

# **Islamic Private Banking – Now and in the Future**

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## **Islamic Private Banking – Now and in the Future**

### I. Introduction

#### A. Objectives of Presentation/Outline

The purpose of this outline is to provide the reader with some insights on how the Private Banking industry is currently addressing the needs of the Islamic investor and areas in which one can reasonably anticipate the expansion of services and products in the foreseeable future. Three particular points that I hope you will have a better understanding of at the conclusion of the outline include: (1) the impact of the emergence of the Islamic Banking industry on the private banker, (2) catering to the needs of the Islamically oriented investor, and (3) opportunities to add-value going forward.

The emphasis will be as much on the wealth management aspect as the product side, recognizing that others will be addressing the latter in considerable detail throughout the two days of this program. In order to provide a framework for discussion, I believe it is helpful to provide an introductory overview of the Islamic Banking industry and the modern Private Banking industry.

### II. Overview of the Islamic Capital Market

#### A. Definition

Just as an “Islamic Bank” is defined with reference to its mandate requiring that it complies with two sets of law: (1) the “law of the land” and (2) Islamic Sharia law, the Islamic capital market is defined with respect to global pool of money that has the need to be catered for in a manner consistent with Islamic Sharia. The Islamic Banking industry is not defined to any geographic area, however it is concentrated in certain geographic regions. The largest contributions to this market today come from the Arabian Gulf, although other regions (such as South Asia, Far East and the Near East) are growing in importance. Looking ahead, it is anticipated that significant contributions to this market may also come from the 16 million Moslems in Europe and North America.

#### B. Size & Growth of the Market

While difficult to measure with any degree of accuracy, the market has grown from nothing to an estimated \$100bn to \$150bn market in about 18 years time. It is growing today at an estimate of 10% a year and in the view of many leading authorities, this market will be responsible for managing at least 50% to 60% percent of the total saving of Moslems world wide in 8 to 10 years time.

This market, contrary to conventional wisdom, is not growing as a result of the growing awareness of Islam. It is primarily driven by the fact that Moslems in the last 15 to 20 years have built significant wealth that necessitates banking services, compounded with the fact that usury is a very serious sin in Islam.

This assessment is supported in the fact that Islamic banking is not biggest, in market share terms, in the most Islamically conservative markets, but instead in those markets that have developed a larger middle income group and where economic life has developed to a stage where using banking services has become a must for convenient daily living. For example, Kuwait has a market share penetration of Islamic Banking of approximately 30%, compared to only around 10% to 15% in Saudi Arabia. It follows that as those relevant national economies develop, so will demand for Islamic financial services develop and hence market share growth of the Islamic financial services industry.

Another important factor supporting this growth in market share is the fact that the industry is getting much more efficient and sophisticated, and the volumes have aggregated to quite interesting levels. Quality and cost for Islamic financial services are improving rapidly and closing the gap with the conventional market. This means more and more Moslems are finding their needs satisfied and more of them are seeing the cost of that value coming down to a level at which they are willing to participate.

### III. Overview of the Private Banking Industry

#### A. Definition

I am not aware of any universally recognized definition of the term “private banking.” Some differentiate traditional private banking from modern private banking and offshore from non-offshore. Not being an expert in this area, I will leave the fine points to others more knowledgeable and experienced. For purposes of my discussion, the term private banking refers to providing a personalized and high-quality range of financial and related services to wealthy clients, principally individuals.

Private banking is not a single activity, but rather a range of different businesses activities or units, which are targeted at different segments. Institutions tend to concentrate in a few narrow areas, rather than operate across the entire spectrum of private banking activities/businesses. There are no prolific “mega-store” private banking institutions today, although it can be argued that some are being built. In practice, it has been difficult for institutions to operate efficiently and effectively in all niche areas and most have concentrated on their core competencies.

The essence of private banking is perhaps the **high quality of personal service** and important aspects of this include:

- Anticipation of client needs
- Creating or obtaining solutions to address the needs
- Tailoring to individual requirements
- Creation and nurturing of long-term relationships
- Utmost discretion and confidentiality

The main service areas include:

- Discretionary asset management
- Non-discretionary portfolio management
- Provision of in-house funds
- Trusts/estates
- Assistance regarding loans & other financing
- Deposits & cash management
- Off-shore and domestic companies
- Securities trading and foreign exchange
- Structured financial products
- Other (including derivatives, precious metals, and safekeeping).

#### B. Size & Growth of the Market

It is recognized that the pool of Islamic funds referred to earlier, though sizeable, is still relatively small in the context of the global private banking market. Similar to the figure regarding the Islamic market, the monies invested in the private banking arena are difficult to measure with accuracy. This is partially due to the personal nature of private banking and the discretion that participants demand. However, few would dispute that it is a growth area since it appears "the rich keep getting richer" while even those defined as rich are increasing.

I would however, like to illustrate some of the figures that I have seen regarding private wealth in general and the Middle East in particular.

- A 1995 study/survey of global private wealth produced by Oliver, Wyman & Company placed the number of high net worth individuals at 2,550,000, with 3% coming from the Middle East. The worldwide assets of these individuals were estimated to be \$11,500bn, with 4% coming from the Middle East.
- "Middle East private wealth markets are estimated to be \$75 billion and growing at a rate of 15% per year." (David Maude and Dr. Philip Molyneux, *Private Banking: Maximizing performance in a competitive market*, 254 (1996)).
- Personal Finance magazine states that more than US\$5 trillion is estimated to be looking for global wealth management and further refers to a study performed by Gemini Consultants and Merrill Lynch that estimates wealth held by high net worth individuals in the Middle East at US\$1 trillion. (*Product of Change, Personal Finance Middle East*, May 1998 at 12-19.)

- “One knowledgeable observer estimated that more than \$50 billion of savings fled the Gulf region during the Gulf War crisis of 90-91. Most went to Swiss banks, which have long provided wealthy Middle Easterners with safety, discretion, and competitive returns. Little of that money had reportedly returned to the Gulf by the end of 1996.” (Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance Religion, Risk, and Return*, 6 (1998).

#### IV. Trends & Observations

##### A. Changes in the Marketplaces – In General

###### 1. Private Banking

Private banking has been in a state of flux over the past several years due to a number of factors associated with competitive forces. These factors include consolidation and changes within the banking industry itself, the globalization of financial markets, technology advances, regulatory factors and the growth in the size of the markets.

In addition there has been the entry of new types of clients and players, which includes those related to Islamic Banking both from a user and provider perspective.

###### 2. Islamic Banking

The Islamic market has experienced a natural progression from retail to commercial and through to investment and private banking over the last 3-5 years. The two primary drivers for this change in the Arabian Gulf, are: (1) a growing middle income group who recognize the importance of savings, coupled with (2) the increased **sophistication** of the Islamic banking industry in meeting the needs of investors who wish to have part or all of their assets managed in an Islamically compatible manner. The “cross-over” investor will be quite important to the growth of Islamic Banking as it relates to the Private Banking context.

##### B. A Natural Fit

As stated earlier, the essence of private banking is perhaps the high quality of personal service, including the anticipation of client needs and creating or tailoring solutions to individual requirements. It has been said that private banking clients tend to be more diverse, globally minded, sophisticated, risk adverse, sometimes more aggressive and more aware. (Maude and Molyneux, *supra*, at 37).

The very reasons that we see an expansion in Islamic Banking seems to reconcile with the rational and objectives of the private banking industry, namely to effectively cater to high net worth individuals through tailoring and anticipating needs. The “Islamic Investor” is often diverse in his/her holdings and requirements, globally minded, becoming more **sophisticated**, risk adverse, sometimes more aggressive and sometimes more aware. The fit is so good, that it may be appropriate to introduce the term “Islamic Private Bank Investor” or “IPBI” to describe a particular segment or need within the Private Banking industry.

## C. Product Offerings

### 1. Competition

The Islamic market is experiencing an increased level of competition with new entrants seeking to address the needs of an audience that is becoming more sophisticated. As a result, returns to investors have come much closer to conventional market benchmarks. It is important to note that until very recently, this was not the case.

In addition, the product offering has become much more sophisticated and structures are much more complicated and demanding. In general, private banking clients are also placing greater emphasis on performance in addition to historical considerations such as safety, confidentiality and relationships. Clients are searching for more sophisticated products and services.

### 2. Types of Products

There are many products that are available to the IPBI. Products may be offered by the Private Banks or through the facilitation of the Private Banker. Of course, there are many other providers of Islamic products and services. A brief description of some of the generic categories is deemed warranted and presented below. This list is not all-inclusive and this outline omits some of the more innovative ideas that are still "in the kitchen," so to speak.

In addition, I will be happy to discuss with anyone the product offering available through The International Investor; a quality range that I believe is as innovative and comprehensive as can be found in the marketplace today.

a) Short Term Investment Funds - which can provide liquidity for other more specialized investments or provide an alternative to fixed deposits and other money market instruments offered by conventional players. These short-term funds can be denominated in any of the major currencies although the US Dollar and Sterling are the most common currencies.

b) Leasing Funds - there are also many leasing funds which is not a surprise, as leasing has historically been an efficient and flexible Islamic instrument. The differences between these Islamic funds lie in the quality and diversification of the assets being leased, and whether they have any "equity kickers" associated with the residual values of the assets or to the performance of the lessees (through various participative lease structures).

c) Real Estate Funds - which focus on established revenue generating properties, or the development of existing or new sites. This may include equity investments in Real Estate Investment Trusts ("REITS").

d) Equity Funds - which include a wide range of possibilities such as acquisition and trading of listed stocks, investments in private companies and conforming their operations in a manner that is consistent with Sharia principles, and venture capital type investments. TII has even developed a "market neutral" fund which takes short and long positions in smaller publicly held companies listed on United States markets.

e) Commodity Funds - which give investors exposure to genuine commodity price risk in an asset class that includes oil, livestock, grains and industrial metals. These funds often utilize Salam-based structures.

#### D. What about Service!

I refer back to our definition of private banking where the term refers to providing a high-quality range of financial and related **services** to wealthy clients, principally individuals. It is therefore very much a service-orientated business. In paragraph VII, I have set forth a number of possible extended services that could be provided to better serve the IBPI. Tailoring to investor needs is again the overriding theme.

The following points may be worth considering when addressing the needs of the IBPI:

- Islamic investment banking is now a growing industry that is making a major in-road into project financing, providing both equity and funding to major projects in the Islamic world.
- Wealthy individual's funds are often tied up in businesses and require corporate finance advice on acquisitions of companies and assets, disposals, capital infusions (both debt and equity), buy-outs and specific investment projects.
- Second generation family members are highly educated, and this contributes to the increased sophistication of the IPBI with respect to the overall family unit. While second generation business succession offers opportunities, there are complexities to consider, especially with respect to relationship matters and, to a lesser degree, issues related to discretion and confidentiality.
- The concept and role of the family office.
- The fact the regional investment opportunities may be available and desired, especially as stock markets open up throughout the Arab world and in other regions.
- Multi-manager and provider developments and trends.

- Recognition that not all investors are inclined to be just Islamically oriented or vice-versa. (Note the term “Islamic” in this context refers to the investment guidelines and objectives of the particular investment opportunity). Private bankers have perhaps been managing money on a discretionary basis for many years using client guidelines that seek to incorporate certain aspects akin to Islamic Banking (e.g. no stocks of company’s engaged in activities related to alcohol, gambling, etc.).

#### E. Ingredient for Success of the Global Banker

Success in the financial services industry today requires innovation and seeking out unconventional solutions and discovering competitive advantage in areas that others have not thought about and/or acted upon. Being a global player means understanding regional markets and using the knowledge derived from that understanding to add competitive advantage to the global business. The Islamic financial market is one such regional resource that some global players will discover, and will use, to become more successful local competitors and fiercer international competitors.

#### V. Developing a Strategy to Serve this Segment (i.e. IBPI)

##### A. Should this Market Segment be Targeted?

As stated earlier, private banking is not a single activity, but rather a range of different businesses, which are targeted at different segments and historically institutions have tended to concentrate in a few narrow areas. I believe “the story” of Islamic Banking (growth rate and future potential) make it a compelling and lucrative area, whether the private banker be global, regional, offshore, Swiss, non-Swiss or otherwise.

I have often wondered if a private bank determines its core competencies and targets and attracts clientele based upon its strengths or if their core competencies are a factor driven by their relationships and clientele. My guess is that there is a balancing and business decisions need to be made. However, since the business is service oriented, it would appear to be driven by clients and the need to change, as investor needs change and develop.

##### B. How to Best Target

Often, private bankers and asset managers cannot effectively provide all products and services, and have to “buy-in or bring-in” the expertise. Hence the move among industry players towards takeovers, alliances, distribution agreements and partnerships. Some may also choose to build from within but this can be costly, time consuming and dilute resources in an already fiercely competitive environment.

For years, Islamic Banks have been clients to asset managers. Recently, some Islamic institutions have been serving assets managers with respect to matters of Sharia, local tailoring, ongoing compliance and structuring. It is all a matter of focusing on core competencies to prove the best product.



The constraints resulting from lack of expertise, outside its core competencies, applies equally to Islamic institutions when presented with furnishing the services that represent the core competencies (i.e. service areas) of the private banker and asset manager (e.g. portfolio management).

Therefore, private bankers and other institutions that desire to cater to this market need to implement strategies that address the following:

- offer experience in managing assets for clients;
- have the administration, custodial, and other support infrastructure;
- provide access to Islamic clients directly or through distributors;
- have the Islamic product range, structuring capability and technical knowledge; and
- have obtained the appropriate Islamic credentials and focus.

Whether an Industry player has existing Islamic client relationships or is seeking to build new ones, it can grow Islamic assets under management most effectively by aligning itself with a specialist Islamic institution. Such a link-up can provide a complementary placement capability (if required), a wide range of Islamic products and transactions which are constantly being developed to reflect prevailing opportunities in the global markets (across the different asset classes) and the investment priorities and preferences of the investors, as well as the “perceived or focus value” that collaboration with an Islamic institution offers.

## VI. Live Example -- ALBAIT S.A.

### A. In General

The International Investor (“TII”) & and Pictet & Cie (“Pictet”) invested in creating the entity ALBAIT S.A. (“ALBAIT”), a Geneva domiciled investment company dedicated to furnishing Islamic Swiss Private Banking Services. A brief overview of TII follows. The name Pictet is virtually synonymous with private banking and background information on this prestigious partnership, formed in 1805, has not been furnished.

### B. Overview of TII

TII is not a private bank nor does it provide private banking services. In addition, the Company performs no substantial asset management services but rather chooses to outsource or ally itself with others who have relevant and specialized expertise, thereby allowing TII to focus on its core competencies.

TII is a Kuwait based wholesale Islamic Investment Bank that is listed on the Kuwait Stock Exchange. In a nutshell, the Company “provides access to the Islamic market.” It is a niche player in a niche market concentrating on Islamically

compatible solutions. At December 31, 1998, the Company had approximately \$2.6 billion in assets held in trust or in a fiduciary capacity.

TII's overall strength lies in providing creative and efficient access to the expanding Islamic financial marketplace. TII builds this strength on its structuring expertise and deep knowledge of the Islamic market and its distinct structuring requirements. The Company's activities can be divided into the following three primary categories: (1) corporate finance services (including project financing, mergers & acquisitions, start-up ventures, etc.), (2) "franchising" of Islamic banking capabilities and solutions, including providing a range of wholesale investment products and services, and (3) advisory services, which are generally of a long term strategic nature.

Its mission is to help Institutional Investors locate quality Islamic investment opportunities, Corporates and Governments tap the specialized Islamic market for funds, and asset managers and Institutions build a capability to serve clients who wish to invest in an Islamically compatible manner. Private bankers are thus "clients" of TII."

#### C. ALBAIT – at a Glance

Pictet was one of the first private bankers to commit to such a venture and should reap substantial benefits from getting a jump on its competitors. ALBAIT is a stand-alone, separate entity that has raised in excess of \$150M to date. It was formed in late 1997 and is very much an example of a marriage of strengths with Pictet furnishing asset management, custody, and administrative services to the venture. TII supplies Islamic **advisory services** that consist, among other things, of structuring and placement services.

In addition, TII and Pictet have combined their strengths in the development of an umbrella mutual fund that consists of four compartments: (1) world equities, (2) European markets, (3), Eastern Europe equities, and (4) a balanced portfolio. This product is available through a private bank, through ALBAIT or through TII's distribution network.

From Pictet's perspective, the business and operational challenges include; (1) offering the full range of Private Banking services, (2) making use of existing expertise and infrastructure, (3) insure coherence of investment process with traditional products, and (4) positioning these new services within the product range.

TII serves as Islamic Advisor and it brings to the relationship a sound and consistent understanding of Sharia law. Closely aligned with this understanding is the ability to structure transactions and create Islamic solutions. The Islamic participant also brings knowledge of the Islamic marketplace, including the ability to furnish local tailoring to the relationship.

#### VII. Sharia Advisory Services

This area can involve many aspects with the core being expertise regarding Islamic structuring, tailoring for local preferences, knowledge of the Islamic marketplace and Sharia law. With respect to asset and portfolio management, it may include the following value-added services:

- furnishing an appropriate Islamic index
- providing consultation with regard to investment criteria and guidelines
- screening for compliance with Islamic Sharia
- assistance with dividend cleansing
- due diligence review – compliance opinion
- cash/liquidity management support
- placement advice and assistance
- portfolio and risk management tools
- furnishing other relevant information

## VII. Future Opportunities

The following list is in no particular order and is being supplied in order to stimulate thought and discussion. Some of the items may even be more in line with queries of the author than opinions or statements of fact.

- More competition and more specialist co-operation in order to meet the competition
- Islamic trust services
- Life insurance
- Index funds
- Estate planning/administration and family succession addressing forced succession
- Loans, including consumer financing, Islamic mortgages, and Islamic charge cards
- Tax planning, including Zakat
- Other

## VIII. Closing

I hope you have gained some helpful insights on how the Private Banking Industry is currently addressing the needs of the Islamic investor and areas in which one can reasonably anticipate the expansion of services and products in the foreseeable future. In particular, I have tried to furnish you with an enhanced understanding of (1) the impact of the emergence of the Islamic Banking industry on the private banker, (2) catering to the needs of the Islamically oriented investor, and (3) opportunities to add-value going forward.

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