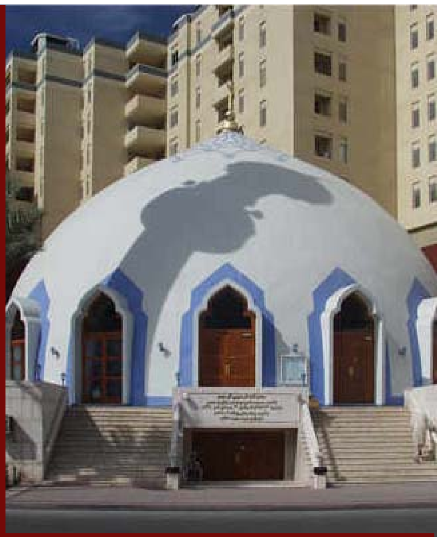
Islamic Finance: What leaders do differently

Lessons learned from Islamic financial institutions in the GCC

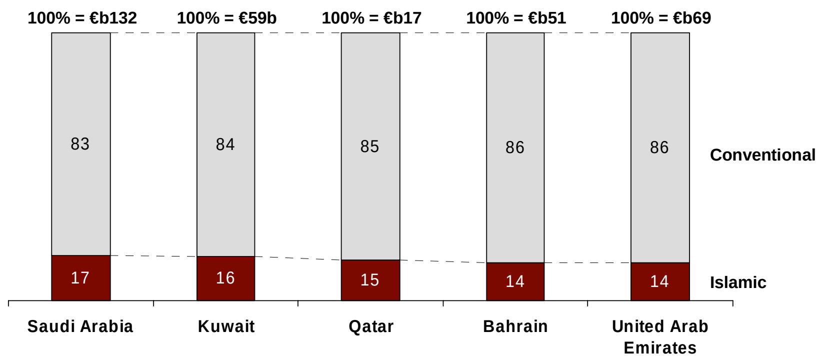


More and more players are entering the Islamic finance market in the GCC, as new Islamic financial institutions are launched and some conventional banks are even converting from conventional practices to those which are Sharia-compliant. With growing competition, the question of how to achieve or keep a competitive advantage in this market is of increasing importance. Therefore, A.T. Kearney has analyzed Islamic finance companies in the GCC and identified best strategic management practices in Islamic finance.

Islamic banks are bound to become a serious threat to their conventional counterparts in the battle for market shares

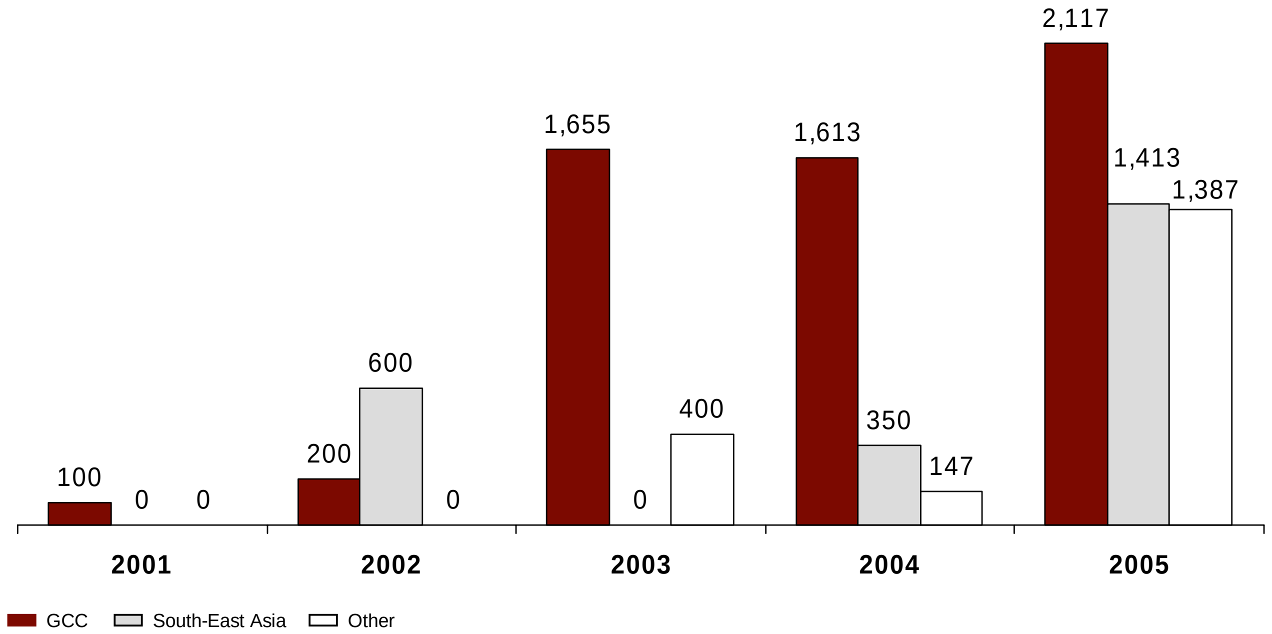
Gaining momentum

Has Islamic finance finally come of age? Although still a niche market (see Figure 1), recent developments in the core markets of Islamic finance – namely the Arab Peninsula and Malaysia – suggest that Islamic banks are bound to become a serious threat to their conventional counterparts in the battle for market shares. The GCC alone have witnessed the foundation of a number of new Islamic financial institutions lately, such as Al Bilad in Saudi Arabia, Al-Rayan Bank in



Source: Bankscope; A.T. Kearney analysis

Figure 1: Banking Assets Market Share – 2004 (%)



Source: LMC; A.T. Kearney analysis

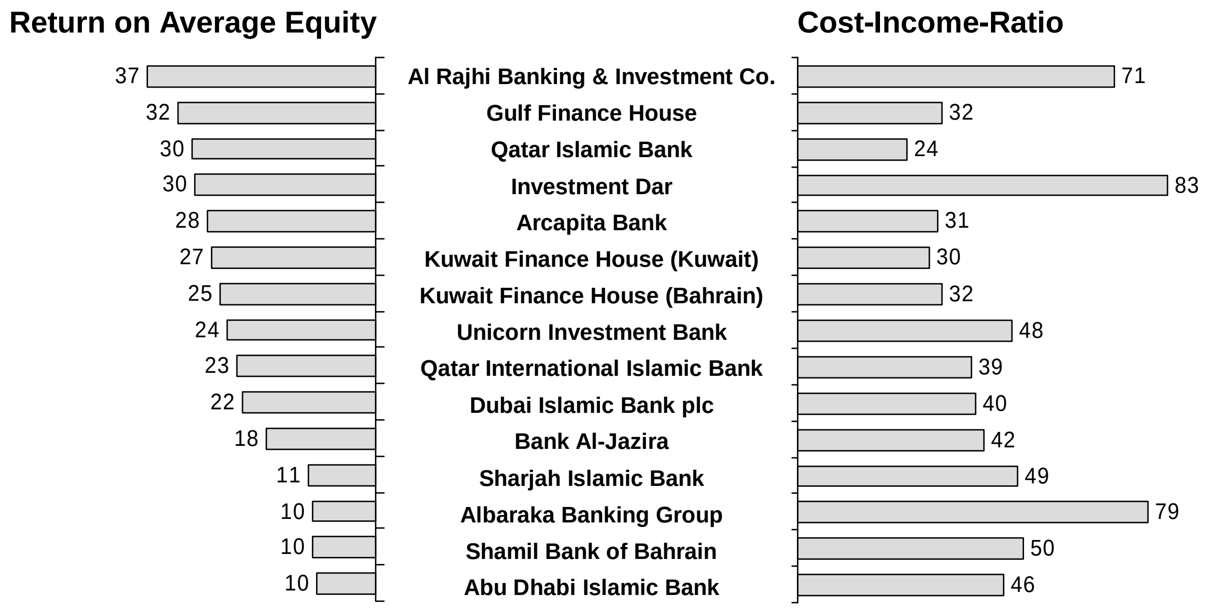
Figure 2: Yearly Sukuk Issues – 2001-2005 (US$m)

Qatar, Boubyan Bank in Kuwait or Yazi Bank in Bahrain. Just recently, investors have announced the set-up of Al Masref, the world's largest Islamic bank to-be with an initial capital of $5 billion. Besides, more and more conventional banks are entering the Islamic finance market. Some are starting up Islamic financial institutions – for example, in the United Arab Emirates, RAK Bank has applied to the UAE Central Bank for permission to set up an Islamic finance company, while Mashreqbank has already been granted approval. Others are even fully converting from conventional practices to those which are Sharia compliant. In the United Arab Emirates again, the National Bank of Sharjah has become Sharjah Islamic Bank, the former Middle East Bank is now known as Emirates Islamic Bank and Commercial Bank International has been granted regulatory approval to go Islamic. Even the largest bank in the GCC, National Commercial Bank of Saudi Arabia, opted to convert its retail operations.

With an increasing number of players in the market, competition is bound to intensify

What is more, major banking client companies are beginning to carry out all their financing activities on Sharia compliant principles: for example, UAE's Dana Gas, a leading regional natural gas company, announced to conduct all of its treasury management, fund investment, depository and accounting activities in accordance with Islamic jurisprudence. Likewise, Sukuk or Islamic bonds are becoming increasingly important in the region as a major long-term debt instrument in corporate finance (see Figure 2). It is therefore not surprising that market observers predict that Islamic banking will continue to grow at about 15% to 20%.

Yet, with an increasing number of players in the market, competition is also bound to intensify. There are already marked performance differences across Islamic financial institutions (see Figure 3 for the GCC). While a greater rivalry in the market will affect both newcomers and established players, the challenges may differ. For instance, traditional full-fledged Islamic financial institutions may have a higher reputation for being truly Islamic



Source: Bankscope

Figure 3: Islamic Bank Performance GCC – 2004 (%)

than conventional banks entering the scene, but may lack economies of scale. On the other hand, conventional banks wanting to enter Islamic banking may have a competitive edge due to their financial expertise and state-of-the-art banking operations, but may struggle to even get the basics of Islamic banking right in order to obtain an Islamic banking license.

With growing competition, the question of how to achieve or keep a competitive advantage is of increasing importance for all participants in the Islamic finance market. Therefore, A.T. Kearney has analyzed Islamic finance companies in the GCC in order to identify best strategic management practices in Islamic finance. The study covers 25 Islamic financial institutions from the GCC, representing approximately 80% of the estimated total on-balance sheet Islamic banking assets in the region. In this paper, we will highlight some of the areas where leaders distinguish themselves from the rest – along the lines of strategy, organization and processes, and resource endowments.

Winning strategies

Leading companies in Islamic finance are moving away from the traditional product focus to a customer focus, which is reflected in the major emphasis they put on marketing, service quality and customer service (see Figure 4). Marketing strategies employed are geared towards building up reputation – both as a financial services provider and as an Islamic company – as well as developing a positive brand image – all areas, where leaders rank significantly higher than their competitors. It is interesting to note in this context, that the reputation of the Sharia board can be an important element in the overall reputation of the company as an Islamic company. Islamic banks should therefore take special care in the selection of their Sharia board members. It may not be a coincidence that a small group of highly reputed Sharia scholars is shared by a number of firms. Of course, the reputation as Islamic company may potentially also be strengthened through such means as corporate design or corporate language. In the long term, a good reputation and brand image of the bank are an indication of high customer satisfaction, which can only be reached if banks deliver on their promises. This puts leaders in stark contrast to the often lamented poor service quality in Islamic banking.

Besides customer focus, leaders put particular emphasis on product innovation, product design and quality as well as product standardization. This result is unsurprising, as both product innovation and standardization are hot topics among Islamic finance practitioners. It is telling, though, that leaders are putting considerably more effort into this than their competitors.

Leaders are also more focused than their counterparts, concentrating on a few customer segments only. Finally, discounting is avoided in the industry, with leaders being even more reluctant to use it than followers.

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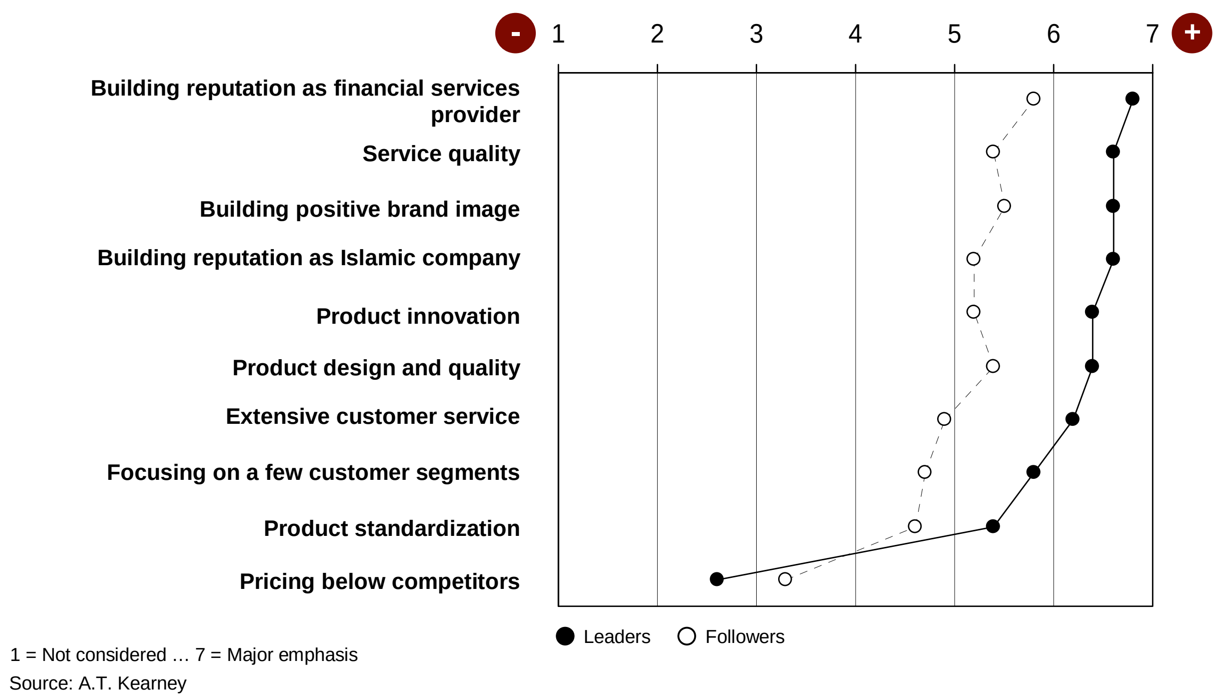
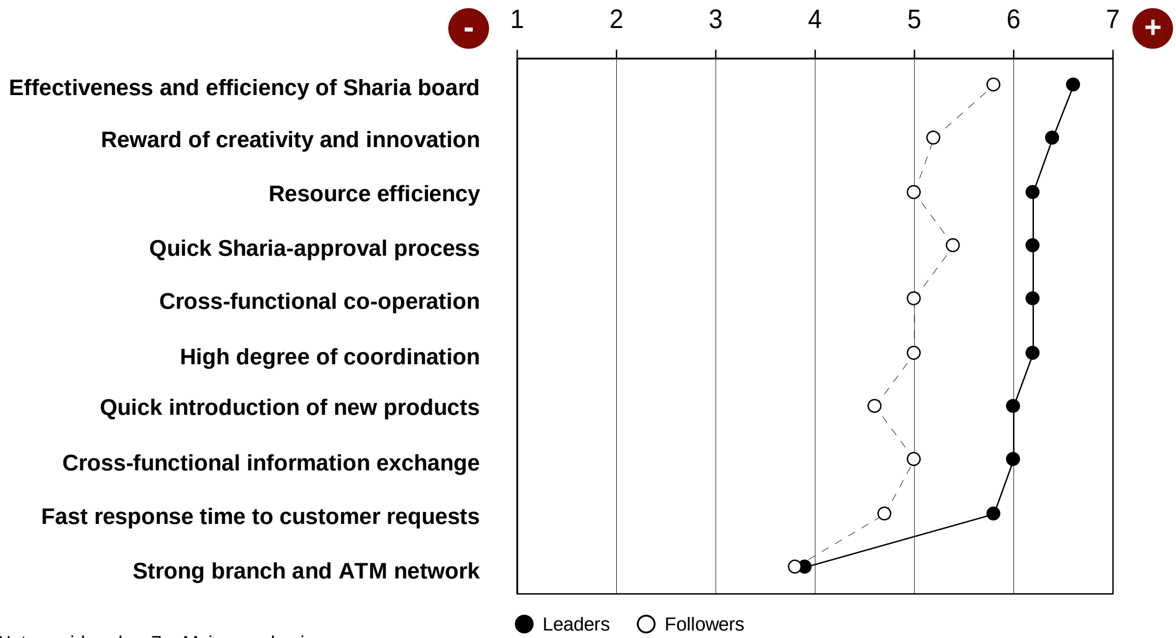


Figure 4: Strategy (Selection)



1 = Not considered … 7 = Major emphasis
Source: A.T. Kearney

Figure 5: Organization and Processes (Selection)

Agile organizations and efficient processes

In order to support the customer-focused strategy, leaders are fostering an agile and responsive firm culture, backed by efficient processes and resources (see Figure 5). The former relates to the organization and the self-conception of the firms, and includes rather soft, behavioral factors. Among these factors are reward of creativity and innovation, cross-functional co-operation, high degree of coordination and cross-functional information exchange. The latter encompasses both general efficiency factors – for example resource efficiency, processes enabling quick introduction of new products, or processes enabling fast responses to customer requests – as well as efficiency and effectiveness of the Sharia board and the Sharia approval process. This means that Islamic financial institutions have to find the right balance between two seemingly contradictory requirements:
On the one hand, the Sharia approval process must be fast, which, by the way, corresponds with the above-mentioned observation that leaders respond fast to customer requests. On the other hand, Sharia compliance may entail a thorough, rather time consuming process. Obviously, further standardization of rules and regulations as well as products and

Sharia rulings can have a considerable impact on the competitive situation of a bank, as they determine which products will be offered

services will alleviate the effects of this task.
Both, leaders and followers, state that they are relatively weak in their branch and ATM network. This might put them in a competitive disadvantage compared to conventional banks, but it also provides an opportunity for further improvement to both.

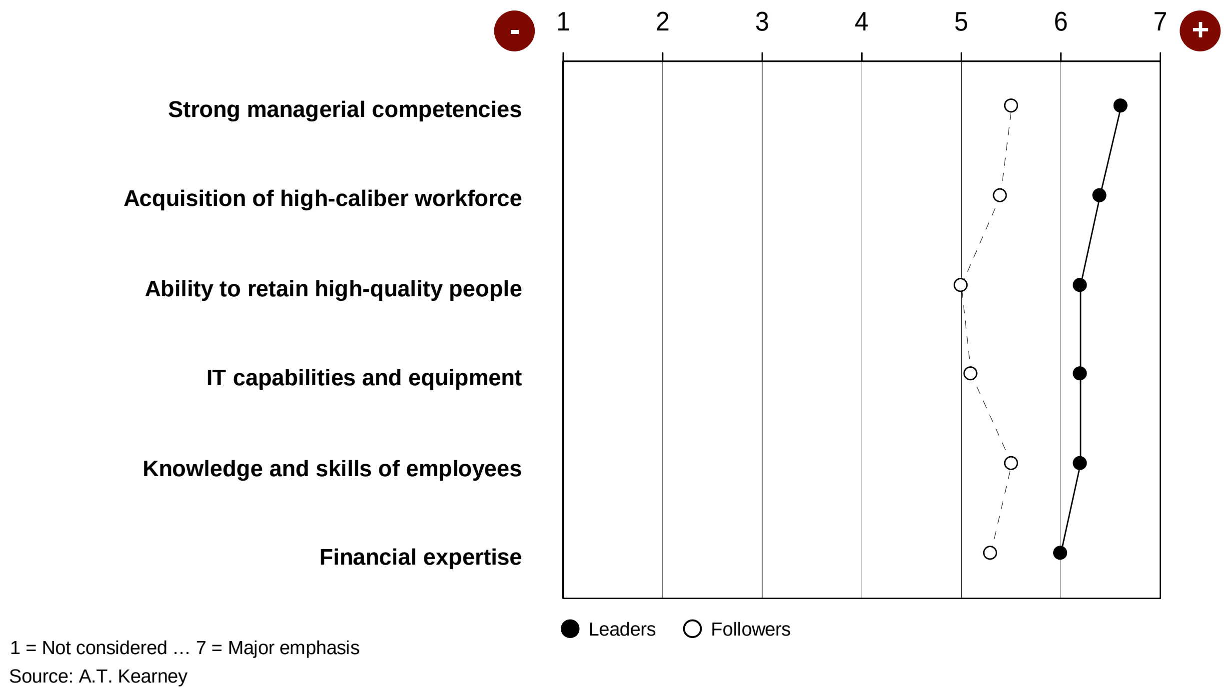


Figure 6: Resource Endowments (Selection)

Ensuring the right resource endowment

Leaders also distinguish themselves from the rest in terms of their resource endowments, in particular human resources, where a high-caliber workforce rates high, but also managerial competencies, knowledge, skills and financial expertise. Another significant factor is IT capabilities and equipment, which leaders again put more effort into than others because Islamic financial products entail specific requirements and applications need to be Islamic-banking compliant.

How to get there

What can Islamic banks do to close the gap to the leaders? The analysis implies three development areas:

Understand your customer:

Islamic financial institutions need to select market segments to compete in and gain a better understanding of customers in order to develop products and services that address customer needs. Besides religious aspects, competitive returns and services are bank selection criteria of many Islamic customers. Therefore, Islamic banks should understand customer's preferences with respect to Sharia compliance versus superior returns and services. This deeper understanding of customer preferences will differentiate Islamic banks from their conventional competitors.

Adapt your organization and processes:

Islamic financial institutions should design their organization and processes to enhance service quality. Emphasis should be on turnaround time and customer experience, as Islamic financial services companies compete on differentiation rather than price. They also have to set up their Sharia board and approval process in a way that fosters innovation and enables timely launch of new products.
Sharia compliance must also be taken into account when the organization is designed. Take the example of a conventional bank targeting Islamic banking: the creation of an Islamic window entails less implementation effort than the creation of a full-fledged subsidiary, but might make it harder to gain regulatory approval or be accepted by customers. In fact, most banks create a full-fledged subsidiary, which covers all customer-facing activities.
In the case of Islamic retail banking, the branch and ATM network should be expanded to increase customer convenience, as the networks of Islamic banks as yet are relatively weak compared to their conventional counterparts.

Enhance your resource endowments:

In order to support an enhanced service quality and customer experience, Islamic financial institutions need to put particular emphasis on staff qualification.
This can be done by training of current staff as well as by attracting high-caliber new resources from competitors or business schools. The options need to be carefully considered, given the scarcity of qualified human resources in Islamic banking. An HR strategy also needs to take into account employee nationalization policies, e.g. in the UAE.
Islamic banks also need to develop an IT environment which is conducive to their Islamic banking-specific requirements. This is of particular importance for established market players wanting to enter the Islamic finance market, as they decide whether to adapt their current systems or introduce a new system specifically for their Islamic banking business.

> *Islamic banks have to work on three areas to close the gap*

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