

FINASTRA

Enabling Islamic Financial Services with the Right Technology

What does the right technology look like?



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Executive summary

Despite tracing its origins back more than half a century, the modern Islamic Financial Services Industry (IFSI) is still in its infancy.

Relatively young, but certainly not small – in 2021 the industry was worth an estimated US \$3.1 trillion and growing at 11.3% year on year. Large and growing, but to put it in context, the global IFSI is approximately the same size as the revenue of the US banking sector alone. Clearly there is tremendous room for growth.

What is holding the industry back?

Many initiatives around standardization in accounting, compliance, regulation, processes, legal documentation, and information systems have taken place. Knowledge of the industry is evolving, Sharia awareness is being enhanced – albeit taking into consideration the differences in interpretation. While the industry is expanding into new markets, consolidating existing markets and increasing individual awareness, in many cases it is too slow and not effective enough.

Financial services is a technology-driven industry and so is the IFSI. While technology is rapidly transforming financial services all over the world, its impact on the IFSI has been less pronounced. Why?

The lack of readily available, mature information technology systems in the market that comprehensively address the IFSI business model and its operational framework create many challenges – and risks. Ineffective technology is one of the main reasons for the modest growth and expansion of the IFSI. Poor system design leads to systems that are incapable of tackling the pressing challenges of the operating model – severely inhibiting the ambitions of the Islamic financial institutions (IFIs).

It doesn't have to be this way.

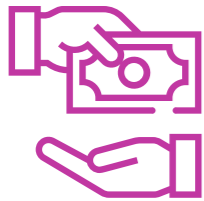


In 2021 the industry was worth an estimated
US \$3.1 trillion
and growing at 11.3% year on year



Technology is transforming financial services – why not the Islamic Financial Services Industry?

Technology continues to transform financial services all over the world. New channels, new products, and new competitors abound. Is the IFSI lagging behind? Can it catch up and overtake?



US \$621b

Global Bank IT spending
in 2022 – Gartner

Neobanks, challenger banks, digital start ups – they go by many names, but they all share a mission to leverage advanced technology and innovative business models to deliver customer delight to their carefully selected market segments. Established players are radically transforming their IT landscapes using a combination of new and existing systems. When designing a banking system, starting from a blank sheet of paper might seem attractive, but banking is sophisticated and banking is nuanced, so the systems needed to serve customers require deep, rich and broad banking functionality. It is little wonder that the providers of established systems have spent decades building out their functional footprints.

However, when it comes to the intricacies of the IFSI, the majority of systems' providers seem to have gotten it wrong. Many misunderstood the basic principles or guidelines of the industry.

Many misunderstood, the business and operating models.

As financial services ecosystems, open banking, AI and machine learning become more prevalent through the industry, the implications for banks running inflexible, legacy systems will increase. In short, the old playbook needs to evolve for banks to survive and thrive.

As McKinsey puts it "the new winners will operate like tech companies, with advanced data capabilities, a cutting-edge tech stack and an agile operating model".

Gartner estimates that banks will spend USD \$ 621b on technology in 2022. Why do banks spend so much and get so little in return?

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The new winners will operate like tech companies, with advanced data capabilities, a cutting-edge tech stack and an agile operating model."

McKinsey



The financial services industry was one of the first to adopt technology systems. With each successive wave of technology banks added to their IT landscape.

don't have to worry about how to connect it to their existing systems. Until recently this gave them an almost unassailable technological edge.

In many parts of the world, the seemingly endless flow of venture capital funds into the fintech world has paused or stopped completely. Driven by evolving economic conditions and the changing competitive landscape, many VCs are evaluating their investment strategies.

Does this mean that the pressure is off? That banks can sigh in relief and go back to business as usual? It may have receded, but the threat has not gone away. The customer expectations that drove the fintechs to such rapid growth are still there. The pace of change of technology is still there. Many of the barriers to entry continue to fall.

The financial services world is being reshaped by technology. Established players need to take advantage of the opportunity to ensure that they thrive in the digital future.

IFIs are faced with all of these challenges and more – due to the increased sophistication of the Islamic Banking business model.

Today most banks have hundreds of systems, barely connected with a fragile, spiderweb of interfaces. The result is a bespoke IT infrastructure that is expensive to operate, difficult to support and almost impossible to upgrade. Little wonder then that most banks spend 70% of their IT budgets on "run-the-bank" initiatives. With a further 15% spent on regulatory changes, this leaves a paltry 15% for "change-the-bank" initiatives.

New entrants – neo banks and digital start-ups – don't have these issues. They don't have legacy technical debt to overcome. They can pick and choose from the best technology on the market, knowing they



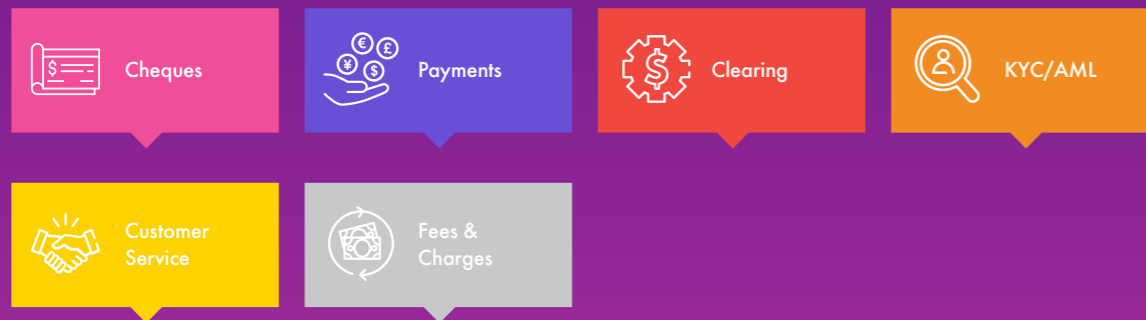
70%

Percentage of Bank's IT budget spent on 'run-the-bank' initiatives – McKinsey

Brilliant basics and super sophistication

The IFSI's ethical principles are increasingly attractive to a growing share of the population. This provides a strong opportunity for growth. To capitalize on that opportunity, IFIs need to address several challenges.

Similarities



Differences



Similarities & Differences

With terms such as *riba*, *murabaha*, *ijarah*, and *gharar* it could be assumed that Islamic banking is completely different from conventional banking. The reality is more complex as the two banking models share both similarities and differences.

From a growth perspective, it is vitally important to get the foundational products and services right. Today's customers expect their financial services provider to deliver cost-effectively and efficiently.

For example, IFIs must (like conventional banks) issue and process cheques and manage the clearing process for these cheques. They also need to interface with standard settlement mechanisms such as SWIFT or other local settlement hubs or switches. IFIs must conduct "Know Your Customer" reviews by their regulatory authority (e.g., central bank). They must service their customers via various delivery channels (e.g., ATM, Call Centre, Branch, Internet, etc.). Customers expect to be able to access their financial information at a time and a place of their choosing.

IFIs must also levy and impose fees and charges on their customers – as long as there is no consideration that would constitute interest. None of these processes raise Sharia issues or violations nor do they have implications or risks in running an IFI business.

IFIs must deliver outstanding services in all of these areas. Put another way, to grow, the IFSI needs to execute the basics of banking brilliantly.

For the IFSI there are added complexities, driven by the differences between Islamic and conventional banking.

Islamic Banking is similar to conventional banking in many ways but differs in some very important aspects

While sharing some features with conventional banking there are fundamental differences.

With an asset-based business model, the financing process in Islamic Banking is addressed in a fundamentally different manner to the way lending is handled in conventional banking.

Interest is strictly forbidden in Islam, as Muslims believe that it promotes unfairness in financial transactions, which leads to social inequality and injustice. IFIs therefore use equity participation, which means that the IFI shares in the profits and losses associated with the account. For depositors this means that their funds are invested in ethical, Sharia compliant trading activities in order to generate a profit. Funds are never invested in any activity that is not in keeping with the values of Islam – such as any activity connected to gambling, alcohol, pornography, arms, tobacco or any interest-bearing activity – or any speculative activity.

The Islamic Finance operating model tends to be more complex in nature when compared with that of conventional banking. It has stricter and more specific procedural controls. These are required to ensure and invoke compliance with Sharia – and to address the cycle in providing the right financing product. This is tremendously important because in some instances, violations during the financing process would impact Sharia-compliance and could cause significant risks.

Implications for technology

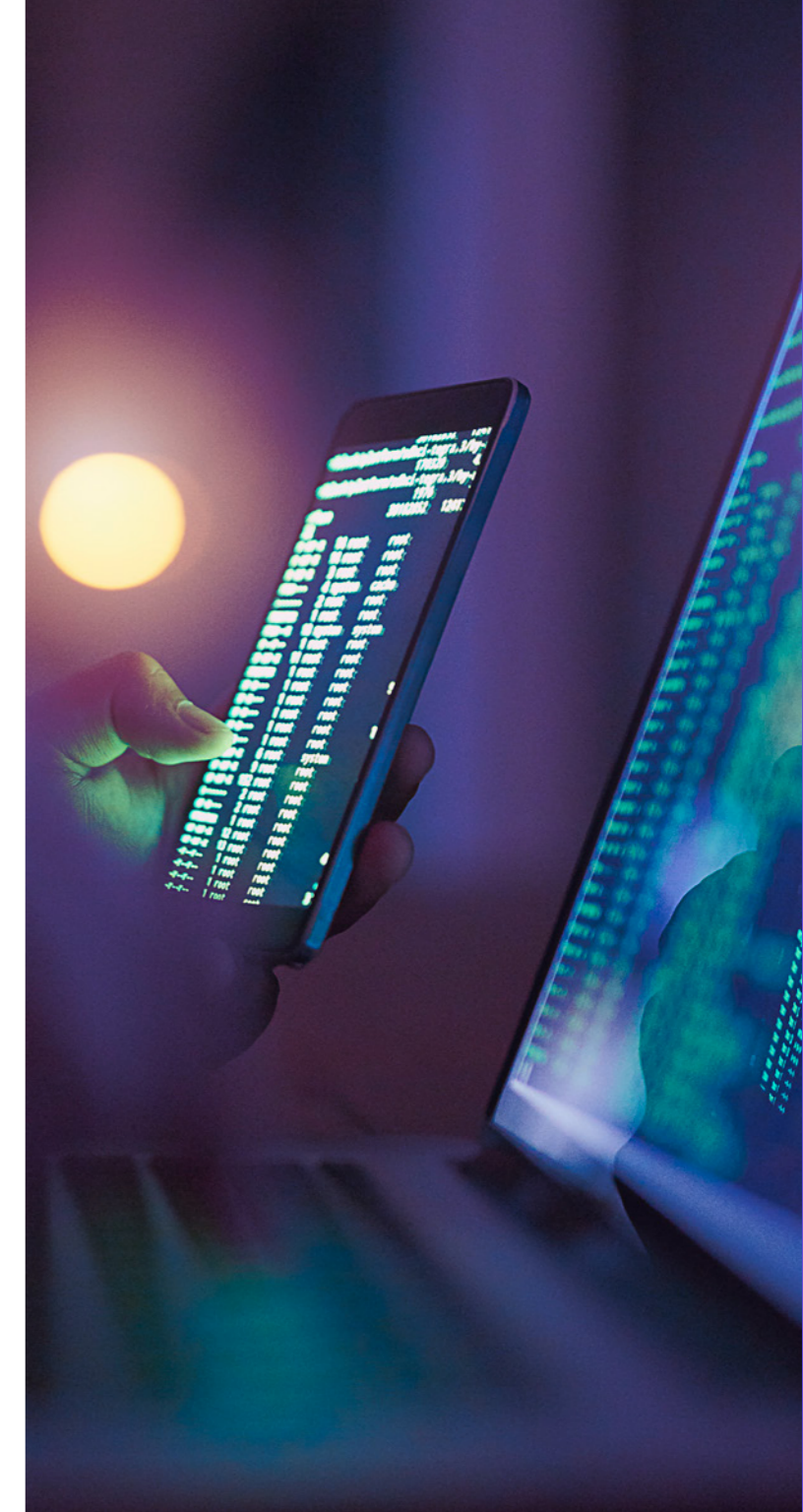
Financial services, whether conventional or Islamic, runs on technology. As previously noted many vendors made minor modifications or used workarounds to adapt their conventional core banking systems to support Islamic Banking. Most misunderstood what needed to be done.

For example, while conventional and Islamic Banking share the need for workflow, some core banking systems' providers use a workflow engine to manage the financing process. While it might address part of the challenge it does not tackle the end-to-end process and may put the Sharia compliance of the financing process at risk.

Even where the solution truly supports the Islamic Banking business model there can be challenges. Consider the situation where a company operates both conventional and Islamic Banking business models. Regardless of whether it is operated as a standalone business or via an Islamic banking window, the typical solution is to have two core banking systems. One for the conventional business and the other for the Islamic business.

Putting aside the costs in money, effort and time to acquire a second core banking system there are a range of other major issues, including:

- Delivering an inconsistent customer experience
- Deploying two tech stacks, increasing costs and the skills needed for support
- Complicating DR and business continuity plans
- Increasing system fragility
- Amplifying credit and operational risks
- Hampering reconciliations and consolidations
- Inhibiting data analysis
- Raising operating costs and reducing profit margins





Finastra understands Islamic Finance & Technology

Finastra has been serving the IFSI for more than 40 years. We have witnessed the industry's development and progress. We understand the details, nuances and specifics of the IFSI.

Not only do we understand the business of banking, but, for decades we have leveraged the right technology to deliver the solutions that help our customers thrive.

At the outset we recognized that conventional banking systems did not comprehensively address the needs and challenges of the industry. Consequently, we embarked on a major R&D program, backed by significant investment to build the components needed by the industry. We created a solution that addresses Sharia guidelines, the challenges and indeed the opportunities in the industry. We have successfully deployed our solutions in many regions and jurisdictions to a variety of institutions including local, national and regional champions.

Our solutions are not based on workarounds, changed wording or modifications to existing functionality. We designed our banking platform to comprehensively address the specific needs of the IFSI, placing special focus on

what makes it comply with Sharia guidelines and principles, namely:

1. How financing is managed
2. How profit calculation and distribution for depositors are performed

We know that replacing interest with profit, or removing the word interest, does not address the substance of what Islamic Banking is about. We know that simply changing terminology – renaming conventional processes in lending functions – inserting Murabaha or ijarah and maintaining the conventional functionality “as is”, does not achieve what is needed. We know that there is a lot more to consider in Islamic financing. We know how the financing process or functionality is addressed. We know how profits or returns on investment on assets or activities in the “unrestricted” asset pool is calculated and allocated to each investor holding – unrestricted investment account based upon the mudarabah contract. We know Islamic Banking.

Not only is the Finastra Islamic Banking solution Sharia compliant but it is also a modern, proven, resilient and functionally rich digital platform. Uniquely, it combines rich, broad and deep banking functionality with advanced technology.

Using our platform, IFIs can shift their focus from running a series of “keep the lights on” initiatives to concentrating on innovating for customers. They can spend time collaborating, dedicating their attention on delivering differentiated value for their customers and growing their business. Finastra's platform equips customers with accelerated agility – paving the way to set the pace in their respective markets.

As previously mentioned, many banks that operate both conventional and Islamic banking businesses have been forced to deploy two core banking systems. One system for their conventional business and another system for the Islamic business or Islamic banking window.

With Finastra's Islamic Banking solution, customers can support both the conventional and Islamic Banking operations on a single instance of the core banking platform. There is no need to deploy to instances or two environments.

	Others	Finastra – single solution
#Core Banking Systems	2	1
Acquisition	Higher cost, multiple vendors	Lower cost, single partner
Integration	Multiple points, duplication	Single point
Customer Experience	Inconsistent, disjointed	High quality integrated experience
Customer identification	Complicated as 1 customer has 2 CIFs	Single source of truth
Support	2 IT teams with different skills	1 team, industrystandard skills
Resilience	Multiple points of failure	Single, integrated system
Continuity	2 x DR plans & environments	1 x DR plan & environment
Upgrade	Upgrade two systems (in parallel), increasing cost & complexity	Single system reduces cost & complexity
Enhancement	Standardization results in lowest common denominator or inconsistent capabilities	High quality products & services rolled out quickly
Risk	2 x systems = more than 2 x risk	Single system reduces risk
Reconciliation	Complex, time consuming and error-prone	Single source of truth reduces burden
Financial impact	Higher operating costs, reducing profitability	Lower operating costs improving profitability

Helping Customers Succeed

For more than 40 years we have helped institutions of all types, including local, national and regional champions. We are proud to have helped established players, start-ups and new entrants achieve their business goals.

Focusing on the IFSI we are proud to support customers in APAC, Europe, the Middle East and Africa. Our customers include both focused Islamic banks and those running Islamic windows.

Awash Bank – Ethiopia

Established in 1995, today Awash Bank is one of the largest commercial banks in Ethiopia. With over 730 branches, more than 1,000 ATMs and 10,000 staff, the bank provides a wide range of banking services to more than 5 million customers.

The bank's mission is "to provide Innovative, Competitive and Diversified banking services accessible to the society with qualified and committed staff in a profitable and socially responsible manner".

In addition to its conventional banking services, Awash Bank also offers a range of Islamic Banking services, including: Wadaih savings and current accounts, Mudarabah savings accounts, Musharakah and Ijarah.

Leveraging Finastra's business expertise and sophisticated technology, Awash deployed a single solution to support both conventional and Islamic business models.

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With Finastra, we
have put in place a
future-proof platform
that will further
enable our growth."

Yohannes Merga

Chief Information Officer,
 Awash Bank

QIIB – Qatar

Since its foundation in 1991, QIIB has focused on offering a seamless Islamic finance experience across all channels. The bank's vision is "to be the most efficient Islamic financial institution, performing to the best global standards, serving the communities where we have presence, and to be the first choice banking partner for national and expatriate citizens of Qatar."

For QIIB, shaping an exceptional customer experience is key to staying on track for success in Qatar's increasingly crowded and competitive banking market. Key to the bank's success is the delivery of fast, reliable, hassle free and very intuitive customer service across a range of digital and physical channels.

The use of streamlined, automated Islamic finance processes greatly contributes to the bank's enviable position in the market.

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The process improvements we are making with Finastra will ultimately translate into a much richer customer experience – a valuable differentiator in a tough marketplace."

Nasser Mahmoud

CIO, Qatar International Islamic Bank

Al Rayan Bank – United Kingdom

Pioneering British Islamic banking since 2004, today Al Rayan Bank is the UK's largest Sharia compliant bank. The bank serves over 90,000 personal, business and premier customers, providing them with Sharia compliant savings, finance and current account services. It was the first Islamic bank in the UK to receive a public rating. The bank's majority shareholder is Masraf Al Rayan, a Qatar-based Islamic bank providing banking, financial, investment and brokerage services. Masraf Al Rayan is the second largest bank in Qatar by market value.

National Bank – Kenya

Founded in 1968, today National Bank provides a wide range of banking services to retail and corporate customers across Kenya via a network of 85 branches and more than 1,500 ATMs. The bank became part of the KCB Group in 2019, which serves 28 million customers in Kenya, Tanzania, South Sudan, Uganda, Rwanda and Burundi.

NBK provides Islamic Banking services through a window alongside its conventional banking products and services. Both businesses operate on a single system.





The Right Technology Will Accelerate Growth

Technology has transformed financial services, radically reducing costs while delivering customer delight. It can and will do the same for the IFSI.

The IFSI has established a strong position in many markets around the world. The industry's ethical principles are increasingly attractive to a growing share of the population. This provides a strong opportunity for growth. To capitalize on that opportunity, IFIs need to combine their business expertise with the right technology partner.

Banking is sophisticated, banking is specialized, and the needs of the IFSI are even more sophisticated and specialized. To create banking platforms that meet these needs requires deep domain expertise, not just in banking but in Islamic finance. It is not about workarounds such as deleting the word interest, it requires a deep understanding of the principles and practices.

But it takes more than that. The pace of change of technology continues to accelerate. Customer expectations continue to evolve. To deliver a technology platform to provide a competitive edge today and tomorrow requires technology expertise and a vision for the future.

Finastra is that partner.

At Finastra we know Islamic Banking. We have supported IFIs of all kinds for decades. At Finastra we know technology. We have created an Islamic Banking solution for today and tomorrow.

Finastra can help you accelerate your growth.

FINANCE IS OPEN

Finastra unlocks innovation across the world of financial services, through our trusted software and open platform.

About Finastra

Finastra is a global provider of financial software applications and marketplaces, and launched the leading open platform for innovation, FusionFabric.cloud, in 2017. It serves institutions of all sizes, providing award-winning solutions and services across Lending, Payments, Treasury & Capital Markets and Universal Banking (digital, retail and commercial banking) for banks to support direct banking relationships and grow through indirect channels, such as embedded finance and Banking as a Service. Its pioneering approach and commitment to open finance and collaboration is why it is trusted by ~8,600 institutions, including 90 of the world's top 100 banks. For more information, finastra.com

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