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Strategic Alliances in Islamic Banking

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ABSTRACT

Strategic alliances are a critical component of the Islamic banking community's effort to become increasingly competitive and responsive to consumer demand as well as further integrated into world markets in the 21st century. There are numerous legal vehicles through which cooperative action is possible, each with varying degrees of control and cooperation between the allied parties. The natural synergies between Islamic banking institutions and conventional banks are both plentiful and obvious. Conventional banks investing in sectors requiring knowledge of the *Shari'ah* can enter into various forms of partnerships with Islamic banks that possess expertise in the *Shari'ah* as well as extensive knowledge of the localized economy and culture. Similarly, Islamic banking institutions seeking to invest in non-Islamic countries or communities can form synergistic relationships with conventional banks possessing the appropriate expertise and knowledge.

I. Overview of Strategic Alliances

Strategic alliances may be thought of as any form of joint cooperation where two or more parties involved seek to pool resources toward a common objective. Joint cooperation may take many forms. The distinctions lie in areas such as the rights and responsibilities of the respective parties, control, and commitment to the relationship. Commitment relates to the risks involved, time involved and the extent to which other resources are devoted.

Some of the primary forms of cooperation are discussed below. While the list is not comprehensive, it presents a useful starting point, beginning with those relationships that generally require the lowest level of commitment.

A. Informal Cooperation

Informal cooperation is a relationship wherein the legalities have not been reduced to writing, although certain legalities may still be implicated (e.g. oral contracts, implications of past dealing and/or implied contracts). An examples of this type of relationship would be the relationship which develops between the treasury department of an Islamic bank with its primary conventional counter-party.

B. Contractual Alliances

A contractual alliance is where a written contract is executed addressing the scope and limitations of the relationship as well as what is expected of each party. The contract may or may not be very specific in all aspects of the relationship. An example of this type of relationship would an asset manager based in the United States which, pursuant to a contractual agreement, serves as the Investment Advisor to a range of Islamic mutual funds sponsored by an Islamic institution.

C. Minority Investments

Minority investments entail an equity infusion in the strategic partner. Often a board seat is obtained or some form of input into the strategic direction of the alliance is granted. Control is typically not obtained since the investment, by definition, is a minority stake. There is significant potential for *Shari'ah* complexities in the event Islamic and conventional entities seek to promote an alliance through this form where the minority investment is made in the conventional entity.

D. Joint Ventures

In a joint venture, the allies create a separate business entity in order to conduct a joint activity in pursuit of a common objective. Joint ventures are a good way to share ideas where the allies view each other as equals. An example of this structure would be a Private Bank and Islamic specialist working together to form an entity which delivers Private Islamic banking services.

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E. Franchising

The characteristic that distinguishes franchising from other forms of cooperation is primarily the control aspect. When a business looks to expand, it may decide to branch out and "go it alone," ally itself with a partner in those locations it seeks to expand into or buy an existing enterprise. The franchising concept generally allows expansion in a manner that allows more control over the new activity than in a strategic partner and requires fewer resources than acquiring an ongoing business. Franchising combines reduced utilization of resources with somewhat reduced risk. A relevant example of franchising would be a conventional bank acquiring a comprehensive Islamic product offering from an Islamic service provider in order to access the Islamic marketplace in a more efficient manner.

II. Who Participates in Strategic Alliances

Islamic institutions must function within the guidelines of the *Shari'ah*. Accordingly, Islamic institutions have generally committed more resources to addressing *Shari'ah* aspects than have participants who are not purely Islamic providers. Capturing the *Shari'ah* knowledge of an Islamic provider is one of the primary impetuses to forming strategic alliances. In terms of institutional providers, the most active and substantial participants in strategic alliances are Islamic retail Banks, Islamic Investment banks, specialty wholesalers and Islamic divisions/units of conventional banks.[i]

III. Why Participants Seek to Establish Alliances

Generally, participants seeking to engage in strategic alliances in the context of Islamic banking are not terribly different from traditional strategic alliances. For instance, the reasons behind the merger between Daimler-Benz and Chrysler includes areas such as obtaining access to desirable markets, bringing together complementary and innovative skills, efficiencies of scale through lower costs, and pre-empting competition in a competitive environment. However, determining which types of combinations could be most beneficial to the respective participant(s), requires understanding the profile of today's Islamic banking market. This understanding also helps in understanding how and why some conventional benefits are more or less valuable in the context of Islamic banking. The rationale for participants choosing the strategic alliance route often includes one or more of the following:

A. Advance the Interests of Islamic Banking

The Islamic banking industry serves as a medium for Muslims to satisfy their banking needs in a manner that satisfies certain religious concerns. In terms of strategic alliances, this form of banking requires reconciliation with the conventional banking system in order to prosper and achieve its objectives (e.g. fair distribution of wealth). From a global perspective, many participants seek to engage in strategic alliances in order to strengthen and support Islamic banking toward the advancement of its viability and growth.

B. Penetrate and Participate in a Growth Sector

A great deal of attention has been focused on the Islamic banking industry in the last several years. New participants not already entrenched or recognized in this niche market must determine the best approach to penetrating the market. Often a strategic alliance is the solution of choice in order to facilitate access to the market. By reducing entry barriers, strategic alliances create increased competition in the marketplace.

C. Shared Expertise and Complementary Skills

Many Islamic institutions, especially those domiciled in the Middle East, do not have the resources to keep pace with the likes of financial engineers and asset managers located in London, New York and other major financial centers. Similarly, those entities not "on the ground" in traditional Islamic markets often lack an in-depth knowledge of *Shari'ah* law, Islamic structuring, follow-up capabilities or market knowledge. An alliance creates synergies that produce a product that meets the needs of the marketplace. The terms "Islamic credibility" and "perceived value" are used by some to characterize the value-added brought to the relationship by the Islamic participant.

D. Level of Commitment and Timing

The extent to which an enterprise wishes to devote and direct its resources will be a factor in determining whether the strategic alliance route should be taken. Certain forms of strategic alliances allow for relatively low costs with a corresponding lower risk. Participants entering into a strategic alliance are typically better served by committing to a long- term view. An alliance allows for quicker entry into the marketplace, reducing costs and pre-empting competition. Lastly, an alliance may well help a conventional bank retain or increase its market share in a geographic location where growth in Islamic banking is the most pronounced.

IV. ALLIANCES BETWEEN ISLAMIC AND CONVENTIONAL BANKS

The Islamic banking industry is not restricted to any particular geographic area. However, the bulk of Islamic banking is concentrated in certain geographic regions (e.g. G.C.C. countries). The geographic location of the participant and its historical involvement or past experiences can be critical, since Islamic solutions often need to be tailored to local preferences.

A. Potential Synergies

Conventional and Islamic banks in strategic alliances create numerous synergies in terms of product offerings to the Islamic marketplace. The Islamic participant brings an understanding of *Shari'ah* law to the relationship. Part and parcel with this understanding is the ability to structure transactions and create Islamic solutions. The Islamic participant also brings localized knowledge of the Islamic marketplace. The conventional participant often has skills such as asset management, financial engineering and administrative services. These attributes are often developed over a long period of time at significant cost. Thus the conventional participant's core competencies are an integral component to the innovative Islamic solution.

The alliance creates a bridge between Islamic banking and conventional financial services. This bridge is necessary to the prosperity and growth of the Islamic banking industry as it is doubtful the Islamic banking system can reach its full potential without some measure of integration into the world markets.

V. SHARING OUR EXPERIENCES

TII is a Kuwaiti-based wholesale Islamic Investment Bank listed on the Kuwait Stock Exchange. As of December 31, 1997, the Company had approximately $2.5 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's strength builds upon its structuring expertise and knowledge of the Islamic market and its distinct structuring requirements. The Company's activities include the following three primary categories:

1. Corporate finance (including project financing, mergers and acquisitions, start-up ventures, etc.);
2. "Franchising" of Islamic banking capabilities and solutions, including providing investment products and a comprehensive range of services; and
3. Advisory services, generally of a long-term strategic nature.

A. Franchising

In general, franchising is characterized as furnishing certain intellectual and tangible physical property in a turnkey fashion to an operator. The franchiser often maintains control of the quality and other aspects of the operation. The intellectual property may include the use of a trademark as well as the methodology for production or performance.

An Islamic wholesaler may equip a conventional bank for the purpose of allowing the latter to effectively compete in the Islamic financial services marketplace. TII selects top tier banks, which are sophisticated in terms of staff and system development and have a well-developed distribution network. The relationship can include a wide array of products and be expanded to areas such as consumer financing, Islamic credit cards, and Islamic mortgages. For the conventional bank, franchising is a low-cost approach to entering a segment of the overall banking population that would not otherwise be able to reach effectively.

B. Advisory

This area has a number of attributes. It may consist of a real estate developer seeking to tap the Islamic market, requesting assistance in developing a structure that meets the requirement of *Shari'ah*. It may also include the asset manager that seeks to develop an Islamic equity fund. TII can add value in its advisory capacity in the following ways:

1. Furnishing an appropriate Islamic index;

2. Providing consultation with regard to investment criteria and guidelines;
3. Assistance with dividend cleansing;
4. Due diligence review – compliance opinions;
5. Cash/liquidity management support;
6. Portfolio management tools; and
7. Furnishing other relevant information as appropriate.[ii]

VI. CONCLUSION

Strategic alliances are a critical component of the effort on the part of Islamic banking institutions to become more competitive and further integrated in the world market in the 21st century. There are natural synergies between Islamic banking institutions and conventional banks. Conventional banks investing in sectors requiring knowledge of the *Shari'ah* can enter into various forms of partnerships with Islamic banks. Similarly, Islamic banking institutions seeking to invest in non-Islamic environments can enter into synergistic relationships with conventional banks possessing the appropriate expertise.

[i] Others who are contributing to this industry in one form or another, and in no particular order, include: (1) investors/depositors, (2) conventional banks, (3) private bankers, (4) governments, (5) project developers, (6) venture capitalists, (7) brokers and distributors of products, (8) financial engineers, and (9) asset managers.

[ii] A few additional topics that have not been discussed but are important to note include: (1) evaluating and selecting an ally; (2) creating strategic synergy; (3) understanding and overcoming cultural differences; (4) corporate and individual compatibility; (5) obtaining top-level policy commitment; and (6) developing effective relationships within the overall relationship.