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Investment banks: Wide array of new names join the party

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On paper, WestLB does not look like the type of institution that might naturally engage with Islam. A medium-sized German bank, it has traditionally earned a living by lending to German manufacturers – and then, more recently, moving into the private equity and derivatives world.

But earlier this year the bank unexpectedly earned a striking accolade: it underwrote a £225m package of Islamic finance to support a leveraged buyout of Aston Martin, the racing car group, by a group of Middle Eastern investors.

The deal marks the first time that Islamic finance has been used for a private equity, leveraged buyout in the UK. But it also highlights another key trend: as Islamic finance expands in scale and complexity, the array of western financial institutions joining the party is widening by the day.

For while a few western banks, such as HSBC, BNP Paribas, Standard Chartered and Citigroup, have been running Islamic operations for almost a decade, they are now facing competition from a host of new names. These include Morgan Stanley, Barclays Capital and Deutsche Bank – as well as smaller players, such as WestLB, which last year alone arranged around a dozen Islamic deals, worth around $4bn.

"Nowadays you will hardly find any major Middle Eastern or western financial institution with operations in the Middle East that is not involved directly or indirectly in Sharia-compliant financial products, financings or investments," says Jawad I. Ali, a partner at King and Spalding. The international law firm claims to have been the first to jump into the field of Islamic finance a couple of decades ago – but now has dozens of competitors at other law firms.

There are several reasons for the trend. One is the rich business opportunities that can now be found in the Middle East, as the result of the oil boom. HSBC calculates, for example, that Middle Eastern investors have now invested some $1,200bn in international assets alone in recent years, some of which is now being repatriated as the political climate has changed.

Other analysts suggest the region could enjoy some $20,000bn of oil income in the coming years – of which as much as a third could be used in the Islamic finance sphere, Darshan Bijur of the consultancy KPMG suggests.

And even before this extraordinary forecast comes into play, the business bonanza is also creating vast corporate financing and infrastructure needs. Not all of this is using Islamic finance. Indeed, until quite recently, markets such as Malaysia were more developed than the Middle East in their use of instruments such as *sukuk.*
However, the Gulf region is embracing Islamic finance with a speed that has taken practitioners by surprise.

"The reality now is that if you are a financial institution and want to do business in the Middle East, you simply have to have a Sharia-compliant window or division that offers Sharia-compliant financial products. That wasn't the case two years ago, but it is now," Mr Ali notes.

But western banks have also spotted other reasons to embrace the sector. One is the fact that Islamic products can often prove to be distinctly lucrative. For, like any nascent, fast-emerging area of finance, the sector is so fragmented and opaque that it can often produce high margins – particularly where products are not commoditised.

Moreover, contrary to what a casual onlooker might suspect, western investment banks do not appear to face any significant impediment as a result of their national affiliations – or lack of Islamic roots. That is partly because they tend to distribute their products through local Islamic banks, or act with a local partner.

However, the pattern also reflects a distinctive point about the way that Islamic finance operates: namely, that the religious "brand" of any product typically rests not in the reputation of the institution that has produced it – but with the religious scholars who have approved it. Thus, western banks have entered this field by engaging the service of esteemed religious scholars who can rule on the Islamic merits of products.

Some, such as HSBC, have done this by creating a dedicated Sharia advisory board, attached to a specific Islamic banking unit. Others, such as Deutsche Bank, have created so-called Islamic “windows” (or dedicated pools of capital that are used only for Sharia-compliant finance) – but have used Islamic finance consultancies for religious advice.

Still others, such as Barclays Capital, have turned to Islamic scholars on an ad hoc basis, as product opportunities arise. Either way, by engaging renowned Islamic scholars, the banks have been able to create the necessary Islamic “branding” – whatever their origins.

It remains an open question just how sustainable this approach will be in the long term. After all, the expansion of the Islamic financial industry this decade has occurred in a very benign credit climate. However, if markets were to crash, investors and issuers might become more discriminating about the source of Islamic products – particularly if the Sharia-compliant qualification of a product sold by a western bank ever came into dispute.

Moreover, the western investment banking industry has a history of dashing *en masse* into new products when they are booming – and retrenching when the climate changes.

There is a good chance that this pattern would be repeated if Islamic finance were suddenly to suffer a sharp downturn – or the Middle East region were to tumble into recession as the result, say, of a collapsing oil price. This could fuel Islamic populations’ cynicism about western banks’ role in this field.

However, with the oil price booming, there is little sign of this scenario emerging yet: on the contrary, as more banks expand in this field, the battle to hire Islamic banking talent – or retain the services of credible scholars – is becoming more intense.

“Compensation [for Islamic banking] is often higher now than in the conventional banking world,” says Samer Hijazi of KPMG. That is perhaps the surest sign yet that western banks’ Islamic ambitions are still rising.