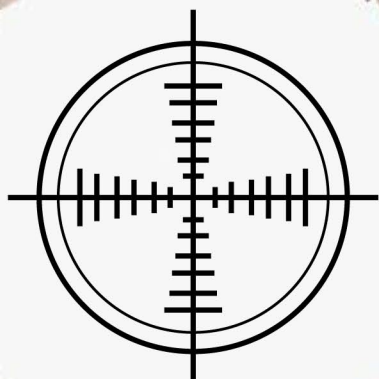


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Retail Banking

INSIDER

INTELLIGENCE TO BANK ON FOR THE GLOBAL
RETAIL BANKING INDUSTRY



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Crisis turns attention to Islamic banking

As the banking crisis claims more victims, eyes are turning to an alternative that has remained relatively unscathed: Islamic banking. In markets such as the US and the UK, where credit has dried up and depositors are questioning the safety of their savings, Islamic banks have the potential to expand beyond their niche and go mainstream. **Jane Cooper reports**

Islamic banks have avoided the toxic assets of the sub-prime crisis because, as interest-bearing instruments, they are *haram*, or forbidden by Shariah law. Unlike their conventional counterparts that are facing liquidity problems, Islamic banks have also avoided the interest-based lending of the interbank market for their funding.

"Essentially, we utilise money from shareholders and from our savings account holders, who, to some degree, are partners in the business," says Steven Amos of the Islamic Bank of Britain (IBB). "On the asset side, we are quite strong because all Islamic finance has to be based on underlying assets. The bank actually has to take ownership of that asset and as part of our home purchase plan we actually go into partnership with the customer with the house."

Conservative underwriting

Naveed Siddiqui, CEO of Zayan Finance, a Shariah-compliant mortgage lender in the US, tells *Lafferty Retail Banking Insider*: "Because we are co-owners, we have to be extremely transparent and conservative in our underwriting standards. It is not that we are not competitive, but our due diligence has to be very thorough."

In the Shariah-compliant home purchase plan, the bank typically purchases the property on behalf of the customer and charges rent – like a landlord – for the portion that the bank owns. The customer also pays an 'acquisition payment' to gradually increase their ownership in the property. When asked how the pricing compares to those who rent a property or have a conventional mortgage, Amos

says that it is competitive and that the Islamic products are benchmarked against mainstream alternatives.

Islamic banks may have avoided bad assets, liquidity problems and defaults, but the changing economic conditions are having an effect. "I think it is fair to say that no bank can claim that they have been immune," says Keith Leach, head of Islamic retail financial services for the Arab Banking Corporation (ABC). "All banks have been affected."

The profit- and loss-sharing model of Islamic finance also means that customers have to share in the bank's losses during an economic downturn.

On the surface, Shariah-compliant savings products are comparable to their conventional counterparts. Amos explains that customers' funds are invested in Shariah-compliant transactions, such as non-precious metals on the London Metal Exchange. "With non-precious metal, there is less chance of fluctuation and risk," explains Amos. The profit between these trades is shared between the customer and the bank at a pre-agreed ratio. The bank announces monthly profit targets, which are around 4 percent for IBB's online savings product.

Leach points out that these products do not strictly function as Islamic profit- and loss-sharing because the customer does not risk losses, as deposits are insured in markets such as the UK. Any deposit-taking institution in the UK is licensed by the Financial Services Authority and would have to sign up to the Financial Services Compensation Scheme (FSCS), which insures against loss to the customer's capital.

Amos acknowledges that there is an element of risk to the capital sum, but the investments are put into low-risk transactions for the savings products. "We say to our customers that in order to be completely 100 percent Islamic, you have to accept an element of risk. However, it is up to the customer's discretion whether they choose – if the worst came to the worst – the option to take the FSCS compensation. It is up to the customer's religious beliefs whether they accept that compensation or not," says Amos.

For non-Muslim customers looking for somewhere to invest their money, the returns on Islamic products may be more favourable, and for this reason they might be interested in choosing these over conventional products. When it comes to home financing, however, non-Muslims might need more persuading to accept the different structure of the product.

Leach says that there are very few non-Muslims in the UK that would be interested in taking out a Shariah-compliant mortgage because they have difficulty accepting that they do not own the property.

Psychological barrier

Michael McMillen, a partner of US law firm Fulbright & Jaworski who works on Islamic finance deals, comments that Americans can accept leasing and buy-backs when it is applied to car finance, but not with home ownership. The psychological barrier is part cultural, he says, because of political drive since the Reagan administration to push home ownership in the US. "People often cringe at the idea of profit-sharing and participation," he adds.

McMillen blames a lack of knowledge and says that Islamic financial institutions could do more to reach out and explain how their products work to non-Muslims. With some effort on the part of the industry, non-Muslims could become accustomed to the idea that the bank – not them – owns their home, he says.

There are also opportunities for financing for non-Muslims, McMillen explains. He argues that in the current climate, many conventional banks are unable to lend to consumers, even those with good credit histories. Those customers may not care whether the finance is Islamic or non-Islamic: "They just want financing," he says, and if there was more awareness of Islamic products, they would be more likely to explore this option.

This is the case in commercial financing, where many construction companies need emergency funds to complete their projects. At present, it is Islamic banks from oil-rich Middle Eastern countries that are servicing this need. The role of Islamic finance in non-Muslim projects has been dramatically increasing, says McMillen. However, because of the political impact of the 9/11 attacks on the US, this Islamic financing in the West has been kept quiet, McMillen argues.

"On the retail side there are tremendous opportunities in the US," comments McMillen.

Efficient acquisition

Siddiqui points to the retail potential within the Muslim community, even before the products are marketed to non-Muslim customers. He says that there are around 1.3 million Muslim households in the market in the US, many of which are untapped: "It is a good, strong credit market, untapped and bankable," he says. Since this segment is already banked, there is an efficient acquisition process; the banks do not have to explain to the customers how banking and financing works.

Siddiqui adds that a Zayan Finance study of Muslim customers in the US found that they have on average 60 percent more deposits in banks than conventional customers. A lack of Shariah-compliant retail banking products means that these customers are borrowing 60 to 70 percent less than regular customers, he says.

The first stage of introducing Shariah-compliant products to non-Muslim customers may come out

of the initial affinity marketing to Muslim communities. Siddiqui says that Muslims in the US come from 45 different ethnicities. As financial institutions tap into the Muslim market, people who may share the same regional – rather than religious – identity become aware of the products. "If there are Indian Muslims, then there are Hindu Indians and Christian Indians as well. If there are Arab Muslims, there are also Arab Christians," he says, explaining that these groups may be drawn to Islamic products if they have good service and ethical standards. "If it is packaged the right way, this is a product for everyone," he says.

Islamic products can be targeted at Muslims and non-Muslims alike, but not everyone can provide for Muslim customers because of the required expertise in Shariah law. While non-Muslim customers may need to adjust to the different structure of Islamic products, non-Muslim mainstream banks would also have to realign their thinking if they were to exploit the opportunities of providing products to the Muslim market in the US or the UK.

One example of a mainstream bank exploring this opportunity is Bank of Ireland (BOI), through its UK division. In a partnership with ABC, the Irish bank launched a Shariah-compliant home finance product in 2004 under the *alburaq* brand. ABC takes care of the marketing and finding the customers, whereas Bank of Ireland UK Financial Services processes and funds the home-purchase product.

While ABC – which has a London base and a parent bank in Bahrain – has expertise in Shariah-compliant banking and access to the UK Muslim market, BOI has the experience in providing retail financial products. A spokeswoman explains that the Irish bank has recognised the opportunities of the Muslim community: there are an estimated 2 million Muslims in the UK, and 5,000 of them are millionaires with combined liquid assets of £3.6 billion (\$6.4 billion).

IBB remains the only fully Shariah-compliant retail bank in the UK. One

advantage of this one-stop shop for all Islamic retail products is that the bank can guarantee to its Muslim customers that both the source and the investment of its funds are Shariah compliant. Amos argues that with Islamic windows, the large bank cannot guarantee that the source of the funds is Shariah compliant. With a fully Shariah retail bank, the funds are taken from Islamic deposits at source and are used for an investment – such as non-precious metals – that is also compliant.

With larger mainstream competitors possessing Islamic divisions, there is the possibility that the funds have come from another source within the bank that is not Islamic. The Islamic window can only guarantee that the output – or the investment – is Shariah-compliant.

Ethical guarantee

While IBB's guarantees are popular with Muslim clientele in the UK, non-Muslim customers are becoming increasingly interested in Islamic banking. Islamic banking's stance against investments related to products such as alcohol, tobacco and pornography mean that the products are attractive to those looking for ethical banking.

Amos argues that the current crisis has brought a reconsideration of the interest-based way of making money, and that the ethics of the banking industry have been called into question. Many are attracted by the idea of the bank taking responsibility for the risk that they are taking on with their customers.

Siddiqui agrees, arguing that customers will appreciate any institution that is able to adhere to standards, and present a simplified and timely process that turns around their application efficiently: "If they convey a sense of ethics, integrity and responsibility on the part of the institution, then no matter who the customer is, there is always going to be appreciation for this kind of financing."

Siddiqui says: "That is what the current consumer market is yelling out for now. They are saying 'stop' already." ●