

## **Islamic Banks: Front and Center**

By Douglas Clark Johnson

As a newly declared finance major in college, I recall my Money & Banking professor proclaiming on the first day of class, “Don’t ever forget that our banking system is most fundamentally based on confidence.”

It struck me as an odd statement at the time. Given decades of institution-building and multiple regulatory overlays in the United States, her notion seemed almost antique. Or was it?

The professor’s precept popped back into my mind 25 years later as the subprime crisis made it newly relevant. Certainly a foundation of confidence is a tenet that the Islamic and conventional banking systems have in common, in part because confidence in the economy (or lack thereof) is impartial and all-encompassing.

Islamic banks in general will likely weather the current storm better than most conventional banks, but they are not immune to the spillover effects of the subprime crisis. Indeed, to the extent that Islamic banks depend heavily on transaction volume for their profitability, they will be ensnared with their conventional peers in the worldwide downturn. Suffice it to say that a receding tide—like a rising tide—takes most things with it.

To be clear, Islamic institutions do not have exposure to subprime-linked assets because of the prohibition of engagement with *riba*. This feature kept them outside of last year’s unfolding financial-sector drama. In addition, the underdeveloped interbank market for Shariah-compliant banks means that they generally have high cash balances to ensure proper operational liquidity. The “cash crunch” that eroded confidence in most conventional institutions never befell the Islamic banking sector.

Yet I find it misleading to argue that Islamic banks are unscathed by global developments. Especially in the Gulf, such institutions may have relied too heavily on real-estate backed products and structures to support their profitability. And of course the demand for such business and the value of underlying assets has eroded or even collapsed. Niche situations aside, there appears to be no market globally where real estate is a growth opportunity nowadays.

Islamic banks will likely not see a meaningful recovery in profit generation for some time. For perspective, conventional banks traditionally can build revenue both in an early cycle economic-growth stage (because of the potential for higher spreads as market rates begin to rise) and during the mid-to-late cycle because of greater transaction volume. Islamic banks, on the other hand, have an earnings structure that primarily builds mid-to-late cycle, when business volume is most pronounced. Given that the global economy may not recover until late 2009, in conjunction with a presumed US economic rebound, it could be 18-to-24 months before Islamic banks again approach the sort of earnings levels seen earlier this decade.

As a point of industry structure, Islamic banks may be further affected by diseconomies of scale in the wake of failed economic growth prospects. Marginal players will no doubt find it hard to survive in this environment. Consequently, governments may be prompted to step in to offer assistance under the cloak of administrative guidance. Certainly the rapid growth of the Islamic banking industry begs some consolidation in a low-to-no-growth environment. In addition to some non-starters, we may see a chain of Islamic banking mergers over the year ahead, albeit provoked by the desire for cost reduction rather than the need to repair balance-sheet holes.

We see only pockets of growth in the Islamic retail banking segment at this time. There may, however, be strong opportunities in the traditional investment-banking roles of advising and structuring, especially in the near term as slow growth raises balance-sheet and business-model concerns among corporate clients. Also promising is the potential for a new range of Islamic investment products focusing on cash-flow for investors, as well as those tapping into distressed asset situations.

Long-term prospects for the Islamic banking industry remain bright. A side-effect of the post 9/11 era has been a powerful sense of cultural demonstration across the Islamic world, albeit not without its dark side. As Shariah-sensitive companies and consumers continue to identify with their Muslim heritage, the industry will no doubt prosper. Certainly with regulatory and fiscal support from governments as geographically diverse as Saudi Arabia and Malaysia, the industry is positioned to build impressively on its early-stage foundations.

In this sort of environment, Islamic banks could be particularly effective in helping to rebuild confidence in the global economy. That calls for moving beyond the standard retail model to adopting a more pronounced role in issuer/investor transactions, in risk-shared financing facilities, and in economic development initiatives. Such focus is an unexpected way for the Islamic banking sector to take a pronounced role in global economic leadership. Indeed, the overall Islamic banking industry may be surprised at how receptive conventional markets are to its style and substance.

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