Alexander von Pock

Strategic Management in Islamic Finance

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Alexander von Pock

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1 Introduction

In the last decades, Islamic finance has evolved to become one of the most dynamic and fastest developing business areas in the global financial industry. Although still a niche market, the segment is experiencing ever increasing competition and, especially in recent years, has left its home turf with Islamic financial products being offered in major markets outside the Muslim world, such as the United States and Great Britain. While academic research has extensively covered the basics and a selection of special issues regarding Islamic finance and Islamic economics, the determinants of strategic management in Islamic finance have not drawn the same degree of attention in the literature. As will be presented in the following paragraphs, this study intends to make a contribution to this significant research area.

1.1 Research Problem

> "The foremost belief around which all the Islamic concepts revolve is that the whole universe is created and controlled by One, the only One God. He has created man (…) to fulfill certain objectives through obeying His commands. These commands (…) cover a substantial area of almost every aspect of our life."[1]

It is therefore little surprising that Muslims have to abide by the precepts of Islam even in their financial dealings. The first serious attempts to cater to Muslim banking clients – who wanted to reconcile Islamic principles and their financial requirements – dates back to the 1970s, when the first modern, non-governmental Islamic banks were created. Largely unnoticed by the general public in the West[2], Western financial institutions also began to enter the Islamic financial market in the 1990s. Citibank was the first Western bank to open up an Islamic bank in Bahrain in 1996. Today, Western banks as diverse as the Swiss private bank Pictet & Cie., large universal banks as Deutsche Bank or BNP Paribas, or investment banks such as Goldman Sachs offer Islamic financial products. UBS is for the time being the last Western financial institution that founded its own Islamic bank: Noriba. These Western banks are in competition with purely Islamic banks such as the Saudi Arabian Al Rajhi Banking & Investment Corp. or the Kuwait Finance House, two of the largest Islamic banks originating in the Muslim world.

The ever-increasing importance of Islamic finance is also mirrored by the introduction of Islamic stock market indices. The two key indices are the Dow Jones Islamic Market Index and the FTSE Global Islamic Index, providing a benchmark for the selection of Islamically appropriate companies. Since a number of years, the Islamic finance industry is also striving to develop common accounting, auditing, governance,

[1] Usmani (2002), p. xiii.

[2] „West" is meant to comprise Europe, the Americas, Australia and New Zealand, as the term is frequently used.

ethics, and Sharia standards for Islamic financial institutions. These are developed by institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) or the Islamic Financial Services Board (IFSB).

However, the Islamic finance industry can still be considered as an emerging market. Moreover, the market seems to be quite inhomogeneous at first glance. It is characterized by a number of different firms with strongly varying market presence and penetration: from globally acting banks such as HSBC Amanah Finance, which draw on the global network and resources of its parent company – the HSBC group – to local, independent banks such as Dubai Islamic Bank; from Islamic finance-specific universal banks catering to corporate and private clients to free riders that selectively offer Islamic financial services as exotic products. Consequently, market players obviously distinguish themselves in terms of their resource endowments and the strategies they employ to position themselves on the market. At the same time, conventional wisdom suggests that Islamic banks most probably differ in their performance. The strategic management determinants of such performance differences are the focal point of this research.

From a broader perspective, the research problem also touches upon general issues of strategic management. There are two different perspectives in strategic management regarding the sources of sustainable competitive advantage. On the one hand, success factors are derived from market requirements. Industry effects, i.e. the relative attractiveness of the industry compared to other industries, largely drive company performance. On the other hand, success factors are derived from the company's endowment with distinctive resources and core competencies. Firm-specific effects are viewed as the major driver of company performance. So far, empirical research has reported contradictory findings and remains inconclusive: the question of the relative impact of industry and firm-specific effects is still open. However, both concepts are more and more regarded as complementary in the literature.

1.2 Research Objective and Approach

The main objective of this research is to identify key success factors of superior firm performance in Islamic finance. This is done on the basis of a holistic conceptual framework, taking into account current practices in Islamic finance, strategic management theories, and previous empirical research from the fields of strategic management and economics. The study examines external factors (global environment and industry forces), internal factors (core competencies), and company strategies as potential explanatory factors of performance differences of Islamic financial institutions.

The theoretically derived hypotheses about explanatory factors of company performance in Islamic finance are empirically tested in a survey of 77 Islamic financial institutions operating across the GCC area and Malaysia. The necessary data was collected using a standardized questionnaire. Out of the 77 Islamic financial institutions contacted, 36 or 47% participated in the study, leading to a highly satisfactory response rate. What is more, the participants represent approx. 80% of the estimated total on-balance sheet Islamic banking assets in the GCC area, and approx. 70% of the estimated total on-balance sheet Islamic banking assets in Malaysia. As both markets are highly concentrated, this also means that the major players are included in the study.

The empirical data analysis follows a two-step approach. First, the reliability and validity of the measurement model is tested. The conceptual model mentioned above consists of the assumed relationships between theoretical constructs. These theoretical constructs or latent variables are abstract, non-observable entities, which cannot be measured directly, but have to be represented by one or more indicators. The operationalisation of these constructs largely draws on factor analysis as statistical tool.

Second, the hypothesized relationships between the constructs are analyzed. For this matter, several statistical tests are applied. The impact of the various factors on the different company performance variables is analyzed using correlation and regression analysis. The investigation of differences of the factors or the performance indicators across various groups or clusters – such as hypothesized strategic groups – are performed using the t-test and ANOVA.

1.3 Research Structure

The present research is organized as follows. The introductory chapter 1 gives an overview of the research problem, the research objective and approach, and the research structure.

Chapter 2 sets the analytical framework of the study. It begins in chapter 2.1 with a depiction of the major theories of strategic management, starting with an exposition of state-of-the-art strategic management approaches – the market-based view of strategic management, the resource-based view of strategic management, and New Institutional Economics approaches. Next, strategic management propositions on banking are derived on the basis of an analysis of the various steps of the strategic management process. For this matter, corporate vision, mission and objectives, external factors, internal factors, company strategies, and strategy implementation are scrutinized.

In chapter 2.2, Islamic finance is presented both in terms of its theoretical basis and its actual manifestations and practices. First, the fundamentals of Islamic finance are depicted, including the sources, methods, and schools of law, followed by an exposition of a set of principles in an attempt to help the reader understand the underpinnings of Islamic finance. Next, there is a detailed description of Islamic financial instruments, where these products are organized according to their economic and financial characteristics into debt-like instruments, equity-like instruments, derivative-like instruments, hybrid instruments and other transactions and services. Finally, the Islamic finance market is illustrated. A market overview presents market size, regional scope, and major market types in Islamic finance. Subsequently, the institutional framework – including the regulatory and supervisory environment, as well as the framework for liquidity management and secondary markets – is depicted. Two regions – namely the GCC area and Malaysia – are then looked at in greater detail – with for example a description of major players, marketed products and the specific regulatory environment – as these regions can be considered to be the most important ones for profit-oriented, free-market Islamic financial institutions.

In chapter 2.3, an empirical literature review is presented. It starts with a review of general studies that analyze the importance of the various factors brought forward in strategic management theories, followed by a depiction of Islamic finance studies, which so far adopted economic rather than strategic management approaches.

Drawing on the previous expositions of Islamic finance, strategic management theories, and empirical research on factors influencing company performance, chapter 2.4 develops a conceptual model – composed of three different partial models – and hypotheses about strategic management in Islamic finance. It starts with an overview of the three models, depicting its various building blocks. Next, detailed hypotheses regarding the building blocks of the models and their interrelation are presented. Finally, a summary complements the exposition.

Chapter 3 contains the empirical validation of the conceptual model and its propositions. It begins with the exposition of the research methodology in chapter 3.1. First, the data collection and sampling process is presented, including a depiction of the data collection tool, and the data generation method. In particular, some descriptive statistics are offered in order to further characterize the firms included in the sample, and to shed some light on a few areas of discussion in the Islamic finance literature, which are not part of the conceptual model of this study. Next, the data analysis methodology and tools are described. The major part of chapter 3.1, however, documents the operationalisation of the theoretical constructs developed previously in the analytical framework. In detail, the operationalisation of the external factors, internal factors, company strategies, and company performance is presented.

Chapter 3.2 presents the findings of the empirical test of all three models with their corresponding hypotheses. The exposition starts with the analysis of the impact of external factors on performance. Next, the impact of internal factors on performance is scrutinized. Then, the impact of company strategies on performance is examined. Finally, the chapter is wrapped up with a summary of the empirical results.

Chapter 4 serves as a summary appraisal of the main arguments and major results of both the analytical framework and the empirical study. It is organized in three sections. Chapter 4.1 presents an analytical and empirical summary. Next, implications of the study for Islamic financial institutions are described in chapter 4.2. Finally, in chapter 4.3, research limitations and suggestions for future research are discussed.

2 Analytical Framework

This chapter lays the analytical foundations for the subsequent empirical analysis of strategic management and competitive strategy in Islamic finance. It is organized in four sections. First, the main theories of strategic management are described with an emphasis on the possible influencing factors of company behavior and the repertory of competitive strategies. Second, Islamic finance is presented both in terms of its theoretical basis and its actual manifestation and practices. Third, an empirical literature review presents previous studies of the determining factors of firm performance. Finally, drawing on the previous sections, a conceptual model is developed that is used as a framework to generate detailed hypotheses for the empirical study.

2.1 Theories of Strategic Management

Strategic management is a relatively new notion in business and economics research, which came into existence at about the same time as modern, non-governmental Islamic banking: the mid 1970s.[3] Theories of strategic management have evolved along several lines, the commonality of all approaches being that they define best practices for steering and managing a company. The current section focuses on the major concepts of strategic management, which view management as the process of corporate planning and governance.[4] It starts with the depiction of various strategic management approaches. After that, strategic management propositions on banking will be detailed.

2.1.1 Strategic Management Approaches

There is no generally accepted definition of "strategy" and "strategic management" in business and economics research.[5] Following Welge and Al-Laham, we define strategy as a fundamental, long-term-oriented behavior (combination of actions) of the firm and its relevant parts vis-à-vis its environment in order to realize its long-term objectives.[6] Inter alia, it covers the scope and domain of the firm's activities, its distinctive competences, and its competitive advantage. Strategic management shall

[3] Cf. Welge and Al-Laham (1999), p. 8 and Bea and Haas (2001), p. 6. However, the term "strategy" was introduced into managerial economics by Ansoff and other followers of the "Harvard approach" in the 1960s already. Cf. Eschenbach (1993), p. V and Welge and Al-Laham (1999), p. 12.

[4] In this respect, the predominant Anglo-Saxon strategic management approaches are followed. Evolutionary approaches – such as the approach of Kirsch (1996) – are discarded.

[5] For an overview of different strategy and strategic management definitions cf. Hammer (1988), p. 53, Kreikebaum (1989), p. 25-26, Hax and Majluf (1991), p. 2-5, Dichtl and Issing (1993), p. 2021, Eschenbach (1993), p. V and Welge and Al-Laham (1999), p. 12 et sqq.

[6] Welge and Al-Laham (1999), p. 19.

be defined as the process of formulating and implementing company strategies.[7] The strategic management approaches brought forward in the literature are manifold.[8] In the following, three approaches will be detailed: the market-based view, the resource-based view and new institutional economics. The first two are generally considered as state-of-the-art approaches of strategic management.[9] The last is gaining increased relevance in the strategic management literature.[10]

2.1.1.1 The Market-based View of Strategic Management

Basis of the market-based view of strategic management is the classical industrial organization (I-O) "structure-conduct-performance paradigm" of Mason and Bain.[11] According to this paradigm, the industry structure or competitive environment influences the conduct or strategic choice of a company, which in turn affects the performance or economic success of that company. The primary constitutive elements of the industry structure are the number and size of market players including suppliers and customers, the extent of product differentiation, demand elasticity and barriers to market entry. Conduct is defined as the strategic choices of the individual companies, essentially regarding price, promotion, product features and quality, research and development or production capacity. Performance relates to the companies' economic success and is often equated with return, technical efficiency or innovation capabilities (e.g. rate of new product introductions).[12]

Porter, who is regarded as the exponent of new industrial organization and as a pioneer of strategic management, has further developed the classical structure-conduct-performance approach. He observed that the classical paradigm had major drawbacks regarding its usefulness for strategic management research[13]: First, classical I-O focuses on the allocation efficiency of the whole industry rather than the profitability of individual firms. Second, firms are modeled as single-product companies operating in a single industry rather than diversified companies with multiple business units operating in various sectors. Third, classical I-O takes the industry structure as given and does not acknowledge any repercussions of the companies' strategic decisions on the industry structure. Last, classical I-O views the companies as single, rational units that maximize profits and not as entities with multiple decision makers and corresponding political processes as well as differentiated goal systems. Starting from these observations, new industrial organization enhanced the structure-conduct-performance paradigm by adopting a

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[7] Ibid. Despite the missing universally accepted definitions of these terms, usage of the terms in the literature is very similar to our definitions. Cf. Hinterhuber (1992), p. 7 et sqq., Delley (2001), p. 16 et sqq.

[8] For good overviews of these approaches cf. Knyphausen-Aufseß (1995), Bea and Göbel (1999).

[9] Börner (2000b), p. 50. This appraisal is also reflected in the number of articles using market-based view and/or resource-based view in the Strategic Management Journal, the research area's paramount publication channel.

[10] Welge and Al-Laham (1999), p. 43.

[11] Cf. Mason (1939) and Bain (1968).

[12] Cf. Welge and Al-Laham (1999), p. 36-37 and Bea and Haas (2001), p. 24-25.

[13] Porter (1981), p. 611 et sqq.

more dynamic approach and incorporating the impact of performance on strategy as well as the impact of strategy on the industry structure. According to this improved paradigm, companies adapt or revise their strategies subject to their performance. Furthermore, the industry structure can be altered by the conduct or strategic decisions of a company: for example, innovation or product differentiation can create barriers to entry; vertical integration, co-operations or alliances can change the degree of concentration and competition in an industry.[14] With his "five-forces" model, Porter was the first to develop a comprehensive concept of an industry's competitive structure.[15] The five forces, which determine the attractiveness of an industry, are the bargaining power of the suppliers, the bargaining power of the customers, the threat of entry of new market players, the threat of substitutes and the intensity of competition within the industry. Porter holds that the industry attractiveness is inversely correlated with the intensity of these five forces.

The market-based view of strategic management adopts an outside-in perspective of the company: success factors are derived from market requirements; success potentials are sought in product-market combinations. Following Porter, competitive strategies can be divided into two basic forms: cost leadership strategy and differentiation strategy. Both will be detailed in the subsequent section on strategic management propositions on banking.

2.1.1.2 The Resource-based View of Strategic Management

As an alternative to the market-based view of strategic management, the resource-based view developed a "resource-conduct-performance paradigm" to explain the causal logic of companies' rent generation. According to this paradigm, a company's distinctive resource endowment influences the conduct or strategic choice of that company, which in turn affects its performance or economic success. Following Barney, firm resources are defined as "(…) all assets, capabilities, organizational processes, firm attributes, information, knowledge, etc. controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness".[16] A variant of the resource-based view – the knowledge-based view – even considers knowledge as *the* crucial resource in modern, dynamic economies.[17] Although there is no generally accepted typology of resources in the literature, resources are often divided into tangible and intangible resources.[18] The former covers physical and financial assets such as IT hardware, production facilities or equity base. The latter is further classified into personal resources – covering skills and capabilities – and impersonal resources – covering intangible assets and organizational routines and processes.

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[14] Cf. Tirole (1995), p. 169-203 and p. 305-360.

[15] Porter (1980).

[16] Barney (1991), p. 101.

[17] Cf. Nonaka and Takeuchi (1995) and Grant (1996).

[18] Cf. Knaese (1996), p. 17, Börner (2000b), p. 77, Delley (2001), p. 28-29. Barney classifies resources into physical capital resources, human capital resources and organizational resources.

The foundations of the resource-based view have been formulated in a seminal work by Penrose: she held that the heterogeneity of resources determines the uniqueness of companies.[19] Consequently, a company's resources are not all regarded as fungible goods tradable at perfect factor markets – some are specific to the company. At least for a certain time these resources cannot be acquired or imitated by the company's competitors because of information, transfer and replication barriers and the lack of the possibility to substitute them.[20] Information barriers arise for example from causal ambiguities between company-specific resources and the resulting competitive advantages or the social complexity of resource combinations. Imperfect factor markets, patents or the path dependency of the resource built-up are exemplary causes of transfer and replication barriers. Competitive advantages are derived from distinctive resources of a company, which are not only specific to that firm but also offer superior customer value.[21]

Hamel and Prahalad, who introduced the notion of "core competencies", further developed the initial resource-based view of strategic management.[22] They observe that "(…) the real sources of [competitive] advantage are to be found in management's ability to consolidate corporate-wide technologies and production skills into competencies that empower individual businesses to adapt quickly to changing opportunities"[23]. Although the concept of core competencies was quickly adopted in the strategic management literature, there is no single, universally accepted definition of the term. According to Hamel and Prahalad, a core competence has to satisfy three criteria: "First, a core competence provides potential access to a wide variety of markets. (…) Second, a core competence should make a significant contribution to the perceived customer benefits of the end product. (…) Finally, a core competence should be difficult for competitors to imitate."[24] In relation to resources, core competencies can be viewed as distinctive resource bundles. As such, they are intangible, since they result from the integration and unique combination of resources.[25] Core competencies are effective in three areas: market-access core competencies refer to market development activities and cover capabilities in sales, distribution and marketing. Integrity-related core competencies pertain to the co-ordination of the various departments or business units. Functionality-related core competencies refer to product design and the consequent customer value of a company's offering.[26] Competitive advantages arise from an efficient and effective

[19] Penrose (1959), p. 75. Penrose's idea has been further developed by Rumelt (1984), Wernerfelt (1984) and Barney (1991) who laid the groundwork for the later conception of core competencies, which will be detailed later in this section.

[20] For a good overview and discussion of the reasons for resource specificity cf. Barney (1991), p. 105-112 and Knaese (1996), p. 18-24. Rumelt (1984) talks of "isolating mechanisms", Wernerfelt (1984) of "resource position barriers".

[21] Cf. Börner (2000b), p. 65-75.

[22] Hamel and Prahalad (1994).

[23] Ibid., p. 80.

[24] Ibid., p. 83 et sqq.

[25] Börner (2000b), p. 80.

[26] Hamel (1994), p. 16.

bundling of resources and a continuous renovation and further development of the resulting core competencies.[27]

The capability of a company to continuously acquire and develop its core competencies is usually regarded as a meta competence. Among these meta competencies are learning and innovation capabilities, communication capabilities, relationship management capabilities and management systems.[28] In the literature, the capability of innovation and organizational learning is often viewed as the most important meta competence, as it is a *conditio sine qua non* of the built-up of competencies.[29] As a consequence, it is stipulated that a firm's organization and culture should be configured in a way favoring this meta competence.

The resource-based view of strategic management adopts an inside-out perspective of the company: success factors are derived from the company's endowment with distinctive resources and core competencies. Although it is sometimes seen as a counterdraft to the market-based view, both concepts are often regarded as complementary. In relation to the SWOT[30] analysis, a traditional strategic planning tool, the resource-based view is often equated with the analysis of internal strengths and weaknesses of the firm, the market-based view with the analysis of external opportunities and threats.[31]

2.1.1.3 New Institutional Economics Approaches

As new institutional economics actually is not part of the realm of strategic management, it does not attempt to explain the economic success of a company but rather deals with problems of economic co-ordination. The three main approaches of new institutional economics – property rights theory, transaction cost theory and principal agent theory – are however of some relevance for strategic management research, as will be highlighted in the following exposition.[32] All three approaches are based on the same assumptions about human behavior[33]: First, individual utility maximization: people are individually pursuing clearly defined goals – specified as utility functions, which are maximized. These utility functions are constant over time, so that changes in behavior cannot be attributed to changes in people's preferences. Second, bounded rationality: both knowledge and information processing capabilities of people are limited. As a consequence, problems cannot be comprehensively structured and solved. People decide and act on simplifications and approximations of

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[27] Börner (2000b), p. 82, Delley (2001), p. 36.

[28] For a detailed review of these meta competencies cf. Knaese (1996), p. 29-35.

[29] Cf. Börner (2000b), p. 87-88, Delley (2001), p. 35.

[30] SWOT = Strenghts, Weaknesses, Opportunities, Threats

[31] Cf. Wernerfelt (1984), p. 171, Barney (1991), p. 99-101, Knaese (1996), p. 8-13, Börner (2000b), p. 118 et sqq. In particular, Börner formulates an integrated model of both the market-based and the resource-based view.

[32] For an overview of various uses of new institutional economics approaches in strategic management cf. Milgrom and Roberts (1992), Scott (1995), Picot et. al. (1997), Kieser (1999). For a good overview of new institutional economics cf. Williamson (2000).

[33] Cf. Cezanne and Mayer (1998), p. 1345 et sqq. and Welge and Al-Laham (1999), p. 43-44.