Investment Banking

Islamic banking: Impressive growth underscores success

Camilla Hall reports on the sector's increasing popularity

Camilla Hall MARCH 27, 2012

When Islamic banking was first introduced to the Middle East more than 40 years ago, sceptics labelled the industry a sham and an effort to rebrand conventional banking products in a misleading way.

At that time, no one could have foreseen that sharia-compliant banking could grow into the $1.1tn global industry that it has become today. Whether one accepts it as a financial phenomenon or not, the numbers speak for themselves.

Bankers in Dubai say the debate over the sustainability of Islamic finance is over and it is rapidly becoming an important revenue generator for some of the world's biggest lenders "We are continuing to expand," says Afaq Khan, the Dubai-based chief executive of Saadiq, Standard Chartered's Islamic banking arm.

For Saadiq, revenue in the United Arab Emirates increased 65 per cent last year compared with 2010. The bank is not compelled by law to provide a full breakdown for its Islamic services. But it is upgrading its branches in Pakistan and establishing new ones in Asia while it builds and expands its client base in the Middle East. Assets under management at Islamic institutions in the region are forecast to double to $990bn by 2015 from $416bn in 2010, according to Ernst & Young.

The success of Islamic finance is linked to a growing population of Muslims who readily deposit their funds with sharia-compliant banks, both local and international.

Islamic law forbids the acceptance of interest and sharia-compliant products are typically asset-backed.

What started as small local banks decades ago have become vast pools of liquidity. Saudi Arabia's Al Rajhi bank, for example, the world's biggest Islamic lender, saw its assets grow to $58.8bn last year from $49.2bn in 2010.

As assets increase, there is an appetite for more sharia-compliant products from the holders of assets in the region. It is also another area in which international investment banks can benefit from debt capital markets mandates.

The growth is impressive. The top 20 Islamic banks in the Gulf have grown 20 per cent in the past 18 months, compared with 9 per cent for conventional banks, according to Ernst & Young's Bahrain-based sharia-compliant advisory group.

Saudi British Bank, part-owned by HSBC and Standard Chartered, is the top arranger of Islamic bonds in the Middle East so far this year, according to Dealogic, the data provider.

Banks have seen mandates increase as the sale of Islamic bonds in the region has risen exponentially to $5.7bn in the year to date, from $500m in the same period last year, and $446m the year earlier, according to Dealogic.

While not necessarily a measure of the size of the industry, it indicates that selling Islamic debt has become more popular among issuers. The investment banks certainly gain market presence through sukuk deals but often earn more by structuring more complex sharia-financing for their clients.

A number of regional companies has decided to sell sharia-compliant debt for the first time as the cost of selling sharia-compliant bonds has become cheaper than conventional debt. The demand for sukuk from Islamic investors prompted issuers to consider selling Islamic debt for the first time.

As with any industry, the commercial benefits are helping to increase the popularity of Islamic finance. It has become cheaper and easier to issue bonds through the Islamic process.

Banks can operate both Islamic and conventional arms, apart from in Qatar, which recently insisted that each lender must choose between whether it is Islamic or conventional. The decision forced international banks to close their sharia-compliant operations in the country.

Razi Fakih, deputy chief executive of Global HSBC Amanah, says: "Customers are increasingly turning to Islamic finance because the proposition is on par with conventional banking."

"Companies can get sharia-compliant solutions for both their simple and complex needs." HSBC Amanah growth was in the double digits last year, according to Mr Fakih.

These so-called Islamic "windows" are likely to outgrow pure Islamic banks, according to Ashar Nazim, head of Islamic financial services group at Ernst & Young. "It will be most beneficial to these large conventional banks because they're able to reach out to the mainstream segment," says Mr Nazim. "They can say, 'we are the best bank in town and we offer Islamic as well'."

The market share of Islamic banking compared with conventional banking is also becoming hard to ignore in the Gulf. Whereas sharia-compliant banking accounts for 14 per cent of the market in the Middle East and north Africa, the Islamic industry represents more than a quarter of the market in the Gulf Cooperation Council, according to Ernst & Young's data for 2010.

"Islamic finance today has its own distinct infrastructure spanning bankers, lawyers, regulators and scholars. Any serious advisory practice will need to develop the wherewithal to interact effectively with all of these constituents," says Yavar Moini, executive director at Morgan Stanley in Dubai.

This article is subject to a correction.