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# Islamic Banking in the European Union Countries

**Iwona Sobol**

University of Gdańsk, Armii Krajowej 119/121, 81-824 Sopot, Poland



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## Abstract

In the 1970s Islamic financial system based on religious belief emerged in some of Muslim countries. The purpose of the Islamic financial system is just like in the case of the conventional one, to facilitate the smooth flow of funds between savers and investors. However, what is distinguishable about the Islamic financial system is that it is based on principles of sharia, which is a religious law of Muslims. With the share of around 80% in total assets of Islamic financial institutions, Islamic banks play a dominant role in the Islamic financial industry. They operate in over 75 countries, not only Muslim ones, but also those, where Muslim minority live. The aim of the paper is to analyse the opportunities and challenges for development of Islamic banking in the European Union countries. The analysis should give an answer to the question whether Islamic banks can have more significant presence in the European financial market in the future, than they have today.

The article consists of four parts, not counting introduction and concluding remarks. The first part of the paper is a descriptive analysis of the main principles of sharia, which have impact on operations of Islamic banks. They include: prohibition of interest (riba), avoidance of uncertainty (gharar) and prohibition of trading in illegal (haram) products. Because of the necessity to comply with those principles, the instruments offered by Islamic banks must be constructed differently than conventional ones. Islamic financial instruments are briefly described in the second part of the paper. In the third section of the article the evolution and the current state of Islamic banking in the EU countries is presented. The main focus is put on the United Kingdom, since in this country Islamic banking sector is the most developed. In the fourth part prospects for development of Islamic banking in the EU are discussed. First the factors that should contribute to the development are presented. Then challenges faced by Islamic banking industry in the EU are analysed.

The key results show that Islamic banking in the European Union countries is at a very early stage of development. Even in the United Kingdom, which is the European Islamic finance leader, assets of Islamic banks account for less than 1% of total assets of British banking sector. However, there is a potential for the development Islamic banking market in the EU, which mainly lies in large and increasing population of Muslims in Europe. Moreover, after the global financial crisis, which severely affected European banking industry, there is a higher demand for ethical investments among Europeans, which could translate into higher demand for Islamic financial services. On the other hand, there are still a lot of challenges faced by the Islamic banking industry in the EU, which cannot be easily solved. They include: lack of suitable legislation in majority of EU countries, especially with regard to tax and supervision issues, problems with risk management, high costs of Islamic banking products and hostility towards Islam, and thus Islamic banking among the European society.

The article uses descriptive and analytical method of analysis, based mainly on scientific literature, market reports and statistical data.

**KEYWORDS:** Islamic banking, non-interest banking, European Union, sharia, United Kingdom.



## Introduction

In the 1970s of the 20<sup>th</sup> century Islamic financial system, based on religious principles started to emerge in Muslim countries. Among all the Islamic financial institutions, banks emerged at the earliest. The reasons why they were established across the Muslim world were connected with the neo-revivalist movements among Muslim societies on one hand and the raising wealth of some Middle East countries on the other. One of the most influential movements was the Muslim Brotherhood, established in Al-Isma'iliyya (Egypt) in 1928 by Hasan al-Banna. The Muslim Brotherhood criticised interest-based financial system in Egypt and other parts of the Muslim world and argued that since Islam provides its followers with a comprehensive ideological framework for all aspects of life, economic affairs should be also included within that framework (Saeed, 1996). The opinions of Muslim Brotherhood and other Muslim movements found followers in the academic world as well as among market practitioners. But if it were not the wealth of the Gulf states, which was the result of oil crisis and the enormous increases in the oil prices, the development of Islamic finance probably would have been much slower. Almost all the Islamic banks that were established in the 1970s were partly or even totally funded by oil-linked wealth. Since then, the increasing significance of Islamic finance has been observed. Up to now banks have been playing a dominant role in the Islamic financial industry. The value of their assets accounts for about 80% of assets of all Islamic financial institutions. Apart from banking services, other Islamic financial services that develop dynamically include Islamic bonds (*sukuk*), Islamic insurance (*takaful*) and Islamic funds.

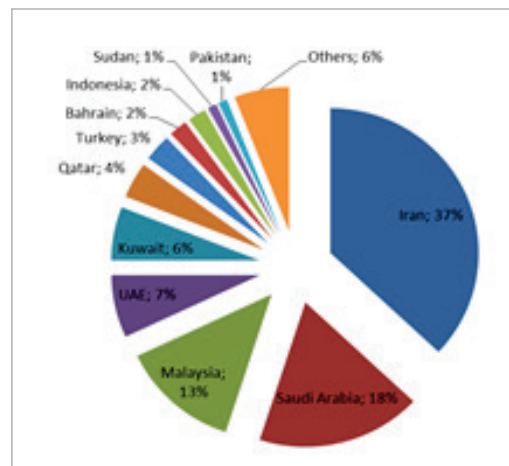
According to Ernst & Young, assets of Islamic banks amounted to 1.54 trillion USD in 2012 and estimations indicate that this figure will grow to 3.5 trillion USD by 2018 (Ernst & Young, 2013). Islamic banks operate in over 75 countries, mainly Muslim ones. As it can

be seen in Figure 1, Iran is the country with the highest volume of assets. In 2013, assets of Islamic banks operating in this country, accounted for 37% of total global Islamic banking assets. The second and third places were taken by Saudi Arabia and Malaysia.

However, Islamic financial services are also offered in other parts of the world, where Muslim minorities live, such as the USA and Australia. In the European Union countries Islamic financial services are still at a very early stage of development with the marginal contribution in the global Islamic financial assets estimated at 50–60 billion USD in 2013 (Malaysia International Islamic Financial Centre, 2015).

It is rather dubious that the Islamic financial system could become a serious alternative for a conventional system in the EU countries. But Islamic banks could become a viable addition to the conventional financial institutions. They could achieve a similar position to the position, held by co-operatives banks. Whether Islamic banks will find their place in the EU markets though, the question remains open.

The aim of the paper is to analyse the opportunities and challenges for the development of Islamic banking services in the European Union countries. The analysis should give an answer to the question whether Islamic banks can have more significant presence in the European financial market in the future, than they have today.



Source: Malaysia International Islamic Financial Centre, 2015.

Figure 1

Domicile of Islamic Banking Assets

The aim is pursued by addressing the following objectives:

- \_ identifying principles of Islamic religious law, which have impact on operations of Islamic banks,
- \_ presenting the evolution and the current state of Islamic banking in the European Union,
- \_ discussing prospects for development of Islamic banking in the EU.

Scientific novelty and originality of this article lies mainly in the subject, which is rarely raised in the European scientific literature. Most of the articles, dedicated to Islamic finance, concentrate on markets of the Middle East and Southeast Asia, while this paper makes a contribution to the studies on the current state and prospects for development of Islamic banking in the European Union countries.

The article uses descriptive and analytical method of analysis, based mainly on scientific literature, market reports and statistical data.

## Principles of Islamic Banking

The purpose of the Islamic financial system is just like in the case of the conventional one, to facilitate the smooth flow of funds between savers and investors. However, what is distinguishable about the Islamic financial system is that it is based on principles of sharia. Sharia (in Arabic “the way” or “path to watering place”) – Islamic religious law – can be defined as “a set of norms, values and laws that governs the Islamic way of life” (Dusuki, 2011). Sharia regulates all spheres of life, including politics and economy. Compliance with sharia principles by Islamic banks should guarantee that they act ethically and do not exploit in any way their partners, whether these are their individual or corporate clients or other financial institutions.

The main principles of sharia, which have a big impact on operations of Islamic banks, include: prohibition of interest (*riba*), avoidance of uncertainty (*gharar*), prohibition of speculation (*may-sir*), prohibition of trading in illegal (*haram*) products (e. g. alcohol, pork, pornography, tobacco), reliance on the participation model of banking.

The basic principle applied by Islamic financial institutions is the prohibition of interest (*riba*). It also constitutes the main difference between Islamic banks and conventional financial institutions, which base all their operations on interest rate. The prohibition of *riba* has its origins in the holy book of the Muslims – the Koran. The Koran forbids expressly the practice of *riba* several times (Koran: 2.275, 2.276, 2.278, 2.279, 4.160, 4.161). The hadiths, which describe the life and actions of Muhammad, the Messenger of Allah, also state that *riba* is condemned. However, neither the Koran nor the hadiths define what *riba* is. According to most Islamic economists, it is any sort of increase over the principal amount (Hasanuz Zaman, 2001). According to Islamic scholars, *riba* creates wealth without being the outcome of productive economic activity and all interest-based financial arrangements are unfair and morally unjustifiable. The prohibition of *riba* means that Islamic banks must construct all their instruments, whether on asset, or liabilities side of the balance sheet in such a way, that they are *riba* free.

The necessity of avoiding *gharar* is another principle that must be followed by Islamic financial institutions. Islamic scholars define *gharar* as ignorance (*jahl*) or lack of knowledge about the physical attributes of the subject transaction, and the lack of knowledge that the object exists. *Gharar* can be also understood as an inequality in the bargaining power that arises from ignorance or lack of knowledge about the subject matter and features of the contract (Balala, 2011). Mainly due to that principle, derivatives are hardly used in Islamic finance. It can be explained in several ways. One of the purposes of the prohibition of *gharar* is the elimination of risk and uncertainty. And these are imminent for derivatives trading. In the case of derivatives there is

no guarantee that the transaction will be settled by the counterparty. It must be also said that despite the fact that derivatives were created in order to protect against risk, in a very short time they started to be used for speculative purposes. In Islam speculation is prohibited because of the necessity of avoiding *gharar* as well as due to the prohibition of *maysir*, which is understood as gambling<sup>1</sup>. And it should be pointed out that the majority of Islamic scholars believe that trading in derivatives for speculative purposes is a form of gambling (Sobol, 2012).

Islamic banks are also not allowed to invest in activities, which are considered *haram* (illegal). Thus they are not supposed to lend to companies or individuals involved in industries as those related to pork products, pornography or alcoholic beverages (Duràn & Garcia Lòpez, 2012). This principle is especially important for the clients of Islamic investment banks. When they entrust money to such banks, they can feel sure, that it will not be invested in industries, which are considered unethical.

Another important Islamic banking principle, which results from the prohibition of *riba*, is the necessity to base the bank's operations on a participation model, meaning participants of a financial transaction should share profits and losses of this transaction. A financial transaction which transfers all the risks associated to an investment project on a single stakeholder is, therefore, contrary to the principles of Islamic banking.

The basic principle of a participation or profit and loss (PLS) model is that instead of lending money at interest, the bank forms a partnership with the borrower, sharing in a venture's profits and losses. Hence, unlike interest-based products, in the case of PLS instruments, there is no guaranteed rate of return on the investment, since income depends on the profit earned by the partnership company and may possibly result in losses.

As it was already written in the previous section of the article, a participation model is an ideal banking model from the perspective of sharia. In practice, two main modes of finance based on this model, can be distinguished: *musharaka* and *mudaraba*.

*Musharaka* can be defined as a form of joint venture where two or more parties combine their capital and labour together to share the profits, enjoying similar rights and liabilities. The profits resulted from such a venture are shared according to a pre-agreed ratio between the parties of *musharaka*, while losses are borne in proportion to contributed capital.

In a *mudaraba* contract one party of the agreement, called *rabb-ul-maal*, provides capital finance for a specific venture indicated by the other party, called *mudarib*. *Mudarib's* contribution to the venture is professional and technical expertise. He is also responsible for the management of the business. If the venture brings profits, they are shared according to a pre-agreed ratio between *rabb-ul-maal* and *mudarib*. Losses however are entirely borne by the *rabb-ul-maal*, with the exception of the cases when such losses are the outcome of the managerial negligence or misconduct of *rabb-ul-maal*. Due to the fact that one of the partners runs the business and the other provides solely finance, the relationship between the partners is based on trust, with the investor having to rely heavily on the entrepreneur, his ability to manage the business and his honesty when it comes to profit share payments (Schoon, 2010).

As it can be seen above, in the case of PLS tools, the partners in the venture, have no right to profits if they do not share the risk, whether it is money or the work, dedicated to the venture. Hence, Islamic banks need to adopt a more cautious approach to lending. Being a partner, rather than a lender, compels them to assess risks more carefully and to effectively monitor the use of funds by

<sup>1</sup> In ancient Arabia *maysir* was a very popular game of chance, played with arrows without heads and feathering, for stakes of slaughtered and quartered camels (Wehr, 1976).

the borrowers. In reality, it means that both the client and the financier assess risks which improves discipline of the financial system and restrains excessive lending and borrowing (Chapra, 2009).

However, although PLS instruments should be the foundation of the Islamic banking system, in practice they play only a secondary role. The reason for such a situation lies in the fact that there are many problems associated with those modes of finance. Most of them result from the information asymmetry which may lead to moral hazard behaviour of the borrowers (Warde, 2000).

As a consequence of problems associated with PLS transactions, other methods of finance such as *murabaha*, *salam*, *istisna* and *ijara* are much more often used by Islamic banks. *Murabaha* (a cost-plus, mark-up contract) is a trade contract stipulating that one party purchases a good for its own account and sells it to the other party with a mark-up (Vissner, 2013). The payment usually takes place sometime afterwards or in instalments. There are many controversies connected with this tool of finance. Some Islamic scholars even consider *murabaha* not sharia-compliant, since the mark-up is often based on the interest rate. And thus they say, *mudaraba* can only be used temporarily, when *musharaka* and *mudaraba* cannot be applied because of their impracticality (Usmani, 1998). However, since it is a very useful mode of finance, appreciated by both the banks and their clients, it is widely used. A *murabaha* contract is applied to trade finance, interbank liquidity and house finance.

In a *salam* contract one party of the contract agrees to provide specific goods at a future date while the other party agrees to pay its price in full at the conclusion of the contract. *Salam* contracts are usually short term (1-3 months). The type, the quality and the amount of the goods are precisely specified. Their vendor is required to provide the required goods at the time specified in the contract. If they are not in his possession, he will have to purchase them on the market. It is therefore also important that the goods that are the subject of financing are easily accessible. As a transaction type, *salam* contract is especially suitable for the financing of agriculture and small construction and manufacturing projects (Schoon, 2010).

Just like *salam*, an *istisna* contract is a purchase agreement for future delivery of an asset. Unlike the *salam* contract, however, in the *istisna* contract, the payment to the producer or contractor of the asset does not have to be in full in advance. Payment usually is done in instalments in line with the progress made on the development of the asset. Therefore this tool of finance is especially suited to project finance and construction (Schoon, 2010).

An *ijara* contract is the Islamic equivalent of a leasing transaction. The difference between two instruments is that in *ijara* the proprietorship of the object of the lease stays with the lessor. The asset stays on its balance sheet until the end of the period of the lease. What is transferred is its usufruct (Boumediene, 2011).

On the liabilities side of the balance sheet of the Islamic bank, just like in conventional banks, deposit accounts are the most important elements. Islamic banks usually provide three types of accounts: current accounts, saving accounts and investment accounts. None of these products can bring interests. It is not a problem with current accounts or savings accounts. They often do not bring interests in conventional banking either. In the case of investment accounts, depositors participate in the profits and losses of the bank. Thus they can earn money but also incur losses. *Mudaraba* is an instrument, which is usually used as this kind of deposit. In this case depositors (*rabb-ul-maal*) share the bank's (*mudarib*) profit, but if the bank invests the money into project, that brings losses, the depositors may lose their money.

Apart from the financial instruments and deposits mentioned above, Islamic banks also offer products, not directly related to financing or investing. For instance, there are special Islamic instruments, facilitating international trade transactions. such as Islamic letters of credit or Islamic bank guarantees.

To sum up this part of the article, it should be noted that all financial products, offered by Islamic banks, before being launched to the market, must get consent of a special body of Islamic bank - sharia board, which consists of scholars in Islamic religious law.

Islamic banking in the European Union countries is still at a very early stage of development. There are only a small number of banks, offering Islamic financial products and services in the EU. Most of them are situated in the United Kingdom, which is regarded as the European Islamic financial centre. That is why the analysis conducted in this chapter, will be mainly concentrated on the British market.

The first involvement of European banks in non-interest finance took place already in 1920s of the 20<sup>th</sup> century. At that time, the Eastern Bank, the predecessor of Standard Chartered, was allowed to open a branch in Bahrain on condition of avoiding of all interest-based transactions. At the same time and on the same condition the National Handelsbank of the Netherlands, the predecessor of ABN-Amro, was allowed to establish a branch in Jeddah, the aim of which was to provide money changing services for pilgrims from Dutch Indonesia (Wilson, 1983).

For the next fifty years the European banks involved in the Muslim World conducted their operations using interest, just like their local counterparts. It was not until 1970s, when first Islamic banks were established in the Middle East, that banks operating in Europe came into contact with non-interest banking again. The newly established Islamic banks had problems with management of their liquidity, since they could not use instruments that are available for conventional institutions, because those are based on interest rate. As an answer to this problem, a number of banks operating in London, especially Saudi International Bank and the United Bank of Kuwait started to offer sharia-compliant liquidity management services to Islamic banks from the Middle East. They accepted deposits based on a commodity *murabaha* structure, with the associated short term trading transaction being conducted on the London Metal Exchange (Wilson, 2007).

The big step towards the implementation of Islamic banking services into European financial system was done in 1982, when the Al Baraka Investment Company from Jeddah, bought British Hargrave Securities, a licensed deposit taker and converted it into Islamic bank. Newly established Al Baraka International Bank served the British Muslim community only to a limited extent though. It targeted its services mainly to wealthy Arabs, who spent summers in London. At the turn of 1980s and 1990s, the business of Al Baraka International bank expanded, as a result of which at the beginning of 1990s the bank had between 11 000 and 12 000 clients (Al-Omar & Haq, 1996). At that time the bank offered current accounts, investment accounts based on *mudaraba*, as well as instruments dedicated to housing financing. Despite this, the most profitable area for Al Baraka was investment management and as matter of fact the institution reminded more an investment company than a bank. When it came to retail banking, it lacked the critical mass to achieve a competitive cost base in an industry dominated by large institutions, and the possibility of expanding through organic growth was also limited. In these circumstances, when the Bank of England tightened its regulatory requirements after the demise of BCCI<sup>2</sup>, Al Baraka decided that it was not worth to continue to hold its banking licence, as it would involve high costs, needed for restructuring of the ownership and a greater injection of shareholder capital. Consequently in June 1993, Al Baraka surrendered its banking licence and closed its branches, but continued to operate as an investment company. Depositors received a full refund, and many of them transferred their money to the newly established investment company (Wilson, 1999-2000).

<sup>2</sup> Bank of Credit and Commerce and International (BCCI) was an international bank, established in 1972, which had branches in many countries of the world, including the UK. In the 1980s it came under the scrutiny of numerous financial regulators and intelligence agencies due to concerns that it was poorly regulated. Investigations, which followed, revealed that it was involved in money laundering and some other financial crimes.

## Evolution of Islamic Banking in the European Union and current state of the market



In 1995, at a conference organised by the Islamic Foundation, then Governor of the Bank of England, Lord Edward George gave a speech in which he drew attention to the dynamic development of Islamic banking in the Muslim world and its emergence on the international stage as well as to the need to attract Islamic banks to the UK. He also pointed to a number of problems and difficulties associated with the development of Islamic banking in the UK, to which the banking supervision had to find the solution (Ainley et al., 2007).

These sentiments were first translated into practice in 2001, when a special committee, which included representatives from the government, Financial Services Authority (FSA), banks and the Muslim community, was appointed to determine what legal obstacles stood in the way of further development of Islamic banking in the UK. One of the largest obstacles, that was recognised, was the fact that Islamic mortgages attracted double stamp duty, both on the purchase of the property by the bank and on the transfer of the property by the bank to the customer at the end of the mortgage term (Ainley et al., 2007). The stamp duty on the subsequent sale of the property to the customer was abolished very soon, namely in 2003 (Finance Act 2003, Section 73). This step is considered to be the first step, which opened the door to retail Islamic banks in the UK and equalised their chances with conventional banks.

The year 2004 brought a breakthrough in the field of British Islamic banking. In this year Islamic Bank of Britain (IBB) became the first wholly Islamic retail bank, which received a license from the FSA. It was the first fully-fledged Islamic bank not only in the UK, but in the whole European Union. The licensing process, which required a great effort both from FSA and the bank, was well thought out. During that process, especially two issues arose concern – the security of deposits and the role of the sharia board.

A saving account proposed by Islamic Bank of Britain as a deposit was *mudaraba* deposit, which as it was mentioned in the previous section, means that customers risk the loss of the original capital. However, under the British law, customers have the right to a guaranteed refund of the deposit. Representatives of the FSA and the IBB came to an agreement according to which IBB customers had the right to waive the right to deposit protection on religious ground and choose instead to be repaid under the risk sharing and loss bearing formula. The question of the role of the sharia board was far more complex. FSA had to determine whether the board would act as the management or merely the advisory body, as the delimitation of these two functions is not obvious in the Islamic bank. British law requires banks management to fulfil certain legal requirements concerning, inter alia, economic education and experience in the financial industry. These are the requirements that the Islamic scholars often cannot meet. That is why from the supervising authorities' perspective, Islamic banks need to show that the role and responsibilities of sharia boards are advisory and they do not interfere in the management of the bank (Ainley et al., 2007).

Further legislative improvements were done in 2004 and 2005. The Finance Acts both from both years included regulations that allowed using such Islamic financial instruments as *musharaka*, *mudaraba* or *ijara*. Interestingly, in the provisions of the British law Arabic names for financial instruments such as *murabaha* or *ijara* never appear. The legislature avoids names derived from Arabic and always refers to typical Islamic contracts as "alternative finance". Nevertheless, the analysis of British regulations shows that they also apply to Islamic contracts (Hadžić & Klepić, 2009).

In the following years, several other wholly Islamic banks were established in the UK. In 2014, there were six fully-fledged Islamic banks. These were: Al Rayan Bank (former Islamic Bank of Britain), Bank of London and the Middle East, European Islamic Investment Bank, Gatehouse Bank, QIB UK and Abu Dhabi Islamic Bank.

Among those, only Al Rayan Bank concentrates on offering retail services, such as current and investment accounts and housing financing products. It also has the largest number of clients, estimated at around 50 000.

Other Islamic banks target their offer to wealthy clients and corporations. Their main products include asset management and private and corporate banking services. Since most of Islamic banks in the UK are not listed on any exchange, they are not obliged to publish their financial statements. That is why it is impossible to assess their financial situation in comparison with their conventional counterparts. It can be assumed, however, that this situation is not good, especially when it comes to retail services. Islamic Bank of Britain reported a loss 6.99 million GBP for 2012, the last year for which figures are available, which followed 8.1 million and 8.99 million losses in 2010 and 2011 respectively (Islamic Bank of Britain, 2011, 2012). And in 2012, HSBC Amanah, the Islamic subsidiary of HSBC, withdrew from operations in the UK allegedly because of unsatisfying financial results.

In the UK, apart from six fully-fledged Islamic banks, 16 conventional banks, including Barclays, Deutsche Bank, Royal Bank of Scotland, Standard Chartered, Lloyds offer Islamic financial services through the “Islamic window”, which is a separate department of a conventional bank dedicated to Islamic finance. Their edge over the wholly Islamic banks lies mainly in the recognisable brand. Some clients can prefer to approach such banks, because of their long history and strong reputation. Islamic banks, on the other hand, are usually not so widely recognised in Europe.

Although the number of Islamic banks in the UK may seem small, and the value of their assets, estimated at 19 billion GBP and less than 1% of total assets of British banking sector, low, the United Kingdom is an absolute leader when it comes to Islamic banking in the EU (UK Islamic Finance Secretariat, 2013). In 2013, there were no wholly Islamic banks in other EU countries. Islamic services were only offered by a few Islamic windows in France, Germany and Luxembourg (Table 1). The situation did not change much in 2014, apart from one thing. At the end of 2014, in Luxembourg the first fully-fledged Islamic bank in Eurozone, Eurisbank, was established. It was launched with an initial capital of 60 million EUR. The bank offers retail, corporate and private banking services and is aiming to open branches in Paris in France, Brussels in Belgium, the Netherlands and Frankfurt in Germany (Evershed, 2014).

It should be noted that at present, in two European countries with the largest Muslim populations, France and Germany, there are no fully-fledged Islamic banks. In France, only two branches of Islamic banks from Middle East operate. And the retail banking services are offered only through Islamic window opened in 2011, by Chaabi Bank, a subsidiary of the Banque Populaire du Maroc group. The offer of the bank includes Islamic deposit and Islamic real estate financing products (Commerce International, 2013). In Germany, Kuveyt Türk Katılım Bankası, a participation bank from Turkey, has one branch in Mannheim. In October 2012, Kuveyt Türk applied to Germany’s Federal Financial Supervisory Authority (BaFin) for a full banking services license in order to be able to carry out all retail services, including loan and deposit operations, under Article 32 of the German Credit Act (Kuveyt Türk, 2012). Up till now, however, licence has not been granted to the bank.

One of the reasons, why Islamic banking has no significance in Germany, may lie in the negative experience, German Turks have with financial institutions coming from the Muslim world. In 1990s several Turkish companies, such as Kombassan Holding, Jet-Pa, Yibitas Holding and Yimpas Holding entered the German market with seemingly Islamic finance products. In a short time

Country	Number of banks
UK	22
France	3
Germany	1
Luxembourg	1
Total	27

Source: UK Islamic Finance Secretariat, 2013.

**Table 1**

Number of banks, offering Islamic services in the EU (2013)



they gained about 200 000-300 000 Muslim customers, who they approached mainly through mosques. However, the money was defalcated and the majority of clients lost their savings. Estimates for the losses ranged between 5 and 50 billion EUR, which only shows the potential of Islamic finance among Turks in Germany (Farhoush & Mahlkecht, 2013). However this scandal created great mistrust among Muslims, living in Germany and worked against new approaches to establish Islamic banking market in this country. So now any institution, which wants to gain customers in Germany, first of all must gain confidence of the Muslim community.

## Prospects for Development of Islamic Banking in the European Union

As it was shown in the previous section of the paper, the Islamic banking in the EU is at a very early stage of development. In fact, the expansion of Islamic banking and finance does not meet the high expectations of some of its promoters. In two European countries with the largest Muslim populations, France and Germany, there are no fully-fledged Islamic banks.

In this chapter factors, which should contribute to the development of Islamic finance in this region, will be identified and analysed. Also the threats and challenges, which need to be overcome, so that this market could develop, will be presented.

Islamic banks that start their operations in the European Union countries see one of the main opportunities in the Muslim minority, living in the EU. According to Pew Research Center, the number of Muslims in Europe grew from 29.6 million in 1990 to 44.1 million in 2010.

Table 2 provides information on the estimated number of Muslims, living in selected EU countries in 2010 and projection about that number for the year 2030.

The population of Muslims in the EU is projected to increase by over 10 million by the year 2030. It means that the potential customer base, which is relatively high now, will be even higher in the future. It should be indicated that this is a potential that has not been used so far. It is enough to give an example of the only Islamic retail bank in the UK, Al Rayan Bank, which has about 50 000 customers, and compare this number to a number of Muslims, living in the UK, which is estimated at almost 3 million. And as it was already mentioned, in other countries the situation is much worse.

But it should also be emphasised, that although Islamic banks target their products mainly to Muslims, they also try to gain clients outside Islamic community, especially among middle and upper class individuals. The major appeal of Islamic banking for non-Muslim clients is the ethical and socially responsible nature of Islamic financial investments. In a survey conducted among 100 private bankers around the world by the Economist Intelligence Unit in 2012, the surveyed said that

**Table 2**

Number and share of Muslim population in selected EU countries

Country	2010		2030	
	number	share (%)	number	share (%)
Austria	475 000	5,7	799 000	9,3
Belgium	638 000	6	1 149 000	10,2
Denmark	226 000	4,1	317 000	5,6
Finland	42 000	0,8	105 000	1,9
France	4 704 000	7,5	6 860 000	10,3
Germany	4 119 000	5	5 545 000	7,1
Greece	527 000	4,7	772 000	6,9
Ireland	43 000	0,9	125 000	2,2
Italy	1 583 000	2,6	3 199 000	5,4
Luxembourg	11 000	2,3	14 000	2,3
Netherland	914 000	5,5	1 365 000	7,8
Portugal	65 000	0,6	65 000	0,6
Spain	1 021 000	2,3	1 859 000	3,7
Sweden	451 000	4,9	993 000	9,9
United Kingdom	2 869 000	4,6	5 567 000	8,2

Source: Pew Research Center, 2011.

they expected the annual increase in the amount of money directed towards ethical investments by an average of 9,1% in the following five years. And 25% of private bankers expected a double-digit annual percentage increase in investments, which are sharia-compliant. The need to use ethical services is especially strong among clients from the European Union, where the demand for such investments especially grew in the aftermath of the global financial crisis of 2007-2009. The crisis, which affected severely European financial industry, spared Islamic banks. Proponents of the Islamic financial system even say the crisis would not have occurred if the Islamic principles of finance had been implemented in international financial markets. There is no clear evidence whether, it is indeed truth or maybe Islamic banks were more resilient to the crisis, because of their immaturity. Still Islamic banks use this fact as a factor, which helps to build their positive image.

There is also a big potential for the development of corporate Islamic banking services in the EU. It mainly results from the growing trade relations between the EU and the Association of Southeast Asian Nations (ASEAN) and the countries of Gulf Cooperation Council (GCC) (Table 3), where Islamic banking has a significant presence and where

Islamic banking services dynamically develop. More and more companies from those countries become clients of Islamic banks. While supporting international trade operations of their clients, those banks often need to co-operate with foreign banks. Potential Islamic banks in the EU could become such partners for Islamic banks from the ASEAN and the GCC countries.

	2009	2010	2011	2012	2013
Export	108 047	127 320	142 223	165 220	176 309
Import	91 162	122 537	153 157	161 643	153 770

Source: Eurostat, 2015.

**Table 3**

EU merchandise trade with ASEAN and GCC countries (in millions of EUR)

The above-mentioned factors, although potentially should increase the presence of Islamic banks in the EU in the near future, are not sufficient for the development of Islamic services in this region. There are still some obstacles that need to be overcome. Those obstacles can be divided into two groups. The first group includes problems that are faced by the whole Islamic banking industry, so they can also apply to Islamic banking in the European Union countries. The second group concerns mainly Islamic banking in the EU.

The main challenge for the development of Islamic banking is a lack of uniform regulations and the diversity of sharia-judgements. Especially big is the gap between institutions operating in the Gulf region, and the countries of Southeast Asia. The institutions from the Gulf region usually comply with standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), while in Southeast Asia standards of the Islamic Financial Service Board (IFSB) are more frequently used. What is more, in the GCC countries there is no higher authority, which would affect decisions made by the sharia board of each financial institution. As a result, judgements can differ depending on the scholars sitting on the board. And for instance in Malaysia, the government assigned National Shariah Advisory Council (NSAC) as the highest shariah authority on Islamic banking. Resolutions and judgements of NSAC are binding for all Malaysian Islamic financial institutions. In this way diverging standards for the same products and discussions on whether or not specific products are sharia-compliant are avoided. Just like in the rest of the world, in Europe there is also no agreement about the standards which should be used. For instance, France is more inclined towards the AAOIFI standards, while Luxembourg opted for the IFSB standards.

Islamic banks have also significant problems with risk management, especially with the management of liquidity risk. Conventional banks have access to a number of tools, enabling liquidity management. Those tools include interbank deposits, foreign exchange swaps, repo operations, treasury bills and commercial papers. All those instruments are based on interest rate and that

is why they are not accessible to Islamic banks. Islamic interbank money market is underdeveloped and the secondary markets for most short-term instruments are illiquid. And because of different interpretation of sharia, in different jurisdictions other instruments are permitted which makes it very difficult to develop international money market. Thus the problem with the access to liquidity management instruments constitutes one of the most serious problems and one of the largest challenges for Islamic banks. Though it should be mentioned that some initiatives have been already taken aiming at closer collaboration between different Islamic countries, such as establishment of International Islamic Liquidity Management Corporation (IILM), International Islamic Financial Market (IIFM) and Liquidity Management Center. Those bodies are expected to play a key role in the process of harmonisation and standardisation of transactions across the countries which would facilitate the creation of cross-border money market. The activities of the above mentioned entities should concentrate on increasing liquidity of the secondary markets and the development of instruments which would be approved across different Islamic jurisdictions. Without the sufficient supply of short-term instruments and well-developed secondary market, liquidity risk management in Islamic banking will remain ineffective in comparison with techniques adopted by conventional institutions and this will affect negatively the competitiveness of Islamic finance industry (Sobol, 2013).

A second group of challenges that need to be overcome, affect the European market in particular. The first challenge of this kind is a variety of legal obstacles, not permitting the functioning of banks on the basis of profit and risk sharing model. However, as the example of the UK shows, these are not insurmountable problems. Customers of British Islamic banks, although they are protected against the insolvency of the bank, can surrender this protection on grounds of religious belief. On the other hand, the European Union policy can be against such a solution. The compulsory membership of the European banks in a deposit-guarantee scheme does not only serve the safety of the single depositor, but also should guarantee the stability of the whole financial system. And such a policy can be especially visible in the aftermath of the financial crisis. One of the biggest problems encountered by Islamic banks in the EU, can be lack of demand, resulting from high costs of Islamic products. Due to the highly competitive European market, the price is a key factor affecting the success of Islamic banking in Europe. The low price of conventional products can determine the choice of product and the resignation of the Islamic one. Also, this problem is partially solved in the UK, at least in terms of mortgage loans. As it was discussed in the previous section, the double stamp duty on a *murabaha* transaction was abolished there, which greatly improved the competitiveness of the Islamic housing financing products. However, still the prices of the Islamic products may be more expensive, because of the presence of the additional body in the Islamic bank, which is in the sharia board as well as due to problems with the risk management. Religious Muslim clients may agree to pay even a higher price, in order to benefit from sharia-compliant services. This can also apply to some wealthy non-Muslims, interested in ethical investments. However, for the majority of customers of banks, the price is a very important issue. It also concerns Muslims, living in the EU, especially that not all of them are very religious and many of them do not know Islamic financial system. So in order to cope with competition coming from conventional banks, Islamic banks, entering the EU, apart from indicating the ethical character of their services, should also try to make their products and services competitive in terms of price.

Another obstacle that stands in the way of development of Islamic banking in the EU is the attitude of the general public towards this activity, resulting from the negative attitude to Islam in general. There are allegations that Islamic banking is used in financing of terrorists. Those views are hardly surprising, taking into account the unrest in the Middle East and attacks carried out by

extremist organisations also outside Muslim world. Still are very well remembered the attacks on the World Trade Center in New York in 2001, train bombings in Madrid in 2004 or the terrorist attack on London Underground in 2005. Hostile feelings against Islam among society in Europe were fuelled by the attacks on the Charlie Hebdo magazine in Paris in January 2015.

Another source of hostility to Muslims among Europeans is the fear of the influx of people from Muslim countries and high fertility of Muslim families, which may translate into social changes in the near future.

The problem of hostility towards Islamic banking, resulting from hostility to Islam, cannot be unravelled quickly. The image of Islamic banks, can be improved however, through well thought out promotion campaigns and through the high standards of business conducted by Islamic financial institutions.

Finally, shortages in staff is a problem that also affects the European Islamic banking industry. There are not enough scholars in Koranic law, who could serve on the sharia boards. Even fewer people are familiar enough with the activities of Islamic banks that they could occupy managerial positions. However, this situation is changing slowly. With the growth of interest in this type of banking, there are a variety of courses and seminars on Islamic banking and finance, organised in the EU countries. Again, the UK is the leader in this field. Two of the British universities, the University of Durham and the University of Reading offer master studies in Islamic finance and in the University of Durham even doctoral programme on Islamic economics and finance is organised.

Islamic banks fulfil the same needs of customers, as conventional banks. They provide a variety of religiously acceptable financial services to Muslim communities, but also can be an alternative for non-Muslim clients seeking ethical investments and greater risk diversification. In many Muslim countries, Islamic banking has become a significant segment of financial markets. And three countries (Iran, Pakistan and Sudan) even decided to fully transform their financial system into the Islamic one.

In the European Union countries, Islamic banking was introduced in 1980s, when Al Baraka International Bank started operating in the British market. Until now, the UK has remained the European Islamic banking leader. The UK has achieved this title thanks to the support of the government, the favour of the supervising authorities, the reputation of the world's financial centre and money from the Gulf countries, which helped to establish Islamic financial institutions in this country.

The Islamic banking market in other EU countries is in the infancy stage of development. Even in such countries, as France and Germany, with large Muslim communities, there are no fully-fledged Islamic banks. It is improbable that Islamic banking could develop as dynamically in the EU as in the Islamic countries. But it has a potential to have a more significant presence in the European financial market and it could achieve a similar position to the position, held by co-operatives banks. The main factors that should contribute to this include:

- \_ large and increasing Muslim community in the EU,
- \_ growing demand for ethical investments, also from non-Muslims,
- \_ increasing trade relations between the EU and the ASEAN and GCC countries, where Islamic banking has a significant presence.

However, there are still many challenges and problems that are faced by Islamic banking industry in the EU. They include:

- \_ lack of suitable legislation in the majority of EU countries, especially with regard to tax and supervision issues,

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## Conclusions

- \_ problems with risk management, resulting from the lack of appropriate instruments and insufficient collaboration between institutions, operating in different countries,
- \_ high costs of Islamic banking products,
- \_ hostility towards Islam, and thus Islamic banking among the European society.

If Islamic banks do not solve the above-mentioned problems, their presence in the EU countries will remain insignificant. It is improbable that they could become an alternative for conventional banks, as it happens in some of the Muslim countries. However, if they find the way to overcome numerous challenges, they may become a viable addition to the conventional financial institutions.

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## **IWONA SOBOL**

### **Dr.**

Economics and Finance (science field), Institute of International Business,  
University of Gdańsk, Poland

### **Address**

Armii Krajowej 119/121, 81-824 Sopot, Poland  
Tel. +48 58 5231273  
E-mail: [isobol@ek.univ.gda.pl](mailto:isobol@ek.univ.gda.pl)

## **About the author**