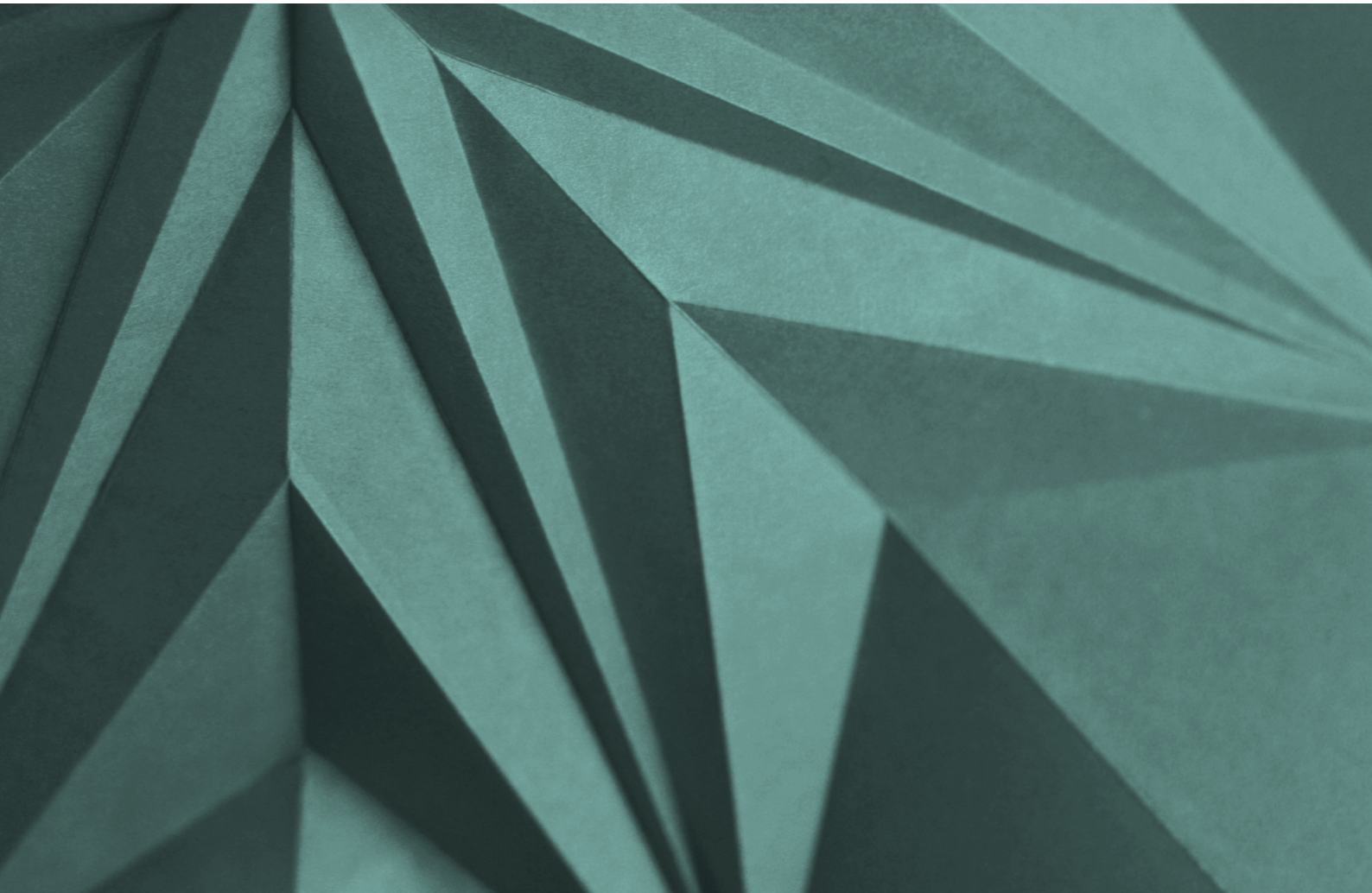


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THE CASE FOR UK HIGH STREET BANKS TO MAKE STRIDES IN ISLAMIC FINANCE



INTRODUCTION

Islamic Finance assets have been consistently increasing globally by an average of 6.5% in recent years, with the market expected to reach USD3.4trn globally by 2024. Moreover, the popularity of Islamic Finance products is not just growing amongst the Muslim population: the data indicates that more than a third of the biggest UK Islamic Finance Bank's consumers are non-Muslim. This can be attributed to the continued growth of ESG (environmental, social and governance), which shares some key principles with Islamic Finance - for example, distribution for all, fair trading, judicious spending of wealth, and the well-being of the wider community.

The UK is now established as the hub for Islamic Finance (IF) in the European region, with five fully Shariah-compliant banks and Islamic Finance assets totalling around USD6bn. The Islamic Finance retail market has really taken off in recent years with the launch of a series of Shariah-compliant products, including Individual Savings Accounts, Home Purchase Plans (HPPs), pension schemes, business start-up financing and an interest-free alternative to student loans.

ISLAMIC FINANCE UK MARKET – KEY HIGHLIGHTS OF LAST 3 YEARS

- Total Shariah-compliant banking assets in the UK were around £5.68bn as of EOY 2019.
- The UK is the 17th biggest market for Islamic Finance out of 48 countries, but the first among non-Muslim-majority nations, putting it ahead of the US, Switzerland, and Germany.
- From an investment point of view, net assets of Islamic funds in the UK amount to \$700m (equivalent to £543m). A total of three Shariah-compliant exchange traded funds (ETFs) is listed on the LSE.
- The mortgage market is picking up as well with around 6 providers of Home Purchase Plans in the UK today. The largest provider's HPPs value increased by 2.6% to £1,184m (2018: £1,154m) in 2019 whilst Commercial plans reduced slightly, closing the year at £466m (2018: £479m).

Sources:

<https://www.thecityuk.com/research/global-trends-in-islamic-finance-and-the-uk-market-2019/>

<https://www.alrayanbank.co.uk/media/512232/al-rayan-bank-plc-2019-accounts.pdf>

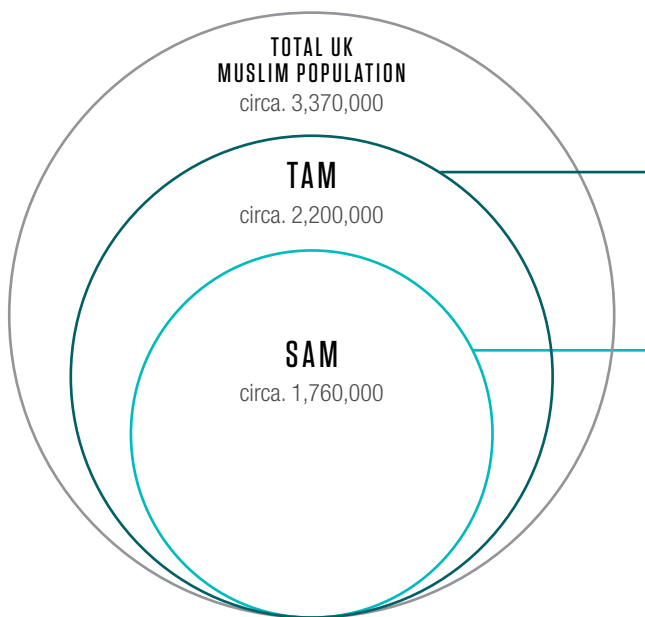
<https://www.telegraph.co.uk/business/business-reporter/uk-islamic-finance/>

https://icd-ps.org/uploads/files/IFI%202019%20DEF%20digital1574605094_7214.pdf

ISLAMIC FINANCE RETAIL MARKET AT A GLANCE

The UK's Islamic retail banking market is slowly maturing and is currently focused on engaging with a Muslim population now numbering approximately 3.37 million citizens - around 5.9% of total UK population. Over a third are aged under 16, and the expectation is that this young demographic will be looking for

Islamic Finance services that are not just Shariah-compliant but also innovative and technologically advanced. There will be an expectation that Islamic Finance services provide similar customer experiences and journeys as offered by conventional banks.



TOTAL AVAILABLE MARKET

This is the value of the entire market which would include the working total Muslim population in the UK.

SERVICE AVAILABLE MARKET

The SAM includes those who have a sufficient household income to purchase Islamic Finance products & services.

As previously noted by one of the leading fully Shariah-compliant UK Banks, around one third of existing Islamic Finance customers identify as non-Muslim, and if that number is extrapolated out to the UK market then it is clear that the number of potential non-Muslim customers in scope is considerable.

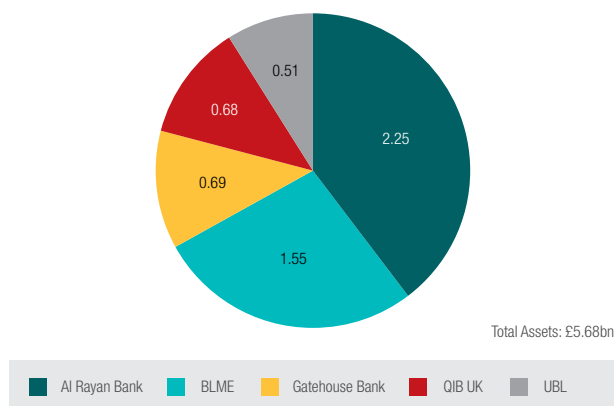
The five fully Shariah-compliant banks in the UK are:

- Al Rayan Bank
- BLME
- Gatehouse Bank
- QIB UK
- UBL

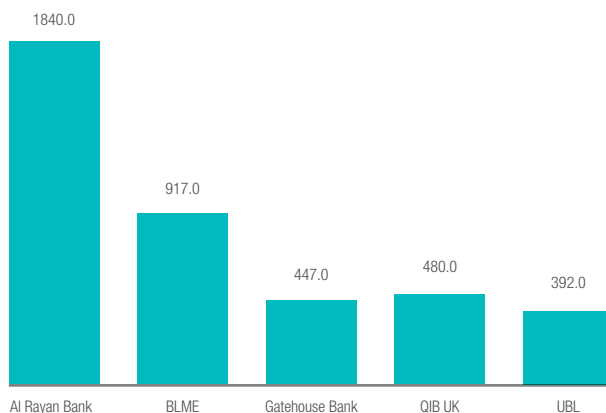
<https://www.ons.gov.uk/aboutus/transparencyandgovernance/freedomofinformationfoi/muslimpopulationintheuk/>

Below is a brief view of the distribution of assets between the fully Shariah-compliant UK banks:

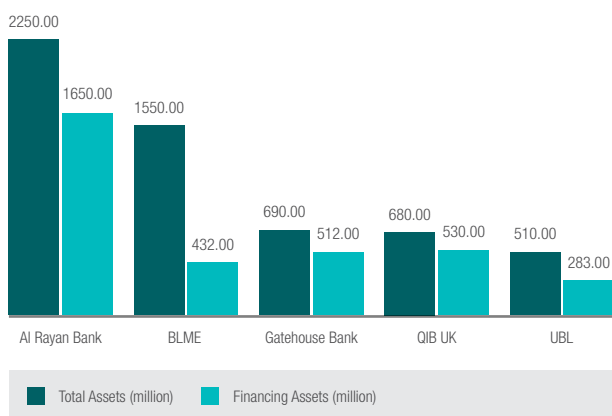
TOTAL ASSETS (GBP IN BILLIONS)



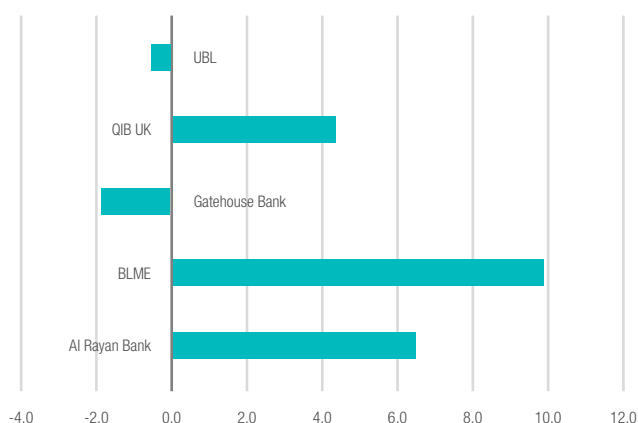
DEPOSITS FROM CUSTOMERS (GBP IN MILLIONS)



TOTAL ASSETS VS FINANCING



PROFIT BEFORE TAX (GBP IN MILLIONS)



Despite this scale and the demand for Islamic Finance products, most of the UK high street banks have not yet capitalised on this trend, and the following two examples illustrate some of the inherent challenges.

During the tumultuous years of the mid-2000s global financial crisis, one UK high street bank confidently predicted significant growth opportunities in Islamic investment banking.

Fast forward to 2012, and the impact of the economic downturn saw the bank cut back its Islamic Finance business.

Another UK high street bank, which was one of the first movers in Islamic Finance scaled back in six markets, including the UK. This

left the firm with an Islamic Finance presence only in 3 countries.

Though the market continued to grow at a healthy rate in terms of assets, revenue and profits were not at par. The decision by the bank to pull back from operations in these markets was not driven by a re-evaluation of their offerings but simply on broader economic grounds.

To add context to the above, the bank did exit from about 20 mainstream retail banking markets on similar grounds as a result of restructuring exercise that focused on exiting non-core businesses to cut costs and improve profitability.

*Annual statements 2019 – Al Rayan, BLME, Gatehouse Bank, QIB UK and UBL

CHALLENGES:

There are certain challenges that UK high street banks face while expanding into Islamic Finance products or services.

- **Cost** - Complex structuring and overheads due to an additional mandatory layer of Shariah-compliance result in higher charges for many Islamic products. The contracts used are less standardised and usually there is more legal work involved in an Islamic Finance product, which adds to the cost compared to a conventional product. Another reason for high costs is that the stand-alone Shariah-compliant banks in the UK are quite small compared to the high street banks. Much of the costs related to functioning of a bank remains unaffected despite its smaller size.
- **Integrity** - The Shariah integrity of the products offered by the mainstream UK high street bank is questionable, in that products are simply Islamic versions of conventional interest-based products. Given the need to steer clear of riba (usury), using conventional products and just swapping the interest component with an equivalent fee is not a satisfactory approach. Conventional banks looking to expand into Islamic Finance need to ring-fence assets so as to ensure that the revenue coming in should be invested into Shariah-compliant businesses only. A lack of visibility or transparency around these elements raises a question regarding the bank's ability to be fully compliant.

ISLAMIC FINANCE BANKS: THEIR CURRENT DIGITAL JOURNEY

The Shariah-compliant incumbents in the UK are at different points on their digital journeys. In March 2020, Al Rayan completely transitioned its online banking services to a digital mobile banking app, complementing its existing branch, telephone, and postal banking services.

This indicates that the appetite for digital offerings by Shariah-compliant banks is developing, however the footprint remains limited.

	ONLINE BANKING	UK MOBILE BANKING APP	WEBCHAT FUNCTIONALITY
AL RAYAN	✓	✓	
BLME	✓		
GATEHOUSE BANK*	✓	✓	
UBL**	✓		
QIB (UK)	✓	✓	

*Gatehouse Bank has an iOS app only

**UBL has a mobile banking app but it is not available in the UK

Moreover, none of these banks yet possess webchat functionality on their websites, instead offering a more traditional telephone-based customer service.

Earlier this year, Rizq, the UK's first fully digital Islamic/Shariah-compliant challenger bank soft-launched its app. The app offers certain features which are not provided by existing Shariah compliant banks.

APP FEATURES:	DIGITAL PAYMENTS	BUDGETING	CASHBACK	CONTACTLESS	SEAMLESS DONATING
AL RAYAN	✓				
QIB (UK)	✓				
RIZQ	✓	✓	✓	✓	✓


























Relatively speaking, the Islamic Finance institutions including Shariah-compliant Banks do lag a little behind when it comes to using digital tools and solutions. Both commercial and consumer drivers will push Islamic Finance institutions towards digitalisation faster. Incumbent Islamic Finance institutions will want to remain competitive as new entrants emerge and incumbents adapt. Consumer habits continue to shift online, accelerated more recently by the COVID-19 pandemic.

UK high street banks already have the required infrastructure and tools/solutions that can be leveraged, and in combination with the right products, they could be an enticing option for investors looking for Islamic Finance options – not least the UK's growing demographic of young, tech-savvy Muslims.

CHANGING MARKET LANDSCAPE

The technology capabilities in Islamic Finance has been growing rapidly with many players coming on to the landscape. Taking in view the Islamic Finance TAM, there is a growing concern of

saturation within the digital sector as companies compete for user numbers and number of downloads. The diagram below details the Shariah-compliant players in the UK market.

 CURRENT UK ISLAMIC FINANCE OFFERINGS					
ISLAMIC BANKS	CHALLENGER BANKS	HOME FINANCING	TRADING PLATFORMS/ ROBO-ADVISORY	COMMERCIAL FINANCING	REAL ESTATE CROWDFUNDING
Existing UK Players	Existing UK Players	Existing UK Players	Existing UK Players	Existing UK Players	Existing UK Players
 AL RAYAN BANK  blme <small>بنك البحرين والقطر</small> Bank of Bahrain & Qatar  gatehousebank  UBL  QIB	 rizq  KESTRL Potential UK Players  NIYAH  moneemint	 heylo  STRIDEUP Potential UK Players  Primary Finance  WAYHOME	 simplyethical <small>Socially Responsible Investing</small>  Wahed  minted™  EIGER	 qardus  izdihar  OFFA Potential UK Players  nester.	 yielders <small>INVEST. GROW. YIELD</small>  intro crowd Potential UK Players  igloo

The UK is leading from the front relative to other Western countries, with the emergence of newer and diverse financial products and services, especially within the FinTech space. For instance, there has been innovation around Shariah-compliant robo-advisors such as Wahed Invest and property crowdfunding

platforms like Yielders. A catalyst in driving the growth in this market will include collaboration and partnerships with other FinTech companies not just Islamic Banks to develop their technological capabilities and more importantly leverage their presence in the market.

SO HOW CAN UK HIGH STREET BANKS RE-INTRODUCE THEMSELVES IN THE ISLAMIC FINANCE SPACE?



Islamic Finance Product Strategy – Innovative products and solutions like Digital Islamic Finance Banks, App-based Investment platforms, Islamic pension funds and P2P financing would go a long way in differentiating high street UK banks with their Islamic Finance counterparts.



Sustainability – More and more investors are now focusing on where their money is being invested and how it is being utilised. They want to ensure they are investing within ethically defined parameters and that their investment is not profiting organisations that carry environmental, social and governance (ESG) 'red flags'. With its core principles of being ethical, asset-backed, and prohibiting highly speculative instruments, Islamic Finance becomes one of the alternatives open to such investors. Islamic Finance specifically prohibits exploitation through uncertainty in asset quality, price or delivery or abuse of unfair advantages, which reassures many potential investors and appeals to ethical-minded consumers of all faiths. If positioned correctly, it presents High Street banks with a conduit through which they can tap into the UK's pool of ethical investors.



Branding – If Islamic Finance-focused investors are reticent to engage with conventional banking brands due to the aforementioned concerns around Shariah compliance, then an option for UK high street banks is to establish separate Islamic Finance brands. This would ensure segregation of assets while also able to leverage the key strengths from the parent organisation in terms of technology and people.



Standardisation – This could play a major role in terms of cutting costs & overheads for Islamic Finance products and ensuring that the prices are on par with their conventional counterparts. Different interpretations of Shariah law across countries limit firms' capacity to expand into new markets. The idea is to have the core elements of the designed products based on commonalities within Shariah law across different regions, and then incorporate add-ons to accommodate additional permissible offerings based on local interpretations of the law. It is important for UK high street banks to hire personnel with an understanding of Shariah law & involve them right from the product development phase, so that any discrepancies are highlighted at an early stage.

CONCLUSION

There is an identifiable demand – and emerging supply – of Islamic Banking services in the UK. The emerging Muslim youth market needs aligned digital banking propositions and products: one-third of UK Muslims are currently under 16, and this market is set to continue growing and to become a mainstream retail and SME banking segment. These products appeal to both the Shariah-conscious and ethical consumer.

This is a perfect opportunity for UK high street banks to enter the Islamic Finance space, tapping into their existing digital capabilities to offer the ‘right’ proposition to investors.

Certainly, one approach is to launch a separate Islamic Finance bank/offering that is sufficiently differentiated yet can still leverage its parent bank’s core resources to design and deliver innovative products and solutions. This would, however, require a substantial investment.

A more suitable approach might be to launch a standalone or co-branded digital-only offering making it a compelling proposition for investors looking for Islamic Finance and/or Sustainable Finance options.

In our next paper, we will look at Islamic Finance Digital P2P lending.

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ABOUT CAPCO

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