

Islamic Banking Experiencing Rapid Growth

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Islamic finance, or financial services that conform to the tenets of Islam, offers a potential market of 1.5 billion Muslims that should continue to offer opportunities for foreign and domestic banks. In the last five years, Islamic finance has grown by 15 to 20 percent annually, with an estimated \$270 billion in assets controlled by approximately 300 Islamic banks in more than 25 countries.^{1,2} Considering both a country's Muslim population and per capita income, the largest markets for Islamic finance include Turkey, Indonesia, Saudi Arabia, the United States, and France. The fastest growing markets are Malaysia, Bahrain, the United Arab Emirates, Indonesia, and Pakistan.

The potential for continuous growth in the Islamic finance sector is significant, with some estimates suggesting that within eight to ten years as much as half the savings of the world's 1.5 billion Muslims will be in Islamic banks. This could represent \$905 billion in total assets in Middle Eastern countries alone.³ Muslims living outside of the Middle East, represent an even larger population, including countries such as India, Indonesia, and Malaysia, but also within developed countries including the United Kingdom, France, Germany, the Netherlands, and the United States.

Islamic banks face several important barriers to becoming competitive with conventional banks. Currently, Islamic finance instruments are more expensive, less service oriented, and not as responsive to innovation. These disadvantages could hold important implications for developing consumer markets and financing trade in Muslim countries.

Historically, Islamic finance fostered trade and business activities in the Muslim world throughout the Middle Ages,⁴ but only emerged as a competitor with traditional banking with the abundance of petrodollars in the mid 1970s.⁵ More recently, a second resurgence in oil prices, an increase in the variety of *Sharia*-compliant products,⁶ and the preference for many Muslims to invest and travel locally and regionally have revived the sector.

Rather than charging interest, Islamic financial institutions will typically share some of their borrowers' risks and profits.⁷ (A bank's profit from a 'loan' will vary with the borrower's profits from the application of the loan to new business activity.) Islamic finance also avoids speculation (e.g., reliance on the occurrence of events that may or may not take place),⁸ and investing in ventures that may have components that are not in line with the values of Islam (alcohol, gambling, drugs and tobacco).⁹ Still, although Islamic financial principles may differ from those of conventional banks, in practice many differences tend to be negligible, and Islamic financial products look a lot like conventional mortgages, leasing, and business lending. *Sharia-*

¹ *Global Finance*, September 2005.

² Estimating the size of this market is complicated by the rapid growth across several markets and untangling assets that are frequently included in both Islamic and conventional accounts within a single bank.

³ Conventional financial institutions manage \$1.1 trillion in Islamic funds. *Khaleej Times*.

⁴ *Institute of Islamic Banking and Insurance*, web site.

⁵ *Institute of Islamic Banking and Insurance*, web site, *International Herald Tribune* 9/20/05.

⁶ Donald Greenless. "Banking in Accordance with the Koran, Greenless, *International Herald Tribune*. 6/2/2005.

⁷ *Khaleej Times*.

⁸ W. Caffey Norman and Simon Schmidt. "Principles of Sharia' in Islamic Finance and Their Application for Western Investors." http://www.menabusinessguide.com/04_mena/086_090.htm (last accessed 1-8-2007).

⁹ *Khaleej Times*.

compliant financial products have expanded to include bonds, mutual funds, and insurance, traditionally an area of great debate among *Sharia*-compliant financiers.¹⁰

The growth of Islamic finance has helped to diversify markets and institutional structures, particularly in oil-rich Muslim countries, but also in countries with large Muslim minorities. Islamic banks operate in countries that have adopted Islamic *Sharia* principles (e.g. Iran, Pakistan, and Sudan), Muslim countries with both Muslim and conventional banks, and in developed countries side-by-side with conventional banks.¹¹

In the United States, particularly in California, New York, and Michigan, Islamic finance has also grown rapidly. There are an estimated six million Muslims in the United States and about one-third of the 1.8 million households desire Islamic financing, especially for home mortgages. Banks in the United States generated nearly \$300 million in revenue from Islamic financing in 2004 and approximately \$450 million in 2005, including \$300 million in Islamic mortgages.¹² Jonah Blank, "The Muslim Mainstream Islam is Growing Fast in America, and its Members Defy Stereotypes. U.S. News and World Report. July 1998.

The make-up of the American Islamic finance market is unique, however. Fewer than one out of eight American Muslims is of Arab descent, and the two largest Muslim groups are native-born African-Americans (42 percent) and immigrants from South Asia (24 percent). American Muslims are also very diverse and include an unusually large proportion of highly educated professionals (about 60 percent are college graduates versus less than 30 percent for non Muslims).¹³

Islamic finance has quickly established itself in several markets, but its spread, growth, and ultimately its character, will depend on how it confronts several key challenges, including the general acceptance of Islamic finance, regulatory and soundness compatibility, obstacles to innovation, and other important barriers such as building economies of scale and training professionals in the intricacies of Islamic financial products.

Many potential customers are not clear about what Islamic banking is and how it differs from conventional banking.¹⁴ The strong and increase desire of Muslims to more closely link their investment and lending decisions with their religious views is the key distinction in a market segment that might otherwise suffer from large disadvantages in price, performance, service, and innovation.¹⁵ The willingness of customers to accept added complexity, higher costs, and lower performance in exchange for a closer alignment with religious beliefs will determine the near-term future of Islamic banking.

Licensing and examination are important regulatory concerns that affect developed and developing countries differently. Many Islamic banks have not yet adopted accounting and control systems similar to those used in conventional banks, making it difficult for regulators to adequately determine a bank's internal health and soundness. Some countries permit only 'pure-

¹⁰ *International Herald Tribune* 9/20/05.

¹¹ Karbhari, Yusuf, Naser, Kamal, and Shahin, Zerrin. September-October 2004. Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK. *Thunderbird International Business Review*, Vol. 46 (5) 521-543.

¹² Norris, Kim. 8-6-2005. "Islamic Mortgages: Faith, Finance, Forge New Path."

¹³ Jonah Blank, "The Muslim Mainstream Islam is Growing Fast in America, and its Members Defy Stereotypes." *U.S. News and World Report*. July 1998.

¹⁴ Ainley, M. 1997. "Under a Veil of Regulation." *The Banker*, 147 (860), 73-74.

¹⁵ *McKinsey Quarterly*.

play' Islamic banks, excluding banks that combine an Islamic unit and a conventional banking parent.¹⁶

Another significant problem for developing Islamic banking is keeping pace with investor demand for new and innovative products. Interpretations of Islamic finance often stall new projects, or at the other extreme, risk alienating a bank's client base. The ability of a bank to innovate depends on its capacity to get its products approved by its *Sharia* supervisory council, made up of esteemed scholars conversant in Islam, economics, and finance, who recognize and sanction a bank's compliance with the requirements of Islam.

Islamic banks must overcome other competitive issues if they are to offer competitive pricing and the same innovative advantage as conventional banks. In some countries, market demand for Islamic banking services may never be large enough to warrant the creation of a banks with efficient scale, so national consolidation of existing Islamic banks may not always be a viable solution. Although merging with a conventional bank might be a possible alternative, this could jeopardize the legitimacy and credibility of an Islamic bank's financial products. Finally, the differences in the structure of products across countries – or even from one bank to the next – add to the difficulties of cross-border expansion and back-office outsourcing.

The Islamic finance market is a rapidly growing and dynamic sector. Successfully entering this market will require careful planning, flexibility to change as the sector evolves, and a broad understanding of not only Islamic finance and Islam in general, but the particular region, or sub-population to be targeted by a market strategy. Finally, to best capitalize on the recent and projected growth of the Islamic finance market, U.S. banks should understand how each country's entry strategy complements their overall market strategies for a country.

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¹⁶ Benaissa, Nasr-Eddine, Mayank Parekh, and Michael Wiegand. A Growth Model for Islamic Banking. *The McKinsey Quarterly*, web exclusive, October 2005.