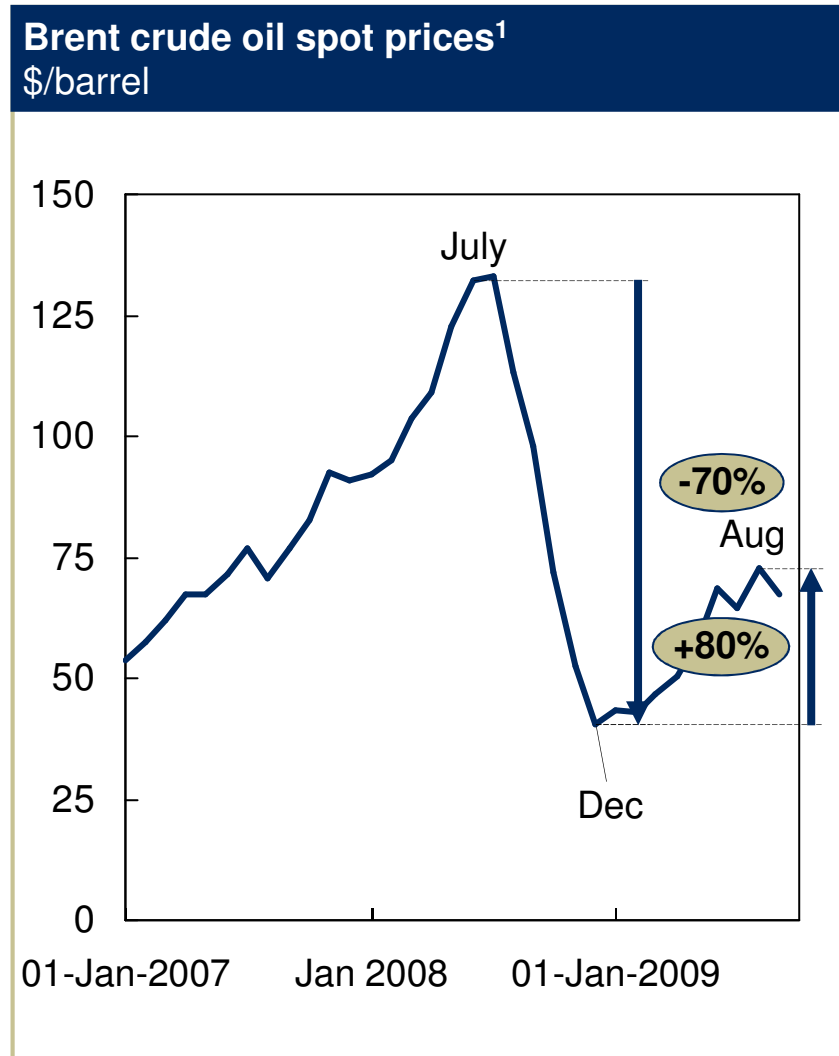
2 33 countries including Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States

3 Remaining 149 countries

Source: IMF World Economic Outlook database, October 2009

Oil prices declined sharply in the second half of 2008 leading to declines in GCC budget surplus

GCC SPECIFIC

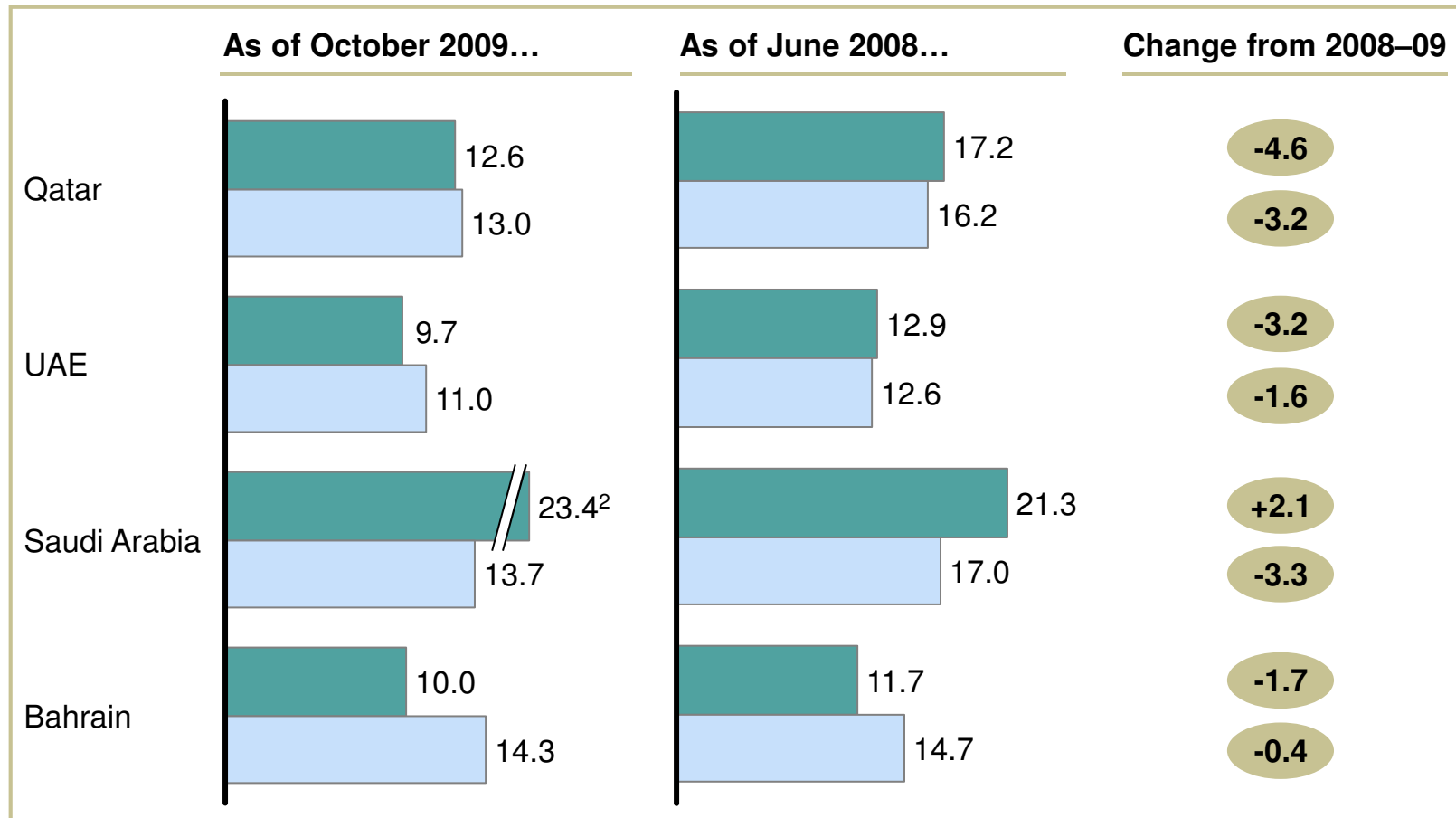


¹ Monthly average spot prices to September 2009
Source: Platts; IMF World Economic Outlook reports; McKinsey

In some countries, Islamic banks are losing their advantage in terms of market expectations

■ Islamic banks
 ■ Conventional banks

Price-to-earnings ratio¹ weighted by market capitalization of banks



1 Current PE is based on share price as on 9th Oct 2009 with the 12 month trailing EPS as on June 2009. Data based on 15 major Islamic and 31 major conventional banks in the GCC excluding non meaningful (negative EPS) data. Recent entrants are considered only after they were listed.

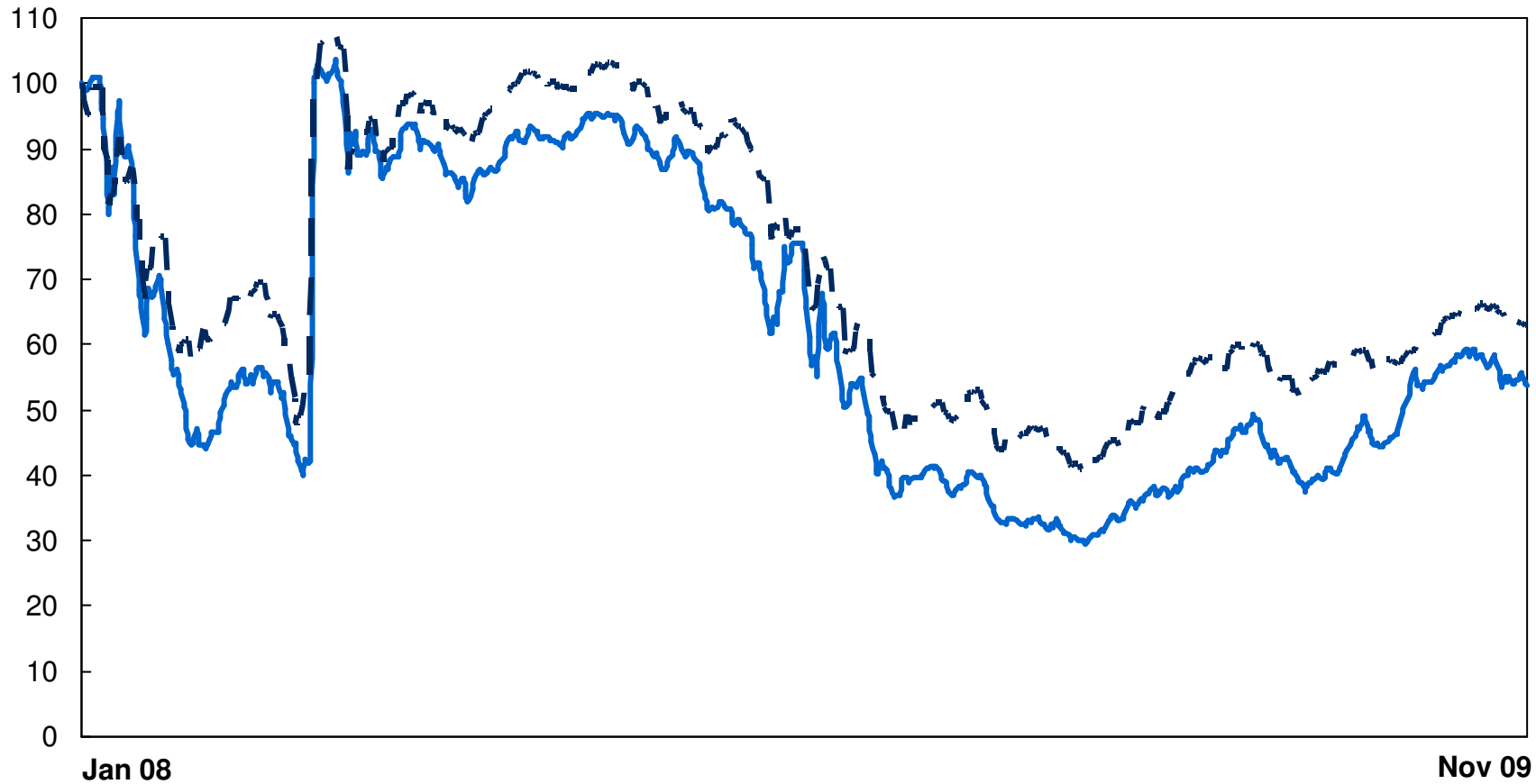
2 Primarily driven by one bank

Source: Bloomberg; Zawya; McKinsey

Returns for top real estate companies have under-performed the market during the crisis

— Real estate companies
- - Stock index

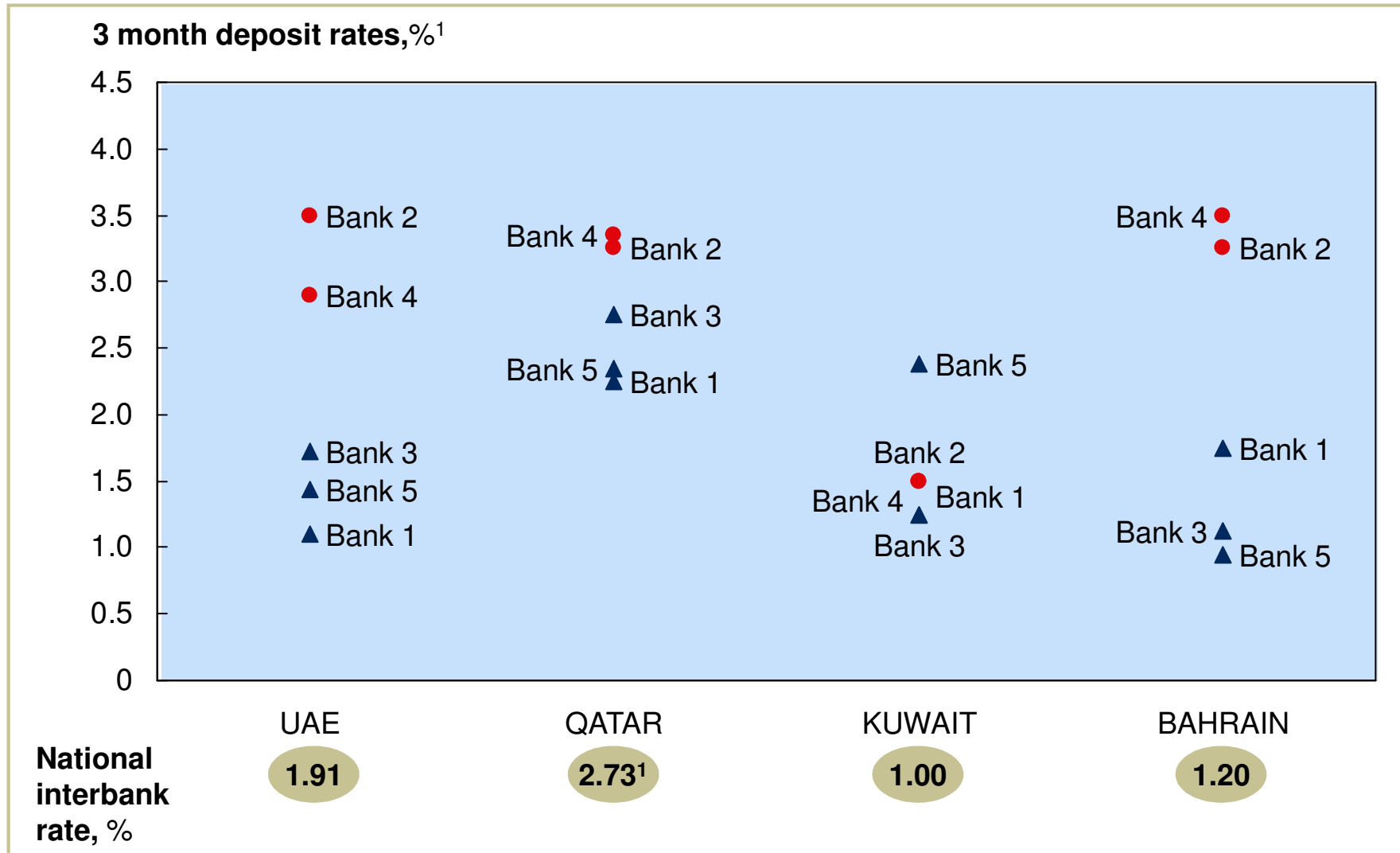
Daily market cap movement of real estate companies¹
Starting point indexed at 100



¹ Aggregate market cap of the largest real estate companies in Qatar, UAE and Saudi Arabia
Source: Bloomberg; Zawya; McKinsey

... however, some Islamic banks are now offering higher indicative profit rates for customer deposits

▲ Conventional OCTOBER 2009
 ● Islamic NOT EXHAUSTIVE



1 Indicative profit rates offered in the case of Islamic banks
 2 As on June 30, 2009
 Source: Primary interviews, Bloomberg, McKinsey

1 The infrastructure investment pipeline will be a key driver of Sukuk growth

Announced investments, USD bn

Sector	Bahrain	Kuwait	Oman	Qatar	KSA	UAE
Transport & Infrastructure	5	24	6	11	18	23
Real estate	19	120	29	25	202	250
Water	1	5	2	2	9	10
Power	-	14	5	7	32	23

- Volumes are based on current publicly available project status, which may change in the aftermath of the financial crisis
- However, even under conservative scenario, significant projects in infrastructure require financing

4 A number of criteria should be considered in such choices

Criteria	Key questions to consider
Market potential	<p>Macroeconomic</p> <ul style="list-style-type: none"> • What is the country credit and risk profile? • What is the current GDP per capita and what are the economy's growth prospects? <p>Banking-specific</p> <ul style="list-style-type: none"> • What is the size of banking assets? What are growth expectations? • What is the existing size of Islamic finance assets? <p>Demographic Demand</p> <ul style="list-style-type: none"> • What is the level of demand for Shari'ah-compliant products?
Ease of entry	<ul style="list-style-type: none"> • How easy is it to obtain a banking license? • What regulatory support does Islamic finance receive? • Does the government provide any additional support to grow the sector?
Degree of competition	<ul style="list-style-type: none"> • What are price premiums on current valuation? • How crowded is the market? • What return on equity are existing players achieving?

3 Global banks have used 5 key levers to run successful cost improvement programs

ILLUSTRATIVE

Typical levers	Description
Optimize cost to serve in distribution	<ul style="list-style-type: none"> • Redesign customer interaction model • Push remote/virtual client commercial management • Simplify/de-staff intermediate commercial structures
Maximize back office and IT efficiency	<ul style="list-style-type: none"> • Optimize onshore processes and ICT systems - lean • Offshore • Outsource
Optimize factories' scale or offshore	<ul style="list-style-type: none"> • Optimize scale of existing factories • Offshore subscale factories
De-layer managerial structure/ optimize span of control	<ul style="list-style-type: none"> • Rationalize managerial structure by reducing number of intermediate reporting levels
Foster cost productivity mindset and behavior	<ul style="list-style-type: none"> • Develop ad hoc cost productivity metrics and cascade them down the organization • Design incentive systems and people development programs and ensure alignment with cost-productivity paradigm

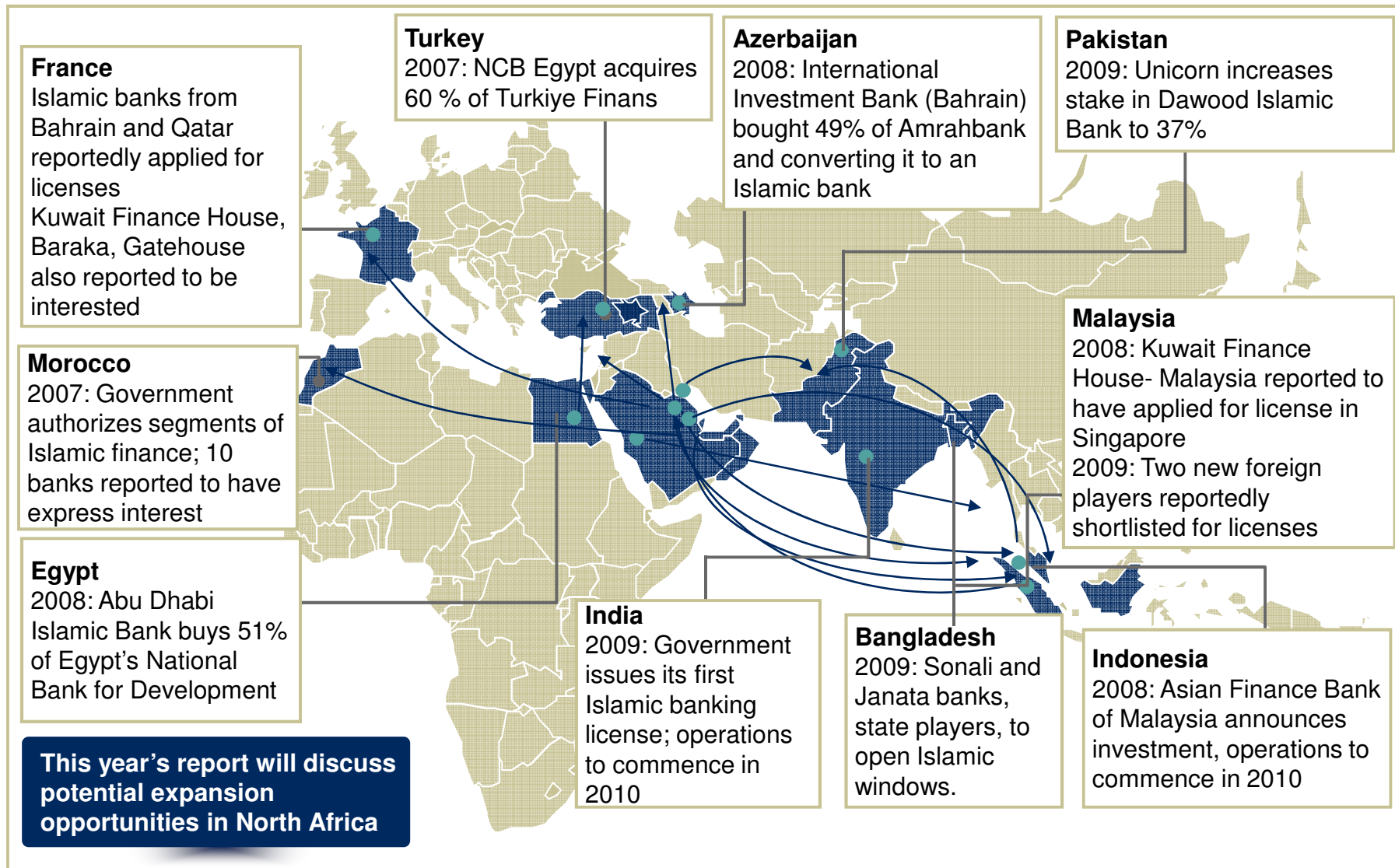
Total cost reduction of ~ 20-25% possible through sustained focus on these key levers

4 Islamic banking players continue to exhibit interest in international expansion

NOT EXHAUSTIVE

PRESS ANNOUNCEMENTS

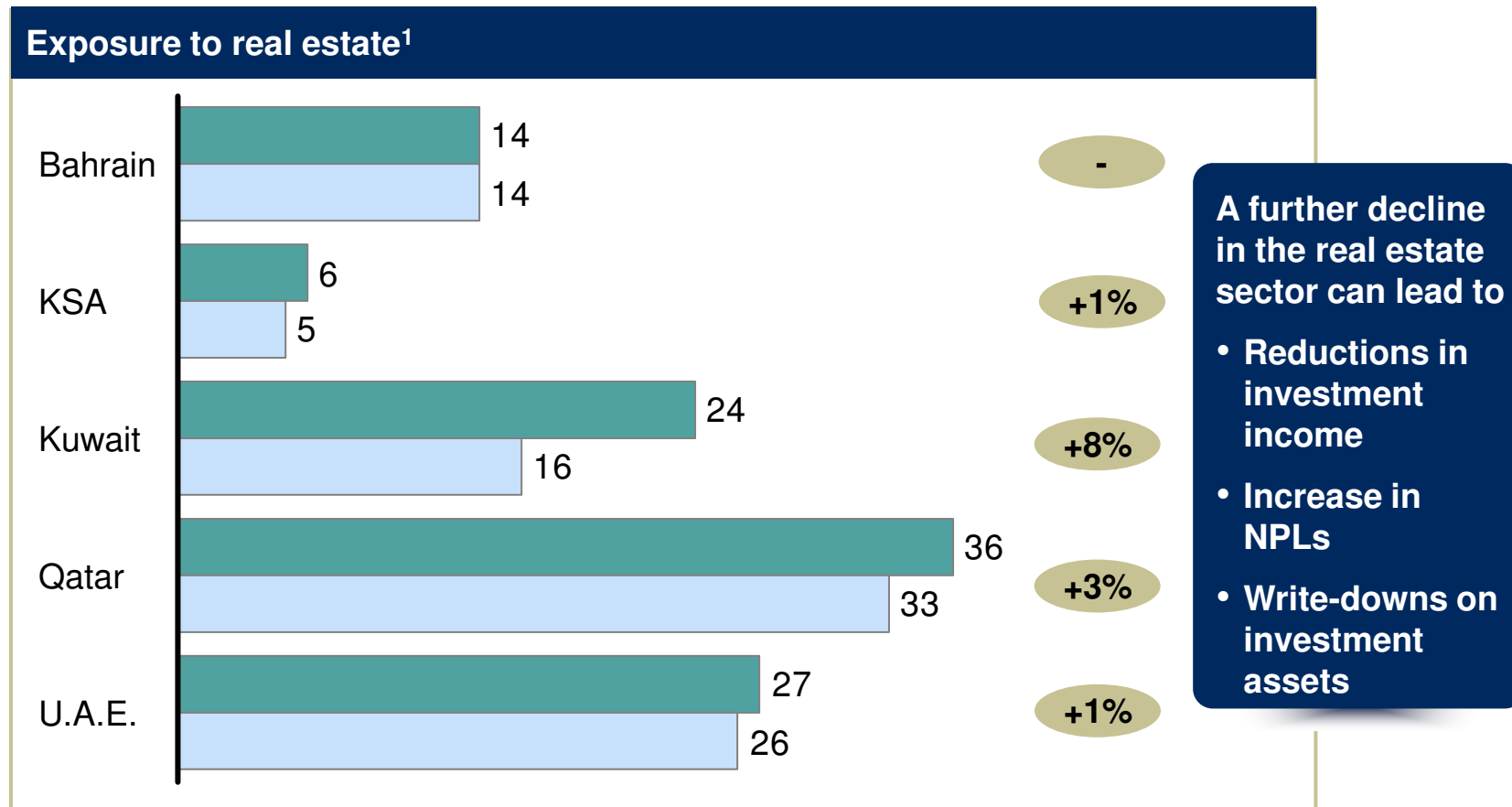
2007- Oct 2009



Overall, the high concentration of real estate assets is consistent with previous years

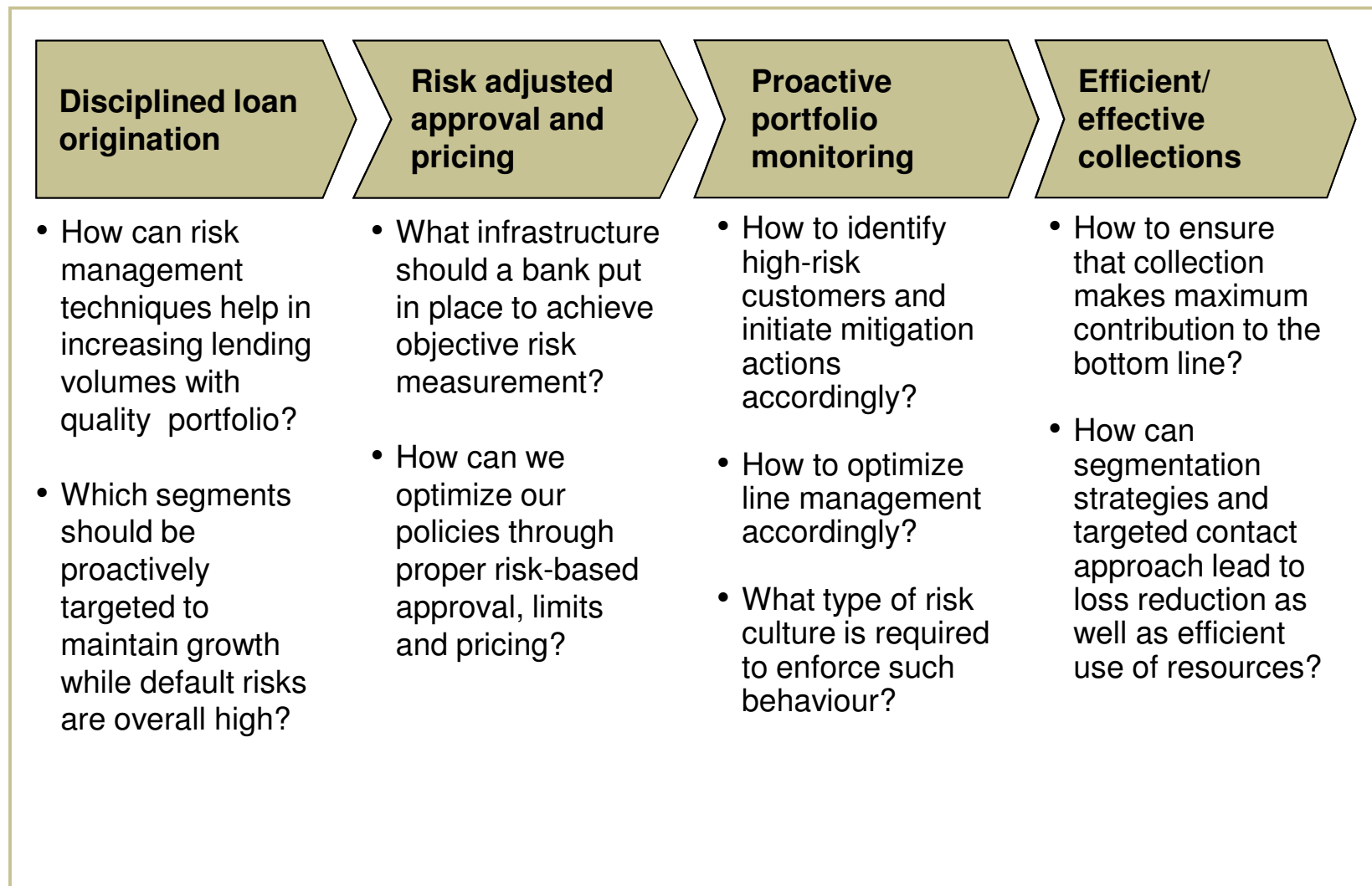
2008
2007

Reported financing exposure of Islamic banks to construction and real estate assets*
Percent, Dec 2008



1 Top 3 Islamic banks (except Qatar where top 2 are considered) versus top 3 conventional banks. Loans and advances of banks have been considered in all cases except one Islamic and one conventional bank in Kuwait, where total assets have been considered
Source: Annual reports; McKinsey

2 Islamic banks must review their capabilities across the entire credit risk value chain




2 Liquidity risk must be managed by taking into account the following key issues

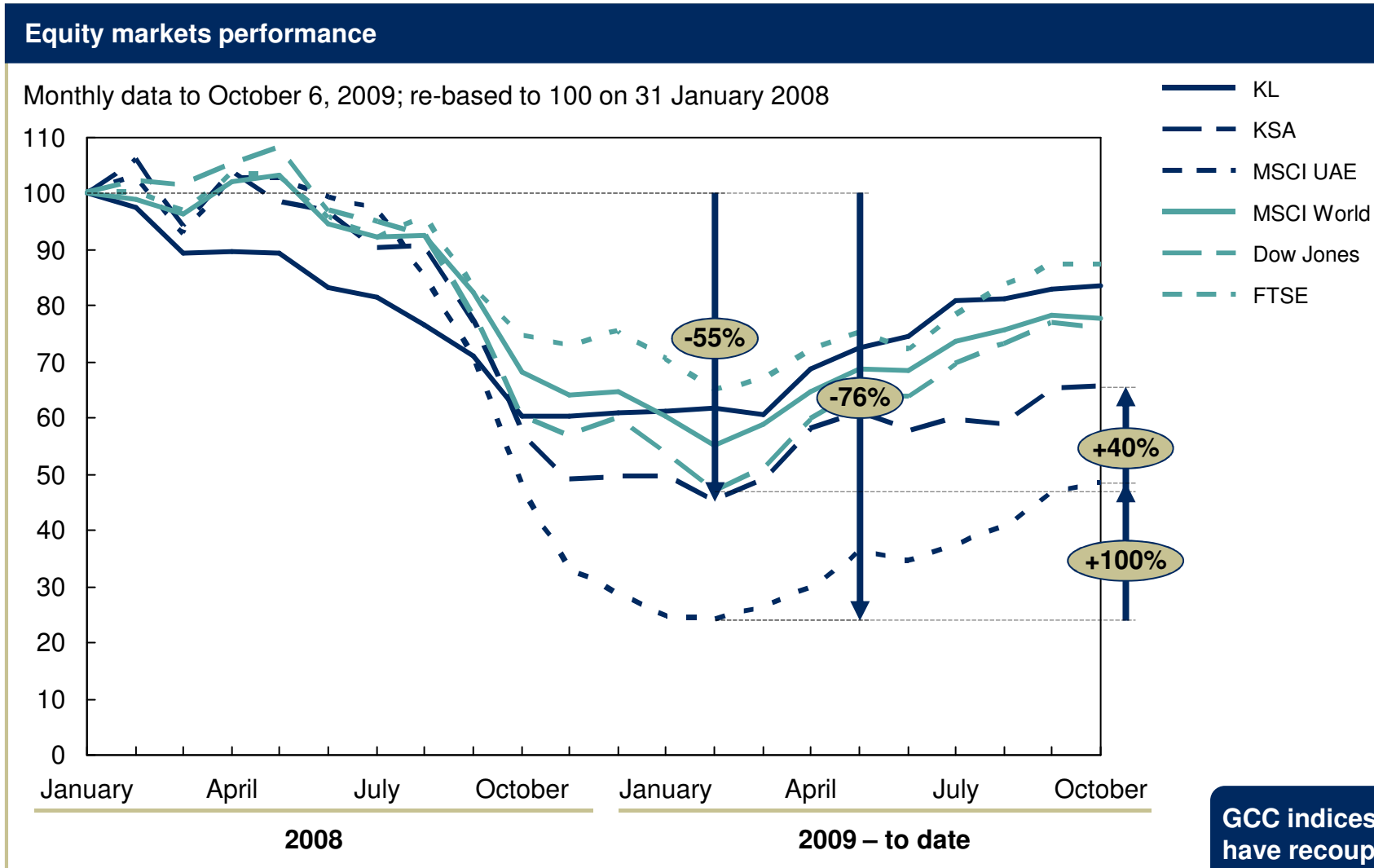
ILLUSTRATIVE

Issues faced by Islamic Banks	
Sources of liquidity	<ul style="list-style-type: none">• Islamic banks face challenges in funding across all maturities. Central banks have helped with short term instruments for liquidity, but the mid-long term problem remains significant• Liquidity constraints were worsened as customer deposits have shrunk; foreign interbank funds have declined considerably and commercial paper issuance has reached near zero levels• Issuing MTNs/Sukuk has been increasingly expensive for regional banks as CDS spreads widened
Availability of hedging tools	<ul style="list-style-type: none">• All banks have access to repo facilities in their Central banks but these facilities are limited• Islamic banks are further limited, as there are little/no shariah compliant central bank windows for availing of short term credit• Mark to market securities which could be used in the available repo window have significantly declined in value
Advanced liquidity management infrastructure	<ul style="list-style-type: none">• Islamic banks need improved liquidity management processes/tools, i.e.<ul style="list-style-type: none">– Improved ability to predict market liquidity– Increased sophistication in liquidity modelling & regular stress testing– Bank-wide gap limits and funding concentration limits

4 There are 3 models that can be used to execute an international expansion strategy for Islamic banks

Involvement	Model	Typical target market	What does it take to enter this market
	Universal expansion	<ul style="list-style-type: none"> • Countries with large populations and opportunity to grow overall banking segment 	<ul style="list-style-type: none"> • Strong ability to scale up current model • International players are already looking to enter the same space • Regulatory moves have been positive in this direction • Underlying market must be attractive in terms of segment presence, growth
	Niche banking in target countries	<ul style="list-style-type: none"> • Countries with pockets of demand, e.g. Western Europe, USA • Countries with specific requirements to grow specific business lines 	<ul style="list-style-type: none"> • Demonstrated demand by population • Regulatory initiatives to capture Islamic banking share • Sufficient volume of activity in a particular segment – e.g., corporate and investment banking due to rising investment, deal activity
	Joint ventures with existing market players	<ul style="list-style-type: none"> • Countries with well established local players 	<ul style="list-style-type: none"> • Recognized expertise in Islamic banking– e.g., sukuk financing, retail

Equity markets in these key regions have suffered significant declines but have been partially recovering in recent times



GCC indices have recouped fewer losses