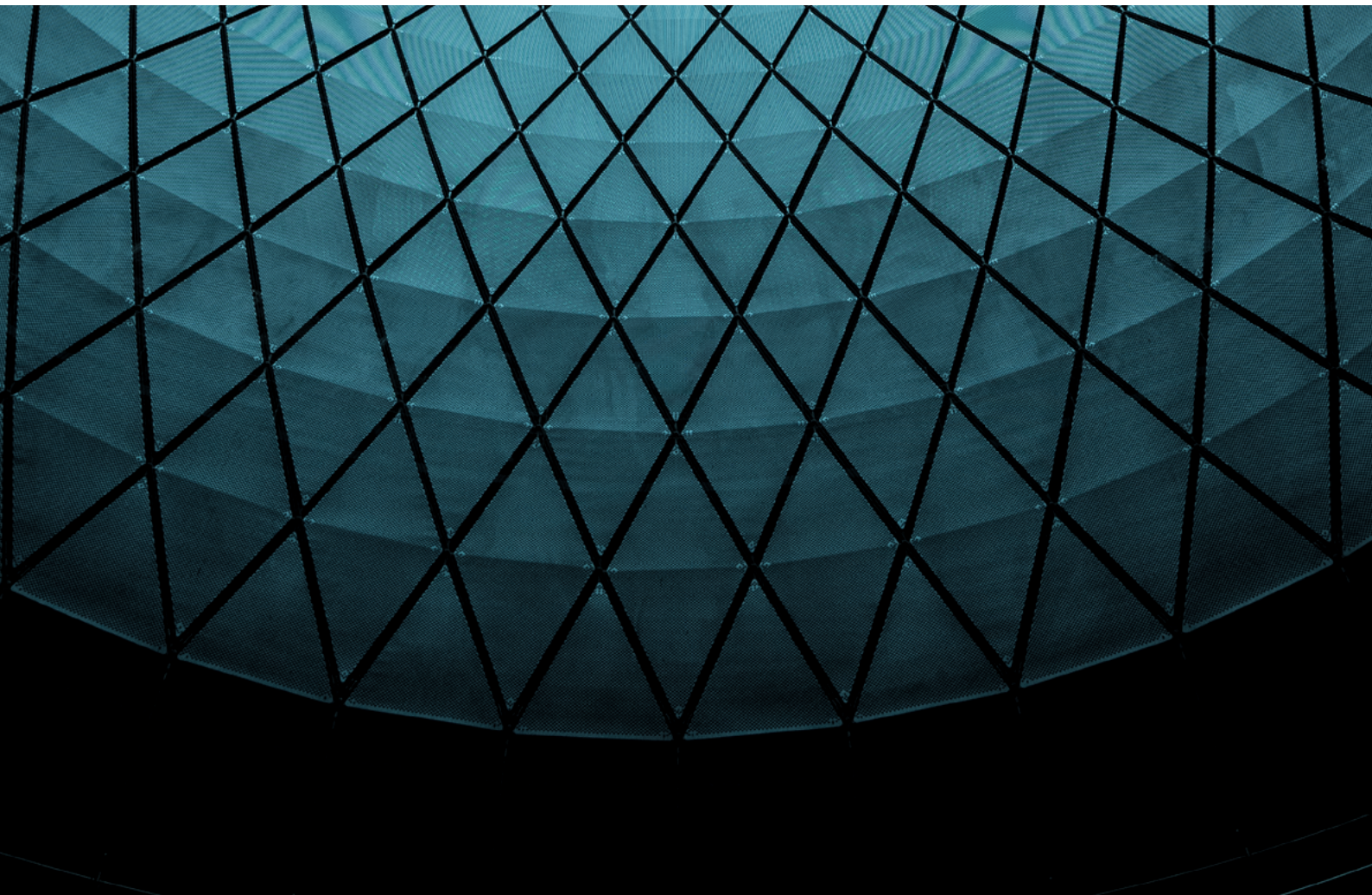


# CAPCO

## **OPPORTUNITIES FOR THE ISLAMIC FINANCE SECTOR: FROM DIGITAL TRANSFORMATION TO STRATEGY**

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# INTRODUCTION

With strong adherence to ethical values that are in vogue to both customers and investors today, and a core demographic population segment that is growing rapidly, Islamic finance is an intriguing opportunity for the various participants in the UK financial services landscape.

With 20 plus organizations operating in this space in the UK, the market presence is quite robust and broad<sup>1</sup>. However, despite the Islamic finance sector's strength in values and demographic viability, its adoption into the mainstream population of both Muslims and non-Muslims has been a struggle. This has been in some part due to a lack of understanding of the core values of the offering along with some misinformation; however, it can also be argued that the lack of adoption to digitalized service offerings have also impeded the sector in reaching its potential.

## WHAT IS ISLAMIC FINANCE?

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Islamic finance (IF) is formed on the principles of Shariah and Islamic law. It outlines acceptable risks, details profit-sharing, prohibits interest payments, and encourages ethical investments for the greater good of society. Islamic financing is not pinned to any particular jurisdiction, it can take place anywhere in the world where there are individuals who wish to engage in financing transactions in a manner consistent with their faith and personal values. This inherent characteristic makes IF products interesting for non-Muslim investors too. Investors who are currently engaged in environmental, social and governance (ESG) investments may find the underlying principles of IF appealing due to a commonality in areas such as – screening (evaluation of an investment) where ESG and IF have a similar approach. This in effect means that the untapped potential of IF products as an ESG vehicle is quite significant.

Even in this era of information and awareness, there are many misconceptions about Islamic finance, hampering growth in this space. One of the most common myths is that Islamic finance is only available to Muslims. This is not true, and IF products have been available to everyone irrespective since inception. Nomenclature of the system i.e. Islamic finance leads to this fallacy but, there is no limitation to type of consumers that can avail these products.

Another common falsehood is there are no underlying differences between Islamic finance and conventional finance. There are instances where Islamic finance is more market efficient and ethical —significant amounts of debt and risk trading in financial markets expose economies to instability, and this can lead to unsavory economic implications.

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1. [www.telegraph.co.uk/business/business-reporter/uk-Islamic-finance/](http://www.telegraph.co.uk/business/business-reporter/uk-Islamic-finance/)

This paper explores how IF has grown within the UK financial services landscape in the recent years and what we believe is a significant growth potential which can be unlocked by harnessing/embracing digital capability. We will also review the current climate and the appetite of these Islamic financial institutions (IFI) that are broadening their horizons, searching for ways to make products and services more accessible for their customers. Finally, we will explore inherent challenges in the market which are opportunity areas for IF to focus on in the near term.

In this ever-growing market, a rising number of unconventional banking institutions come with a multitude of needs. Digital transformation has become a key catalyst necessary to satisfy customer needs, stay current and meet regulatory demands. The need for digital transformation of the Islamic finance world is now greater than ever and produces a huge opportunity for growth in the sector.

## MARKET LANDSCAPE & EMERGENCE OF IF FIRMS IN THE UK OVER THE PAST DECADE

The UK's profile as a leading western center for Islamic finance has continued to grow in recent years. The Islamic Finance Country Index ranks the UK 17th out of 48 countries, placing it first in Europe & first among non-Muslim-majority nations, ahead of US.<sup>2</sup>

The last decade has seen an increase in the number of institutions in the UK offering IF services. There are currently five fully Shariah-compliant banks licensed in the UK, more than any other Western country. These are Al-Rayan, Gatehouse, UBL, QIB and Islamic Bank of Britain. Combined they have an estimated US\$4.7 billion in managed assets<sup>3</sup>. The IF retail market has also developed in recent years in the UK. We have seen the launch of multiple Shariah-compliant products, including savings accounts, mortgages, Shariah-compliant pensions, business financing and an interest-free alternative to conventional credit arrangements.

The growth in IF offerings in recent years can be attributed to the UK's supportive governmental policies which have created a fiscal and regulatory framework intended to broaden the market for IF products. The IF sector is subject to the same legislations that apply to all sectors, enabling a level playing field for both Islamic and conventional financial products. In 2017, The Bank of England established a Shariah-compliant facility (SCF) to support banks in the UK who provide IF products and services.<sup>4</sup>

IF has truly proven its presence within the UK financial market within the last decade with IF specific services now being widely offered by financial intermediaries, asset managers, insurance providers and international law, and accountancy firms. The last decade has also seen an increased use of Islamic finance (Sukuk – Islamic Bond) for major infrastructure projects in London and across the UK. A total of 72 sukuk have been listed on the LSE with a total value of \$53bn.<sup>5</sup>

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2. <http://www.gifr.net/publications/gifr2019/ifci.pdf>

3. Islamic Corporation for the Development of the Private Sector (ICD) and Thomson Reuters, 'Islamic Finance Development Report', p16

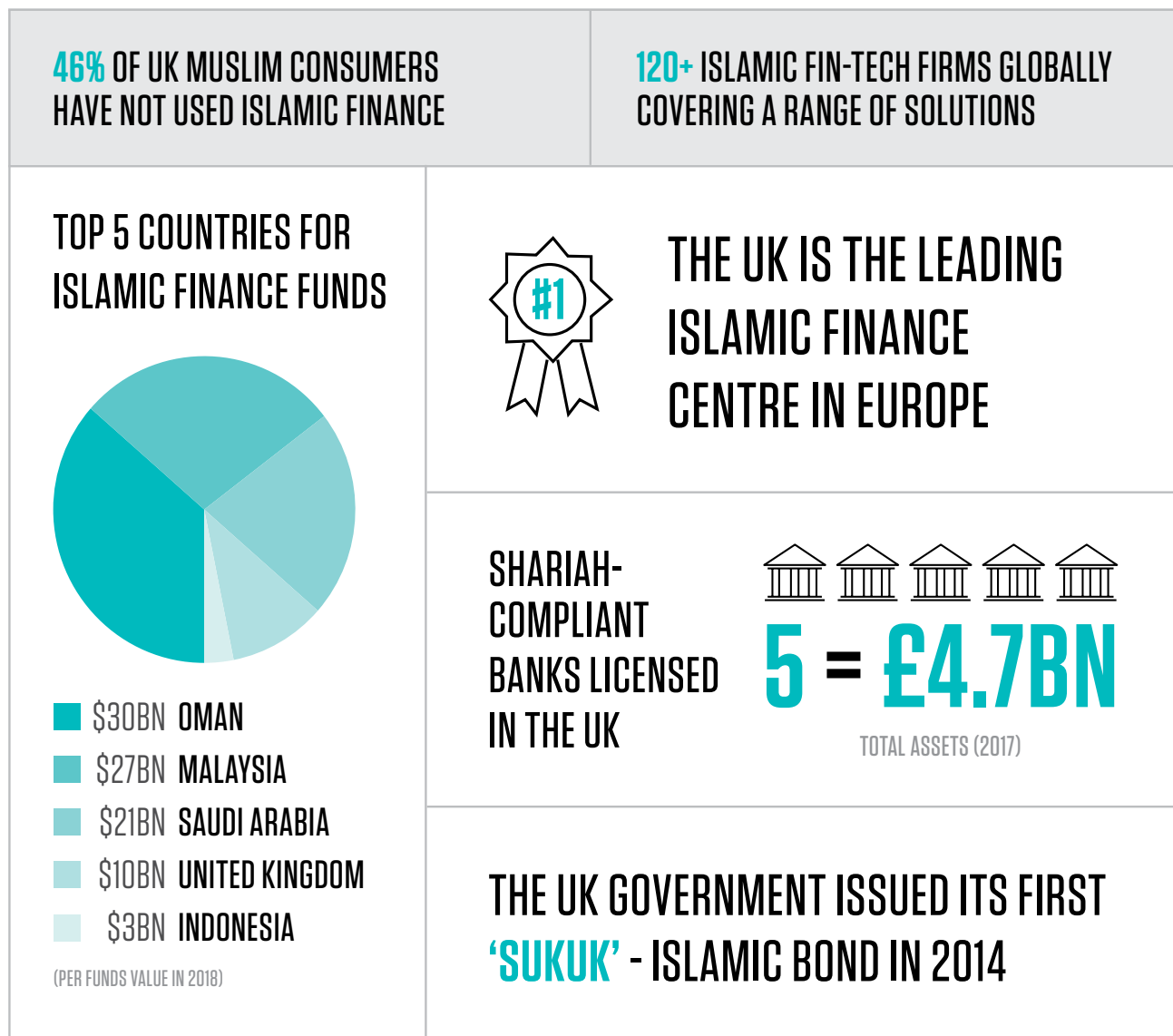
4. [https://www.bankofengland.co.uk/-/media/boe/files/paper/2017/scif\\_consultationpaper2017.pdf](https://www.bankofengland.co.uk/-/media/boe/files/paper/2017/scif_consultationpaper2017.pdf)

5. Islamic Financial Services Board, 'Islamic Financial Services Industry Stability Report', (May 2017), p.7., available at: <http://www.ifsb.org/docs/IFSB%20IFS%20Stability%20Report%202017.pdf>

All current trends suggest that the role of Islamic finance in funding development, growing number of IFIs, number of providers for service and subject matter experts (SMEs) will continue to grow in the years ahead. Fintech in Islamic finance is only in the early stages of development, but the outlook is bright. According to a recent report, there are around 120 fintech firms globally focusing on IF delivery. Islamic fintech can be defined as firms that:

- Support the digital delivery of Islamic finance
- Use fintech utilities: KYC / AML, Blockchain and DLT, cyber, payments, big data & machine Learning in Islamic finance
- Operate in a Muslim market demography that delivers an unmet financial need and or financial inclusion objective
- Are a Sharia compliant fintech fund, investing in digital infrastructure or economic development anywhere in the world.

Although the development of Islamic fintech has been most prominent in Muslim countries, the UK is also a prime market for growth in the space due to its competitive advantages in both financial services and technology.



# INERTIA TO GO DIGITAL

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Islamic finance has faced several challenges in the journey towards digital transformation, a key factor among them has been the customer base itself, in the regions where Islamic finance has been traditionally strong e.g. MENA (Middle East and North Africa), Malaysia and Indonesia. The customer base in these countries has shown a preference in having traditional bricks and mortar banks as opposed to digital services. This along with the fact the variety of services covered in these markets up until very recently were very rudimentary also meant that there was lack of appetite from the service providers to invest heavily in the technology required to provide a truly digital experience. This is in comparison to a market such as the UK, wherein technology is a key driver of consumer choice and has resulted in a lower adoption and exposure of IF services among the customer base.

## DIGITAL TRANSFORMATION OF ISLAMIC FINANCE

Advancements in technology over the past decade has resulted in a rapid change to the business model and customer experience across several industries including financial services. The IF sector has also been one the key benefactors from this monumental shift as technology has provided firms with several tools that have fundamentally changed their business model from a customer engagement perspective. An example of this is Wahed Invest, who are a US-based Halal-focused investment firm.<sup>6</sup> They have developed the first robo-advisor aimed towards Muslim investors with a Sharia-compliant platform, and their objective is to make Halal investing easily accessible and with just \$100 minimum balance to start, they appeal to both affluent and non-affluent clients.

## TECHNOLOGICAL SHIFT WITHIN ISLAMIC FINANCE

From a Shariah perspective, Technology is considered as an enabler. The fintech solutions that require adjustments for Shariah compliance purposes are those dealing with financing and investment including investment advisory services. Services-based fintech specializations such as mobile payments, money transfer and trading platforms are universally applicable for both conventional and Islamic finance.

In the case of crowdfunding and P2P financing, platform operators must ensure financing and investment processes comply with the prevailing Shariah standards for financing and investment activities. This current model is lacking in the market dominated by conventional finance. For investment advisory services, the recommendations must not lead customers to be involved in financial instruments which are not Shariah-compliant. Therefore, fintech specialization in investment advisory such as robo-advisors needs to ensure only Shariah compliant investment products are recommended to the customers.

Fintech disrupts as well as it creates opportunities for Islamic finance. On the consumer side, fintech innovation provides choices which are more aligned to individual needs. With more options, consumers enjoy more competitive financial services cost. Latest technology embraced by fintech leveraging on internet, mobile devices and social media integrations make financial transactions more automated, user friendly and more convenient, thus resulting in superior customer experience. Crowdfunding and P2P financing options provided by fintech firms create hopes for individuals or SMEs that require financing but do not qualify to obtain financing from traditional Islamic financial institutions.

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6. <https://waheedinvest.com>



## TECHNOLOGICAL DRIVERS OF ISLAMIC FINANCE

The potential market for fintech in Islamic finance is substantial as the industry is very new and largely untapped. The digital revolution drives customers' demands for innovative, convenient, efficient, and cost-effective financial services. According to the Global Islamic Finance Report, it is projected that by 2020 there will be between 2 and 3 billion new consumers that will be entering the digital finance space<sup>7</sup>. This presents significant opportunity for fintech in Islamic finance. Strong awareness among Islamic finance stakeholders, encouragement from monetary authority and favorable regulatory environments in key Islamic financial markets will play a major role in stimulating fintech innovations in Islamic finance.

Relevancy of fintech in Islamic finance is still in its early stages. Many of the participants are in the crowdfunding business although Islamic robo-advisors have recently been introduced. Malaysia introduced the first Islamic banks backed financial intermediary FinTech platform and issued the first Islamic P2P Crowdfunding license. Other Islamic finance fintech-related initiatives include the Islamic Fintech Alliance and Global Islamic Fintech Hub in Bahrain.

Major indicators for the positive outlook include growing awareness among the stakeholders, encouragement from monetary authorities and facilitative regulatory environments in key Islamic financial markets, other supportive elements from the broader fintech ecosystem, customer demands and a largely untapped potential market.

## DAWN OF DIGITAL IF

Market penetration in the core Islamic financial markets of the Middle East, Malaysia, Indonesia, and Turkey increased to 31.2 percent in September 2019 from 25.5 percent in 2013, while annual global sukuk issuance increased to US\$179 billion from US\$131 billion<sup>8</sup>. This, along with several different players emerg-

ing in the Islamic fintech scene providing customer friendly products, services and experiences as detailed above, make Islamic finance the next big thing in the world of financial services. Due to this growth trajectory and dependency on technology as a catalyst for change makes it an ideal avenue for Capco to provide services to in the 2020s. There are key areas of transformation that the IF sector still needs to undergo to mature, and Capco's experience in supporting these with other clients, make us ideally suited to help. These areas can be summarised as:

### **Future ways of working:**

As discussed, fintech in the IF sector has the potential to bring the whole financial industry on a level-playing field. Innovation is key to the development of digital transformation in Islamic world. Such innovation needs agility and adaptation from the participants in this sector to make any impact against the rapid pace with which conventional banks are evolving. As the focus remains on regulatory compliance, the sector has been slow in adapting to concepts of digital transformation. This needs to change as the future of finance is changing rapidly and emergence of new technologies is changing the landscape for financial institutions in general. Another aspect here is managing increased customer expectations with the emergence of new digital solutions.

The need to prioritize innovation and experimentation around new solutions and business models is a paramount requirement for the sector. This is only possible when participants in the sector look at transforming their organizations and focus on increased agility, adaptation, and effectiveness. This will require strong partners to drive innovation and growth as the IF industry's focus on restructuring their business models to scale.

### **Business transformation:**

Businesses today are faced with constant market disruption, with the emergence of new industry players, technology advancements, regulatory change and increasing consumer expectations. The rise of digital has created a new kind of organization and way of working that is proving to be a blueprint for success. Pivoting to this new way of working brings together business agility, a shift in mindset and redefining people's understanding of the workplace.

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7. [http://www.gifr.net/gifr2017/ch\\_17.pdf](http://www.gifr.net/gifr2017/ch_17.pdf)

8. <https://www.thenational.ae/business/islamic-finance-to-expand-in-2020-as-demand-for-shariah-compliant-products-grows-1.999324>

Business transformation will be one of the key challenges that IF sector participants will face in the next decade due to a change in the business model driven by both technology and business needs. Businesses now more than ever are becoming more in-tune with making data driven decisions, this means relying on data, algorithms and machine learning to automate, anticipate and solve problems in a manner that enables them to grow and succeed in the future while maintaining robust performance and efficiency as a business in the present. This approach is very suitable for IF as due to limited reliance on legacy processes and procedures allows IF businesses to adopt a more agile approach to their transformation strategy.

### Regulatory transformation:

The lack of a centralized regulatory body governing has been one of the main issues that has affected the growth of Islamic finance to a mainstream level in the past. This situation is likely to change in the coming years due to more co-operation between the two major regulatory bodies in the IF World – Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) and Islamic Financial Services Board (IFSB). The primary issue with regulation in the IF context has been the lack of mandatory standards for IF services and products, which are only followed in certain countries such as UAE and Bahrain. With more co-operation between these two major players in the coming years we can expect the mandatory standards to be better implemented leading to IF offerings to be standardized across the globe.

## UNDERSTANDING THE BINARY PULSE OF DIGITAL SPACE

Islamic finance is built on the principle of mutual benefits between financial institutions and individuals. However, it could be argued that the customer experience is still not at the forefront for IFIs or that there remains a distinct lack of accessibility to Islamic financing for conventional institutions and tech-savvy consumers. To remain competitive in an ever-evolving landscape, all firms must anticipate and embrace the customer perspective and leverage the latest market technologies whilst doing so – this is no different for IFIs.

We believe the future of financial services will be driven based on six areas of transformation:



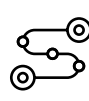
**DIGITAL  
STRATEGY**



**INTELLIGENT  
AUTOMATION**



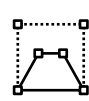
**DIGITAL  
ENGINEERING  
EXCELLENCE**



**WAYS OF  
WORKING**



**DATA DRIVEN  
VALUE**



**TRANSFORMING  
DIGITAL  
ARCHITECTURE**

Transforming digital architecture and a robust digital strategy play a key part in the development of operational and transactional systems. Conventional banks who want to expand their offerings to the IF market, will see the need to reengineer their current structure, building enhancements and Shariah complaint capabilities. Whereas IFIs will look to build newer, better, more efficient versions with intelligent automation – demand for this in the market. Leveraging existing platforms build/buy/modify platforms.

The IF market is moving towards a digital transformation stage of their maturity. The market is looking for ways to drive performance and add business value from insight and data. They want to reach the underserved market segments, which possess enormous potential and unlock the millions, if not billions of pounds of unrealized potential value.

This will give rise to fintechs supporting the development of products catering specifically for the niche market emerging as the economy and clients shift from one generation to the next. We believe a whole wave of neobanks with limited presence, but great propositions will heavily flood the market. They will use agile delivery frameworks to achieve rapid deployment and pose a threat to the larger IFIs, who in turn will feel the pressure to act quickly in order to maintain competitive and secure client retention.

## KEY OPPORTUNITIES FOR EXPONENTIAL GROWTH OF ISLAMIC FINANCE

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With modern Islamic finance being in existence for nearly 60 years, providers have only recently started to embrace technology and using it as key driver of its propositions. This trend is expected to continue over the next few years, as we can expect to see a substantial uptick in both the user base and service diversity of Islamic finance.

### TRANSFORMING IF TO APPEAL TO BROADER CLIENT BASE

Technology has become a key catalyst for IF providers to cater to a broader client base, there have been a number of instances where IF providers have used technology to offer a new or improve an existing product, these include:

- Zurich Takaful has collaborated with Souqa fintech's PayHalal online payment system, which is different from a traditional payment provider as there are fundamental requirements for transactions of money. Every transaction has got a specific transaction contract, items sold must be specific to weight format and price. Float management must be void of Riba, etc.
- Rizq Bank of the UK launching in 2020 as a challenger bank with the aim of providing its customer base with a streamlined and seamless experience without compromising their beliefs or value system. Rizq is also expected to have a non-banking payment model.

- Al Hilal Bank of the UAE initiated the world's first sukuk transaction using blockchain technology. In Islamic finance, blockchain can be applied for smart contracts, payment and remittance as well as streamlining the business processes.

### KNOWLEDGE OF SHARIAH LAW IS KEY TO DEVELOPING NEW PRODUCTS & OFFERINGS

We have already covered that with increased co-operation between the two main IF regulatory bodies (AAOIFI and IFSB) in the coming years, better implementation of mandatory standards is expected, potentially leading to global offerings in the IF space. But bringing the discussion closer to home, it is also important to note the role of Shariah Supervisory Board (SSB) in the functioning and development of existing and new businesses within the IF space in the UK market.

The industry defines the key objective of SSB scholars as ensuring Shariah compliance in all products and transactions within an entity. In practice, Shariah scholars examine a new product or transaction and if satisfied that it is Shariah compliant, issue an approval. Complex products or offerings, having gone through a long process of development, are sometimes rejected by the SSB for non-compliance with Shariah laws. This is really damaging to the IF firms which are trying to compete with much bigger conventional counterparts, and it also affects technical and product innovation adversely.



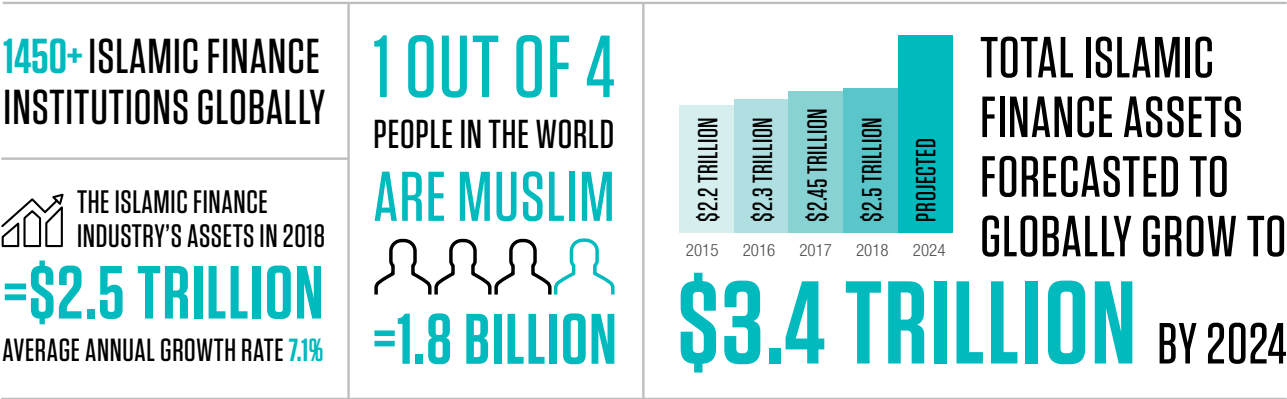
One way to handle this issue is greater involvement by Shariah scholars in the product development process. While this may prove beneficial, it could lead to a more executive role than advisory which is not in line with SSB's responsibilities. A good industry practice, now developing, is that firms are starting to recruit more staff with an understanding of Shariah law. This could help to identify a product's potential non-compliance with Shariah at a much earlier stage.

# CONCLUSION

Islamic finance is at cusp of a revolution due to favourable market and technological catalysts; the three primary ones being:

- A. A broadening appeal of Islamic finance products** – Due to their inherent principles and similarity with ESG investments, IF products have a broader appeal today than at any point in the past. By raising awareness, customers who may be interested in IF products for either its Shariah compliant ethos or for its ESG promoting principles, will support the growth of IF in the near future.
- B. Growth in Islamic finance assets** – The rapid growth in Islamic finance assets stemming from more awareness and government led initiatives across the globe, will provide a robust environment for service providers to solicit Shariah compliant products for both consumers and institutions in the coming decade, in order for this transition to be smoothly achieved it is imperative that access points to the customers is digital and easy to use.
- C. An increase in number of Islamic finance institutions** – There is a trend of rapid growth of IFIs especially in the world scene as this is the case there is the need for a centralised regulatory oversight to ensure that institutions are acting in the best interest of customers, this is an opportunity that an organisation such as a central Shariah board can strongly contribute towards in the coming years.

In order to meet the demand for a growing population with high digital awareness with interest in faith compliant products in the coming decade, it is imperative that IFIs are able to provide this consumer base with products that are easy to access through digital propositions, while ensuring that they are compliant from a faith perspective.



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## ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

To learn more, visit our web site at [www.capco.com](http://www.capco.com), or follow us on **Twitter, Facebook, YouTube, LinkedIn** and **Instagram**.

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