

Islamic finance

Building 150 financial institutions by 2020

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The gap in 'access to finance' in the Muslim world creates attractive banking opportunities with positive development effects – which can be addressed by Islamic finance

Executive summary

Muslims make up roughly one-fifth of the world's population and live in every continent. Yet, in many countries with significant Muslim population, economic growth and development are hindered by a lack of institutions that can finance the private sector.

The problem is compounded by the preference of Muslims for Shari'ah-compliant institutions. An estimated 70% of the 1.5 BN Muslims do not have access to basic financial services.¹

Despite enthusiasm for Islamic finance, the industry remains small. According to our own estimates, Shari'ah-compliant assets represent 1% of global financial assets. However, the market has been growing at over 30% annually since 2000 and is set for continued growth. We estimate that there is demand for at least 150 new financial institutions in the Muslim world. This can come from establishing Islamic windows at conventional institutions, converting existing conventional banks, or creating entirely new Islamic financial institutions.

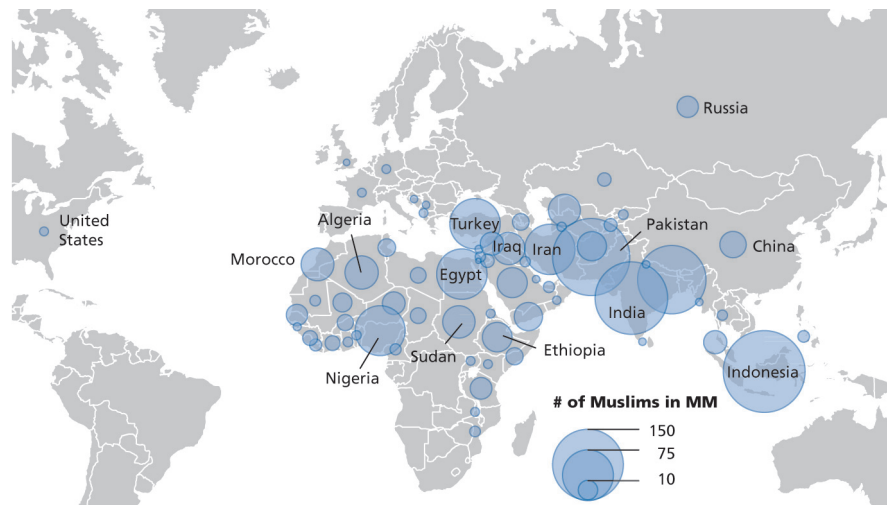
Many players have already made large strategic investments in this space, positioning themselves to take advantage of the significant growth opportunities available in the Muslim world. However, given the size of the buildout required, the most successful entrants will be those that adopt a structured approach to institution-building so that it can be scaled up across segments, sectors and geographies.

¹ World Bank data

The Muslim world: poverty and slow development

“Muslim world” is a broad term. Most Muslims live in a geographic belt spanning across 70 countries from Morocco to Indonesia, comprising approximately 25% of the world’s population. More than 60% of the global Muslim population is located in Asia and about 20% is in the Middle East and North Africa.²

Exhibit 1: Global distribution of the Muslim population³



Despite their geographic and cultural diversity, most Muslim countries are relatively poor. As exhibit 2 shows, over a third rank in the bottom quartile of comparative economic development statistics⁴.

² The PEW Forum on Religion & Public Life, Mapping the Global Muslim Population, October 2009

³ The PEW Forum on Religion & Public Life, Mapping the Global Muslim Population, October 2009

⁴ World Bank data

Exhibit 2: Number of OIC⁵ member countries in the bottom quartile of countries⁶

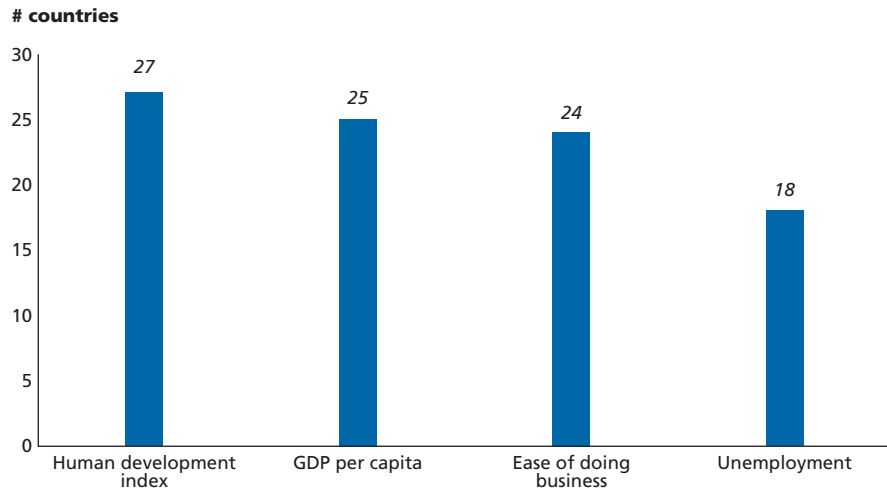
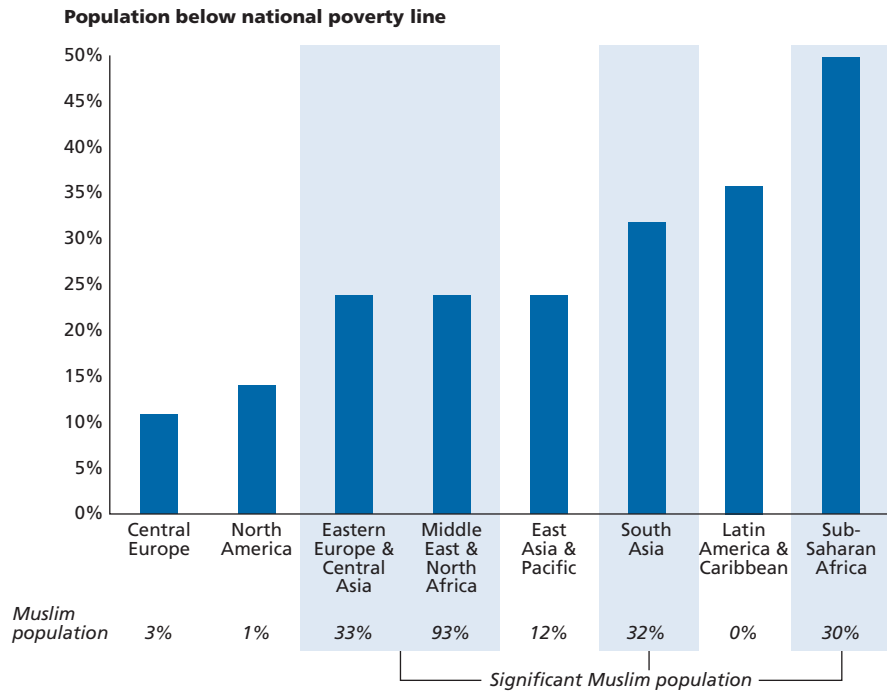


Exhibit 3: Poverty by region⁷



⁵ The Organisation of the Islamic Conference (OIC) is the second largest inter-governmental organisation after the United Nations and has membership of 57 states. The Organisation is the collective voice of the Muslim world and ensures to safeguard and protect its interests

⁶ World Bank and Oliver Wyman analysis; GDP per capita calculated via purchasing power parity

⁷ World Bank data and Oliver Wyman analysis

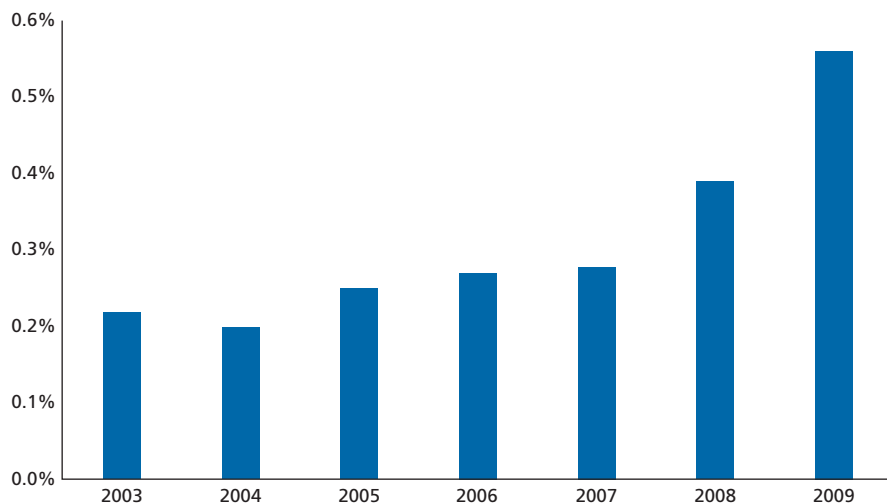
Marhaba⁸ Islamic finance

Economic development in the Muslim world is constrained by a lack of access to finance, with an estimated 70% of the 1.5 BN Muslims without access to basic financial services⁹:

- In the 56 member countries of the Organisation of the Islamic Conference (OIC), only 28% of the adult population uses formal financial intermediaries
- Less than 50% of adults in Muslim countries in Sub-Saharan Africa have a deposit account. In developed countries the number of accounts exceeds the number of people by far
- Africa and South Asia have less than 10 (and in a significant number of countries even less than five) branches per 100,000 adults (in developed markets this number is higher than 20)

This shortage of financial institutions is compounded by the preference of Muslims for Shari'ah-compliant banks. Many Muslims will only bank with Shari'ah-compliant institutions, but as exhibit 4 shows this market is underdeveloped.

Exhibit 4: Islamic share of total financial assets globally¹⁰



⁸ "Hello" or "Welcome" in Arabic

⁹ CGAP, Financial Access 2009

¹⁰ Bankscope data, annual reports and Oliver Wyman analysis

Islamic finance has significant growth potential and provides a possible solution to financial exclusion and economic under-development in the Muslim world.

Banking clients are willing to pay a premium for Islamic banking services, and a majority of Muslim customers who currently use conventional banking products claim that they would switch if Islamic products were available.

Exhibit 5: Examples – Preference for Islamic financial products in the Muslim world

Survey	Country	Year	Result
PlaNet Finance	West Bank and Gaza	2007	<ul style="list-style-type: none"> More than 60% of low-income respondents prefers Islamic products over conventional products More than 50% of these respondents would even pay a higher price
IFC	Indonesia	2000	<ul style="list-style-type: none"> More than 45% of the rural population of East Java prefers Islamic products
IFC	Syria	2007	<ul style="list-style-type: none"> More than 40% considers religious reasons as main obstacle to obtaining microcredit
National Microfinance Foundation	Yemen		<ul style="list-style-type: none"> Estimated 40% of low income population demands Islamic products regardless of price
IFC/FINCA	Jordan	2006	<ul style="list-style-type: none"> More than 30% of respondents cites religious reasons for not taking out conventional loans More than 18% of respondents named religion as the most important factor in their financing decisions
Frankfurt School of Management	Algeria	2006	<ul style="list-style-type: none"> For more than 20% of microenterprises religion is the primary reason for not taking out a loan
USAID	Jordan	2002	<ul style="list-style-type: none"> More than 20% of respondents cites religious reasons for not taking out conventional loans

This appetite for Islamic financial products is based on customers' "identification" with the key principles of Islamic finance:

- **Direct link to the real economy and physical transactions:** All Shari'ah-compliant transactions must fulfil a "productive" and "constructive" purpose, meaning that all financial products must be based on the exchange of real and tangible assets.
- **Prohibitions against harmful products and activities:** Islamic financial institutions may not offer financial support for ethically controversial activities such as gambling, speculation or trading exotic derivatives in intangibles such as weather.
- **Promotion of economic and social justice:** To meet the condition of productivity, Shari'ah-compliant products cannot charge interest. The price for Islamic financial products and services includes the usual zakat¹¹ to support non-profit activities for the redistribution of income and growth.

¹¹ Zakat or "alms giving" is the giving of 2.5% of one's possessions (surplus wealth) to charity, generally to the poor and needy

Despite the strong demand for financial services in the Muslim world, growth of Islamic finance has been slow and will remain so if the unique challenges in establishing Shari'ah-compliant institutions are not addressed. Islamic financial institutions face major issues in operationalising their strategy, largely as a result of the distinctive structure of Islamic financial products.

Exhibit 6: Major challenges for Islamic finance

Challenges	Causes	Mitigations
Availability of profit and loss sharing agreements	<ul style="list-style-type: none"> ■ Increasing demand of young Muslims for Shari'ah compliance in daily life¹ ■ Requires stronger asset/liability management and better asset management capabilities ■ Requires more legal structuring in line with Shari'ah ■ Cost-plus-profit (CPP) products are controversial because mark-up is often bound to interest rates² ■ Regulatory framework often required as it goes against many central banks that want deposits to be guaranteed 	<ul style="list-style-type: none"> ■ Develop risk and rewards sharing products ■ Improve risk management capabilities to mitigate increased risk of profit and loss sharing agreements
Standardisation of Shari'ah, regulatory and accounting principles	<ul style="list-style-type: none"> ■ Unfavourable legal environment for Islamic finance in many countries in the Muslim world ■ Lack of internationally accepted reporting and accounting principles ■ Many Islamic products currently sold are basically conventional products adapted to simulate Shari'ah compliance 	<ul style="list-style-type: none"> ■ Open discussions on a government level in countries where legal and regulatory challenges exist ■ Increase effort to harmonise reporting and disclosure standards across jurisdictions ■ Develop basic criteria to standardise Shari'ah compliance³
Operational expertise and efficiency	<ul style="list-style-type: none"> ■ Shortage of experienced staff ■ Brain-drain from the Muslim community ■ High volume of manual contracts 	<ul style="list-style-type: none"> ■ Increase recruiting efforts and develop succession planning ■ Invest in Islamic finance research, education and training capacity
Product innovations and risk infrastructures	<ul style="list-style-type: none"> ■ Demand for innovative Islamic retail, housing and project finance products ■ High risk of profit and loss sharing agreements for banks ■ Exposure to non-credit related risks of conventional banking ■ IT infrastructure and service models are often based on adapted conventional systems rather than fit for purpose 	<ul style="list-style-type: none"> ■ Strengthen risk management capabilities and infrastructure ■ Improve governance structures ■ Implement state-of-the-art IT systems ■ Develop innovative risk mitigation products, enhancement structures and basic derivatives

¹ Financial news, Firms get ready for a surge in demand for Shari'ah-compliant investments, 21 June 2010

² Nadia Mavrikis, Islamic Finance – A vehicle for economic development, May 2009

³ IFSL Research, Islamic Finance 2008, January 2008

How many more institutions?

How big is the gap in financial institutions to meet the demand for Shari'ah-compliant banking? We use a bottom-up approach to estimate the size of the gap in terms of number of financial institutions.

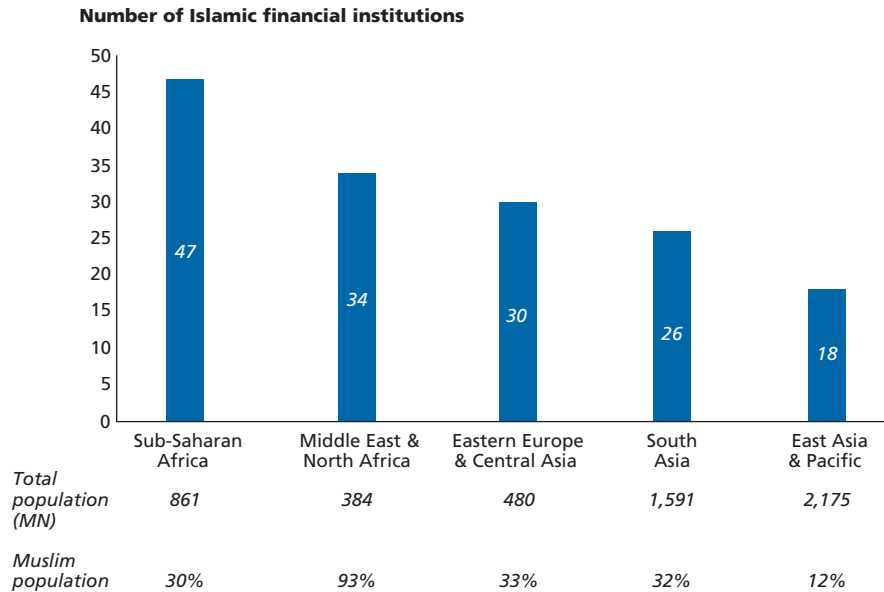
- 1. Growth potential of the financial sector in less developed countries:** Banking assets per capita were used as an indicator of the maturity of a country's financial sector. Malaysia is a good example of a developing country with a mature conventional and Islamic financial services sector, with banking assets of approximately US\$32,000 per capita. For this analysis, assets per capita of under-developed countries are assumed to grow to Malaysian levels. Total asset growth was limited to a maximum of 20% from current levels over the next 10 years, or a 4% annual increase in total banking assets.¹²
- 2. Number of institutions required to fill the gap:** Growth in the total market will come from a mix of existing and new institutions. Assuming that one third of the increase in banking assets comes from "natural growth" of existing financial institutions, the remaining two thirds of the increase in financial assets comes from new market entrants.¹³
- 3. Share of Islamic financial institutions:** In the long run, the composition of the financial services landscape in each country is likely to move toward the Muslim population distribution. The estimate of Islamic financial institutions accounts for the fact that, in Muslim countries with low Islamic financial services penetration, Shari'ah-compliant institutions will need to grow faster.

According to our estimates, around 150 additional Islamic financial institutions will be needed globally to satisfy the increasing demand for access to financial services. We estimate that the majority (135) of new Islamic financial institutions are needed in the Muslim world, and the remaining Islamic institutions need to be established in countries with a Muslim population of less than 10%.

¹² New Islamic institutions were assumed to be of equal or smaller size relative to existing institutions in each country

¹³ The average size of existing institutions in each country was used as a cap for the growth of new players in the market

Exhibit 7: Demand for Islamic financial institutions¹



¹ Regions based on World Bank definitions. Latin America and Caribbean are excluded due to lack of data

- Sub-Saharan Africa has the largest 'room to grow' in Islamic finance due to the underdevelopment of its banking industry
- The demand of Islamic financial institutions in the Middle East and North African region alone amounts to 25% of the total Islamic financial services gap
- Eastern Europe & Central Asia and South Asia also show a sizeable gap between the supply of and demand for Islamic financial services

What next?

As institutions formulate their strategies in the Islamic finance market and turn to institution-building, they will need to consider three strategic factors: market positioning, country prioritisation, and target operating model.

Financial institutions can offer Islamic products in four broad ways.

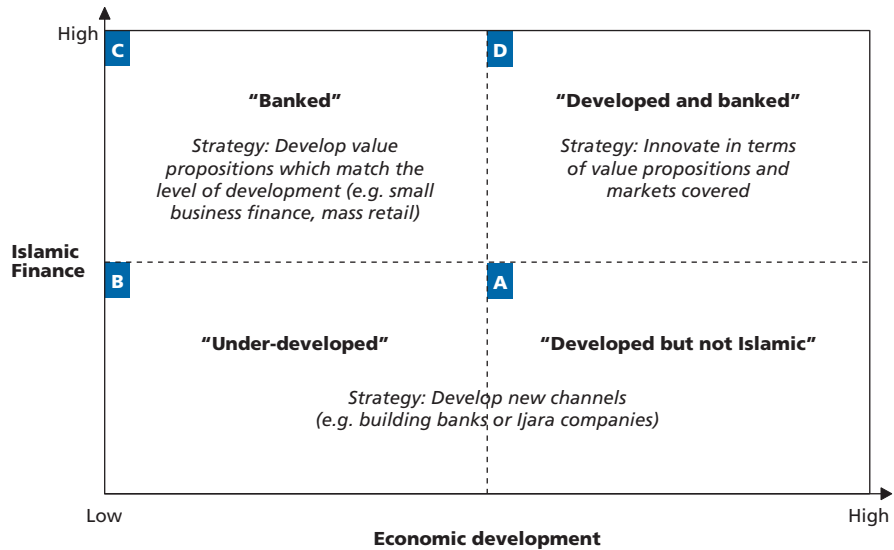
Exhibit 8: Islamic finance channels

Mechanism	Description	Pros	Cons
Islamic windows	<ul style="list-style-type: none"> ■ Segregated Islamic department within a bank without connection to conventional banking activities <ul style="list-style-type: none"> – Separate sales channel of conventional banks for Islamic products – Lines of finance from Islamic to conventional banks ■ More common in Southeast Asia than Middle East 	<ul style="list-style-type: none"> ■ Rapid market entry ■ Separated from conventional operations ■ Segmentation approach possible ■ Test phase strategy 	<ul style="list-style-type: none"> ■ Organisational duplication in order to comply with Shari'ah ■ Reputational risk of acting against Shari'ah principles ■ Limited product suite (deposits, trade finance products) due to entity size
Conversions	<ul style="list-style-type: none"> ■ Transition of existing conventional banks to Shari'ah-compliant institutions <ul style="list-style-type: none"> – Take over or majority stake of Islamic investors – Changing market competition ■ More common in Middle East and Africa 	<ul style="list-style-type: none"> ■ Leverage of existing customer base and infrastructure ■ Phasing approach possible ■ Lower investment necessary than for Greenfields ■ Suitable for countries with regulatory restrictions (e.g. no new banking licenses) 	<ul style="list-style-type: none"> ■ Risk of losing customers ■ Demand for staff with Islamic and conventional banking knowledge ■ Conversion of existing balance sheet (e.g. outstanding loans) necessary
Greenfields	<ul style="list-style-type: none"> ■ Investments in Islamic financial institution start-ups <ul style="list-style-type: none"> – Fully Islamic business model – Solely Shari'ah-compliant funds ■ Stabilisation of the local financial services sector through diversification 	<ul style="list-style-type: none"> ■ High potential future financial returns ■ Attractive option in immature Islamic banking markets ■ Economies of scope and concentration of knowledge and expertise 	<ul style="list-style-type: none"> ■ Riskiness and illiquidity of start-up investments ■ Long investment horizon ■ Long grace periods without financial returns
NBFIs	<ul style="list-style-type: none"> ■ Other types of financial intermediaries <ul style="list-style-type: none"> – Islamic MFIs and Ijara companies – Takaful (insurance) – Asset management and investment funds – Financial exchanges ■ Usually more complex products 	<ul style="list-style-type: none"> ■ Option for highly developed Islamic financial system (i.e. Malaysia, Gulf) ■ Achievable in countries with regulatory restrictions for Islamic banks (Ijara companies and MFIs) ■ Fast market entry strategy ■ Effective vehicles for foreign direct and South-South investment flows 	<ul style="list-style-type: none"> ■ Highly dependent on a country's legal structure (especially sukuk¹⁴ and special purpose vehicles)

¹⁴ A Sukuk is a financial debt certificate that complies with Shari'ah laws. Investors can buy the certificate and subsequently rent it back to the issuer for a fee.

The appropriate market entry strategy will differ according to the level of development of the domestic Islamic Finance sector and the degree of domestic economic development. Countries with developed economies should focus on harnessing existing channels to become Shari'ah-compliant, while less developed economies should focus on Greenfield development and opportunities to expand into new retail or SME customer segments.

Exhibit 9: Alternative strategic positions in the market



A. Developed but not Islamic (e.g Turkey): Islamic banks

Institutions should establish Islamic Windows, new Islamic financial institutions and set-up Islamic funds as their channels. They should target the existing Islamic retail market (Mass, Affluent, HNWI) and develop a new offering for Islamic wholesale and investment banking. In countries where the legal or "enabling" environment is not favourable, they should work with development banks to promote Islamic finance.

B. Underdeveloped (e.g. most west African countries): Cooperation between Islamic and Development Banks

New channels, such as banks, Ijara (leasing) companies or MFIs, are needed. The mass market and SME finance should be targeted and the enabling environment for Islamic finance must be developed.

C. Banked (e.g. Sudan): *Conventional and Islamic banks*

Financial institutions should develop alternative channels and expand their current product offering (e.g. infrastructure finance). They should target untapped markets, such as providing SME finance.

D. Developed and banked (e.g. Saudi Arabia): *Islamic banks*

Focus in these countries should be on product innovation (e.g. wealth management, investment banking products). Additional customers can be reached through regional expansion (south-south integration¹⁵) and the markets can be used as a source of funding.

The opportunity is large and we expect successful players will adopt a structured approach to institution building. Many examples of rapid institutional build-out already exist in the financial services industry. For example, ProCredit has created a group of 19 banks operating in transition economies in Africa, Latin America and Eastern Europe. Their model is that of a holding company acting as a catalyst to form new banks by establishing a start up subsidiary that has access to general banking resources.

Given the number of opportunities, successful growth will come from multiple factors (proven methodology, appropriate tools, adequate human resources...) and will start by a thorough understanding of profit pools and competitive dynamics. Without this knowledge, players run the risk to lose focus and to misallocate scarce resources.

¹⁵ South-south integration includes mobilising financing, promoting foreign direct investment or establishing trade linkages from one developing country to another

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