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Islamic Banking: Dawn of a New Era

Lord, who can dwell in your tent? [...]
He who does not lend his money at interest.
(Holy Bible, Psalm 15, 1 and 5)

Those who charge usury are in the same position
as those controlled by the devil's influence.
(Holy Quran, Surah Al-Baqarah, 275)

1. Islamic Banking

1.1. The Origins of Islamic Banking

Islamic finance is a relatively recent phenomenon. Although several Islamic financial contracts were already in use during the age of the Prophet, Islamic finance is an invention of modern times. The first steps in Islamic finance were taken in Egypt in the 1960s, and the first Islamic bank, the Dubai Islamic Bank, was founded in 1975. Today, there are more than 500 Islamic finance institutions worldwide, and their number is rapidly increasing. In the years 2009-2010 alone, more than 50 new Islamic finance providers – Islamic banks and Islamic insurance companies – were founded. There have also been conversions of traditional banks into Islamic banks, such as the National Bank of Sharjah, which became a full-fledged Islamic bank. Similarly, the National Commercial Bank (NCB) of Jeddah in Saudi Arabia has turned its private client business into an Islamic banking arm. Other conventional banks are also currently considering transforming themselves into full Islamic finance providers.

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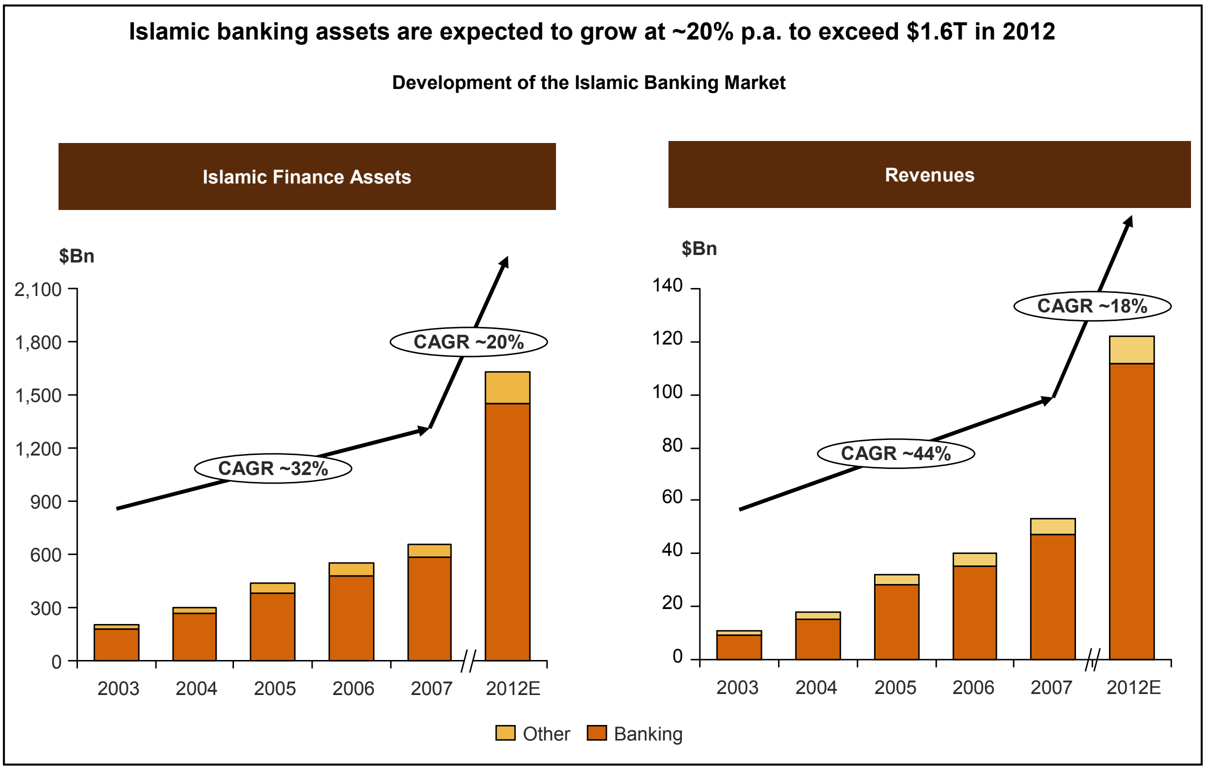
1.2. Islamic Banking Today

Despite the impressive growth rates, the market share of Islamic finance is still quite low. Experts estimate that today more than 15% of all banking business in the Muslim world is conducted via Islamic finance, and the percentage is very likely to increase significantly over the coming years. Nevertheless, as with many young businesses, the Islamic finance market is growing much faster than the banking market as a whole. An important driver of growth is the fact that Islamic finance products and solutions are now able to compete with conventional banking products.

This was not always the case in the past, as the transaction structures of Islamic finance products can be much more complex, and thus more expensive, than structures in conventional banking.

The market for Islamic banking has been experiencing double-digit growth for several years. Studies by the rating agency Standard & Poors and the consultancy Booz & Company estimate the combined assets of Islamic banks at year-end 2010 at nearly US$ **1,700 billion.** Over the past 10 years, Islamic banking has grown by 20% per year and there are no signs of a slowdown in growth – especially not in the context of the current financial crisis, which has hit conventional stock exchange indices, such as the US S&P and Dow Jones or the German DAX or French CAC, much harder than it has Islamic indices, such as the Dow Jones Islamic Markets or the S&P 500 Shariah Index. In Islamic bonds and IPOs, just as in Islamic retail products, the growth tendencies again point northward.

Figure 1
Islamic banking assets worldwide



Source: Bankscope; Central Banks annual reports; Islam-Investor GmbH, Booz & Company analysis.

There are three main drivers for this rapid growth. First, there is the growing demand for Islamic finance products from Muslims (and also non-Muslims) worldwide. Second, there is the growing availability of Islamic banking products, including accounts, funds, insurance and credit facilities. There is also, in various countries, a growing number of Islamic banks, which have started to compete with existing conventional banks. The same holds true for Islamic insurance companies. In Malaysia and Saudi Arabia there is already fierce competition among Islamic banks, as well as between Islamic and conventional banks.

Third, in light of the damage caused by the credit and financial crisis of 2008 and 2009, which has called many Western banking practices into question, Islamic banking has gained even greater authority and approval. Speculation, off-balance sheet transactions, derivative-based products and securitization – all of which are not allowed in Islamic banking – have definitely contributed to the financial crisis. Yet Western standards in banking are very likely to prevail over the coming decades, as sophisticated transactions for hedging currency and market risk have become more and more important in an increasingly global economy. Nevertheless, Islamic banking is expected to experience further growth. Several studies show that Muslim customers prefer Shariah-compliant banking products to conventional ones – as long as they are competitive in price and performance.

Finally, the ethical approach of Islamic banking is attractive not only to Muslims, but also to ethically oriented or religious customers[1] who are unhappy with the way Western banks operate.

There are several examples of Western banks operating so-called "Islamic windows," the largest being *HSBC Amanah*[2]. Barclays, Lloyds, Citigroup, BNP Paribas and Spain's Santander also operate Islamic windows. In France, which has the largest Muslim population in Europe (6 million), an Islamic bank is currently under construction. German banks, including Deutsche Bank and WestLB, offer Islamic banking services in Muslim countries such as Malaysia and the Middle East, but not in Germany itself, which has the second largest Muslim population in Europe after France (4 million). Islamic banks and Islamic windows also exist in South and Sub-Saharan Africa, Australia and the US.

In the UK, which has the most advanced Islamic banking market in Europe, there are five Islamic banks: the retail bank *Islamic Bank of Britain* (IBB), the corporate banks *Bank of London and the Middle East* (BLME), *European Islamic Investment Bank* (EIIB) and *Qatar Islamic Bank* UK (QIB), and the Islamic investment bank *Gatehouse*.

Generally, it can be seen that after the crisis, conventional banks have downsized their Islamic windows, as did, for example, Germany's WestLB, whereas purely Islamic banks such as QIB have opened branches in non-Islamic countries, including the UK.

[1] For example, many Christians are also clients of the Islamic Bank of Britain, an Islamic retail bank founded in the UK in 2004.

[2] The Arabic word "Amanah" means "trust."

2. Islam as a Religion and a Way of Life

2.1. The Five Pillars of Islam

Islam is the youngest of the three Abrahamic religions, which are based on the first ancestor, Abraham (the others being Judaism and Christianity). All three religions share a number of social and ethical values. In the Islamic religion, Jewish prophets of the Old Testament are mentioned, as well as Jesus. The Prophet Mohammed (P.B.U.H)[3] is the emissary of God (Arabic: Allah), who, according to Muslim teaching, received in the Quran the last revelation of Allah. To become a Muslim, it suffices to assert the simple statement that there is no other God besides Allah and that the Prophet Mohammed is his emissary.

This credo *(shahada)* is one of the five pillars of Islam. The pillars of Islam determine and guide the lives of the faithful. The *shahada* is the only formal requirement that a person has to fulfill in order to become a Muslim. The other four pillars are:

- Five prayers each day *(salat)*, following a distinct ritual
- The act of fasting during the month of Ramadan *(saum)*
- The pilgrimage *(hajj)* to Mecca
- The charity tax *(zakat)*, comparable to a wealth tax, to contribute money for the benefit of the deserving

2.2. The Muslim World

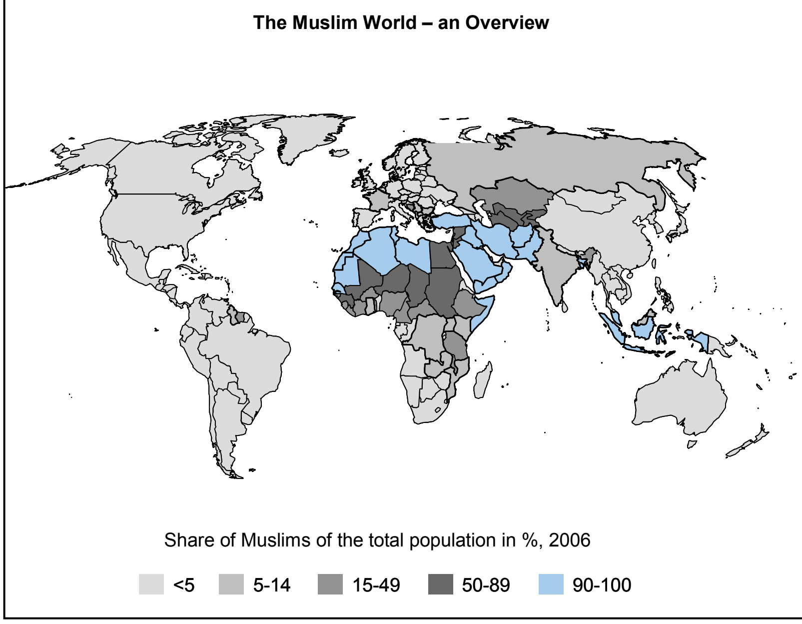
The Muslim world includes North Africa, parts of Sub-Saharan Africa, the Arabian Peninsula, the Arabian/Persian Gulf, the Fertile Crescent and regions in South and Southeast Asia. Of the 6 billion people living on Earth, one in four is a Muslim – which makes approximately 1.5 billion Muslims. 200 million live in Indonesia, followed by India with between 150 and 170 million. Iran, Turkey and Egypt each have Muslim populations of between 60 and 80 million. Saudi Arabia has a Muslim population of more than 20 million.

Apart from the countries where Muslims are the majority, there are many countries with a Muslim minority. All together, the nations of the European Union have a Muslim population of approximately 15 million. The largest Muslim minority can be found in France, which has almost 5 million Muslims, the majority of them of North African descent. The second largest group, amounting to 3.8 million, lives in Germany, 2.8 million of them Turks. Other large minorities of Muslims are to be found in the UK (1.7 million, many of them from Pakistan or India) and Spain (1.2 million stemming from North Africa). Austria and Switzerland each have approximately half a million inhabitants of the Muslim faith.

[3] "Peace be upon him." Muslims must add this sentence when the name of the Prophet is mentioned.

Figure 2
Muslims worldwide

Considerable market potential for Shari'ah-compliant financial services - even beyond the Muslim world



Comment

- At the end of 2008, the Muslim population reached 1.5 bn worldwide.
- Indonesia, India and Turkey are the countries with the largest Muslim populations.
- Especially in resource-rich Gulf countries (Saudi Arabia, U.A.E., Kuwait, Bahrain, Qatar), net assets and net financial wealth have risen strongly over the last few years.
- Despite a sharp increase in liquidity, there is a huge demand for additional funding for large infrastructure and project financings.
- Most parts of the Muslim world are still underdeveloped in banking services (e.g., mortgages and consumer credit) and insurance products (particularly life insurance).
- Non-Muslim markets such as Western Europe, with its Muslim population of 15 million, offer various Islamic finance opportunities.

Source:: EIU, Booz & Company analysis

2.3. The Shariah and the Ban on Interest in Islamic Banking

The Muslim community is very heterogeneous. Apart from the two biggest schools of faith, *Sunni* and *Shia*, there are also differing views within these two major branches. In Sunni Islam there are four schools of law and jurisprudence: *Hanafi*, *Malaki*, *Shafi'i* and *Hanbali*. In Shia Islam there are also different schools of faith and law. As there is no single authority in Islam equivalent to the Pope in the Catholic Church, all schools interpret the Shariah, or Islamic Law, in different ways, ranging from small variations to major discrepancies. Consequently, there is no universal Shariah-based code of conduct in the Islamic World that has a significant impact on the way Islamic finance is conducted.

The Shariah, the body of Islamic religious law, constitutes what is virtuous or forbidden. It also states several important restrictions regarding financial services. For instance, receiving or paying interest, as is common practice in the Western world, is a form of usury that is forbidden to Muslims according to the Quran. Shariah requires that all contracts and transactions be free of *riba*. Literally translated, *riba* means usury and is condemned by Allah. The Quran forbids a Muslim from practicing *riba*.

> "Those who swallow usury cannot arise except as he arises whom the devil prostrates by (his) touch. That is because they say, trading is only like usury. And Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, and he desists, he shall have what has already passed. And his affair is in the hands

> of Allah. And whoever returns (to it) – these are the companions of the Fire: therein they will abide." (Surah Al-Baqarah, 276)

An understanding of the prohibition of *riba* is of utmost importance for the construction of Islamic financial products and the implementation of Islamic banking services. A classical savings account that pays interest or a common loan bearing monthly or yearly interest is not permissible in Islamic banking. Islamic banks face the challenge of creating financial products for faithful Muslims that acknowledge the absence of interest rates yet, at the same time, are attractive enough to compete with Western banking products.

What can a Muslim do, though, if he needs banking services but there is no Islamic bank?

In the Holy Quran it is also written:

> "He only prohibits for you the eating of animals that die of themselves (without human interference), blood, the meat of pigs, and animals dedicated to other than GOD. If one is forced (to eat these), without being malicious or deliberate, he incurs no sin. GOD is Forgiver, Most Merciful." (2:174)

What does this mean? It means that a believing Muslim is allowed to break the law of Allah, as long as there is no alternative or the alternative would mean starvation – as in the example of pork.

With banking products it is a similar situation. Allah forbids interest and usury. "Those who charge usury are in the same position as those controlled by the devil's influence" (2:276). If there are no Shariah-compliant banking products in the country in which a Muslim lives and the believer is thus forced to use interest-based products due to a lack of alternatives, he or she will find forgiveness before Allah. As soon as there are alternatives, however, there is no longer any excuse. For this reason, Islamic banks established in regions with a considerable number of believing Muslims have a major competitive advantage over conventional banks, as long as their products comply with Shariah and are as attractive, in terms of price and performance, as the non-Shariah products of Western banks.

2.4. The Economics of Islam

Is an Islamic bank allowed to make a profit? Of course it is!

The Quran forbids taking interest *(riba)* but allows trade and the profit derived from trade.

> "However, Allah permits commerce, and prohibits usury. Thus, whoever heeds this commandment from his Lord, and refrains from usury, he may keep his past earnings, and his judgment rests with Allah. As for those who persist in usury, they incur Hell, wherein they abide forever." The Holy Quran (2. Surah, 276)

Mohammed himself was a merchant. Merchants enjoy a high standing in the Muslim community. If you go to a city in the Middle East, such as Damascus, Jeddah or Cairo, you will see the delight merchants take in trading on the bazaars.

In Western thinking, however, Islam is often seen as "anti-capitalistic." Being against trade, commerce and wealth is, however, in no way the true nature of Islam. On the contrary, Islam, unlike many other religions, does not treat religion and economics as two separate entities. Islam has a holistic view of life, which means that economics, politics, social affairs and religion are not only interrelated, but also deeply interwoven. Economic and business activity and success play a much greater role in Islam than in many other religions.

In the Western world, the main incentive for trade is the scarcity of goods, i.e., there is a limited supply of goods to satisfy seemingly unlimited demand. Islam has a different view, namely that Allah has provided enough resources for all people to satisfy their needs and make a living. However, unbridled desire and greed and rejection of hard work lead to excessive demand and insufficient supply, creating an economic imbalance.

How can this imbalance be resolved? Concerning demand, Islam differentiates between worthwhile and non-worthwhile needs. Concerning supply, Islam holds the opinion that on a daily basis many of people's resources, which could be used for hard work, are wasted in gaming, gambling, drinking alcohol and consuming drugs, and so on.

As Allah has provided human beings with enough resources, it is up to every person to use those resources in the best way and to work hard. The economic problem of scarcity of goods is thus solved in Islam through self-restraint on the demand side and hard work and focus on the supply side.

One of the most important aspects of Islam's value system is that mankind acts as a trustee for the world and its goods. For the world and all its goods belonging to Allah, man is merely acting as the custodian. In dealing with the resources of the earth and in business activities, therefore, Muslims are bound by Allah's laws and should take great care to follow the Shariah – by, for example, paying the social tax *(zakat)* or not paying or receiving interest *(riba)*.

Striving for wealth and economic success is perfectly acceptable in Islam. Not sharing one's wealth with society, however, or exploiting trading partners and other people through interest and usury is not.

2.5. The Shariah Board

Every Islamic finance institution, be it a bank, an insurance company or an investment company, needs a Shariah board. A Shariah board is like a religious advisory board. It is responsible for supervising the Islamic banking institution and ensuring that all the products it develops and issues conform to the Shariah. The Shariah board therefore makes sure that the Muslim client really gets what he or she has been promised by the Islamic finance provider and not, for example, conventional banking products in "Islamic disguise," often referred to as "Islamic whiskey."

Members of the Shariah board need long years of education to become Shariah scholars, which is a special kind of Islamic jurisconsult. There are only a few scholars in the world who are experts both in the teaching of the Quran and in economic and financial topics. A Shariah scholar, therefore, must in fact be an expert in two very different worlds: religion and money. By giving a financial services provider the certificate that its products conform to Shariah, Shariah scholars guarantee – with their good name – the Shariah compliance of the products in question.

However, the fact that there is no worldwide standard that defines which products conform to Shariah and which ones do not (just as there are different schools of thought in Islam) poses a big challenge for Shariah scholars. As a result, certain products are permitted in some regions while others are not. The permissibility of a product depends on the region in which the bank is located, the individuals on the Shariah board, and the school of Islam to which they belong.

Great efforts are currently under way to establish worldwide standards and codes of conduct for Islamic finance.

2.6. The Role of Shariah in Islamic Investment

As mentioned previously, Islamic financial institutions generally maintain Shariah advisory boards, consisting of qualified scholars, which give counsel on matters regarding the compliance of financial products with Islamic rules on interest or usury.

However, because almost all of today's companies deal with some kind of interest, Shariah advisory boards have set an upper limit to the percentage of a company's income that can be earned through interest. It is unacceptable for a Muslim believer to invest in a firm that exceeds this limit.

If a firm in which an Islamic investor has invested exceeds this limit, the proportion of income earned through interest is termed "impure" and given to charity (*zakat*).

This limit also comes into effect when a company raises money through loans. Shariah-based investments can only tolerate a certain amount of leverage in the company, as outlined below.

- Debt/market value of equity < 33%
- Liquid assets + interest-bearing debt/market value of equity < 33%
- Accounts payable from trade and delivery/market value of equity < 33%

In addition to these obligations, funds investing their money in a Shariah-compliant way are not allowed to invest in the following enterprises, which are considered *haram* (impermissible, forbidden):

- The tobacco industry
- The weapons and defense industry, as well as companies trading in arms
- Conventional banks and insurance companies
- Producers of alcoholic beverages, including service providers that serve alcohol (restaurants, hotels, airlines, etc.)
- Grocers and retailers selling alcohol, pork meat or other *haram* food
- Gambling (casinos, betting, games of chance)
- Pornography
- According to some strict interpretations, the entertainment industry, music, cinema, etc.

It is important to note that companies are allowed to do business in the above segments up to a certain level. However, the revenue generated from these business lines may not exceed 5% of overall revenue.

As most private clients do not have the time and knowledge to calculate all these multiples and judge for themselves, in order to adhere to the above restrictions, index-providers such as *Dow Jones Islamic Indices, Standard & Poor 500 Shariah* or the *FTSE Islamic Markets Index* provide Islamic indices that only include companies that invest in a way that complies with Shariah. These indices thus offer orientation and guidance for the Islamic investor.

Figure 3
Islamic banking rules concerning investments

Islamic Banking rules are grounded in the Surah Al-Baqarah in the Holy Quran, No. 276

"Those who swallow usury cannot arise except as he arises whom the devil prostrates by (his) touch.

And Allah has allowed trading and forbidden usury."

The Holy Quran, Surah Al-Baqarah, 276

Industry segments forbidden

- Weapons/Defense
- Liquor and Wine
- Food Industry
- Tobacco
- Recreational Products
- TV, Radio, Entertainment, Media
- Gambling
- Hotels
- Restaurants and Bars
- Banks
- Insurance Companies
- Consumer Finance Companies
- Special Loan Providers
- Investment Services
- Mortgage Financing

(conventional financial service providers)

Business Requirements

- Debt/Market value of equity < 33%
- Cash + Debt/Market value of equity < 33%
- Liabilities/Market value of equity < 49%
- Revenue from non-shariah compliant products/services[1] /Total Revenue < 5%

[1]Also, an airline or hotel generating sales on alcohol, or a machinery producer producing weapons, etc. is not Shariah-compliant.

Source: Gassner, Wackerbeck: Islamic Finance, Cologne, 2010.

3. Islamic Finance Products

Nowadays, there is almost no mass-market banking product that cannot be offered by an Islamic bank in a Shariah-compliant way. The following is an overview of Islamic accounts, loans, investment products and insurance products.

3.1. Islamic Accounts

3.1.1. Current Accounts

A current account is today the basis for participating in economic life and making cashless payments. The current account is normally the main connection between the client and the bank. Current accounts at Islamic banks can be configured according either to the *Wadiah* principle or the *Qard Hassan* principle.

According to the *Wadiah* principle, the Islamic bank receives payments from the customer in trust. The bank can then invest the received funds by, for example, giving credits to other customers in conformity with the Shariah. For all these transactions, the permission of the customer is necessary. Should the transactions result in losses, the capital contributed by the customer is not affected. Customer deposits are secured up to a certain amount by the deposit guarantee fund.

Alternatively, according to the *Qard Hassan* principle, the current account can be seen as an interest-free loan by the customer to the bank. In this case, the Islamic bank can invest the money thus received in loans and credit lines, which are also guaranteed up to a certain amount. The important difference between the two principles is that with *Qard Hassan*-based deposits, no rewards at all can be given to the bank, because they would be assessed as *riba* and so are not permissible.

Under the *Wadiah* model, however, if the customer lends money to the bank, he or she will receive no interest, but the bank can offer compensation, or a discount on other banking services, or a small gift.

Irrespective of which principle is chosen, the bank is not permitted either to pay interest or to charge any interest should the account go overdrawn. An overdraft facility is not permissible under Islamic law. Normally, should a customer overdraw on his or her current account, a fixed fee will be payable. In general, the customer is obliged to settle a debit balance immediately.

3.1.2. Savings Accounts and Investment Accounts

If a customer provides money to the bank as a deposit, then he or she should expect a reward. As interest payments are not permitted in Islam because of the prohibition of *riba,* Islamic banks have developed alternative models for compensation. In practice, the so-called *Mudarabah* method is common in the Middle East, while the so-called *Wadiah* principle is exercised in South East Asia.

In the *Mudarabah* model, bank and customer enter into a *Mudarabah* partnership, where the customer agrees at the beginning of the partnership on a system of mutual profit and loss sharing. The customer participates in the entrepreneurial risk of the bank. Unlike a savings account, a customer deposit in an investment account is not guaranteed. If the bank generates profits from its lending business, then those profits are shared according to a previously agreed ratio. Should the bank make a loss, then the customer has to bear the loss alone – as the bank has already invested effort and infrastructure, and thus also money, in the mutual business.

Mudarabah-based investment accounts often distinguish between “restricted” and “unrestricted” accounts. In a restricted account, the bank is bound by the customer’s guidelines. In an unrestricted account, the bank can choose in what type of projects to invest the funds. The businesses in which the money is to be invested are defined in a contract at the start of the partnership.

The aim in both models is to pay the profit ratio to the customer regularly at fixed periods (e.g., annually or semi-annually). As this is not always feasible because of payment terms that differ from customer to customer, all the payments are collected into a pool. The transactions for the investment are made from this pool and the profit ratios for customers are also paid into this same pool.

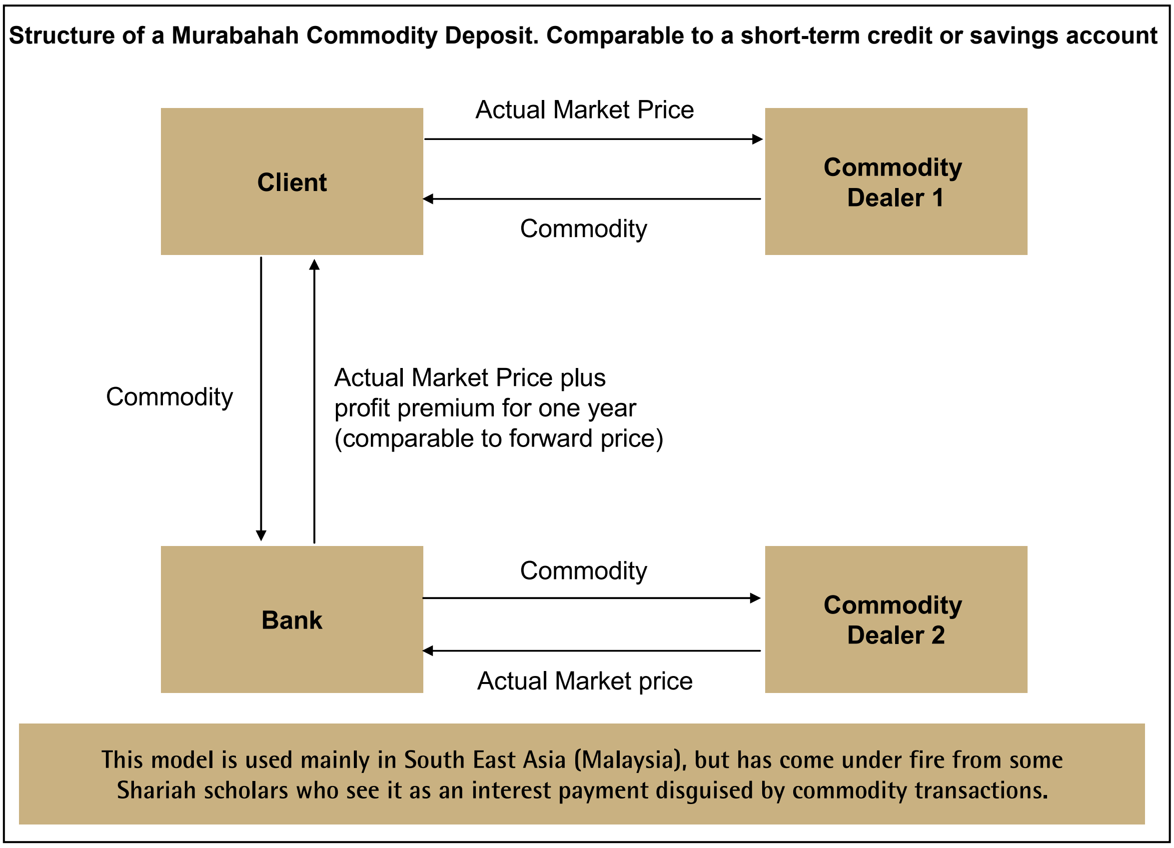
In the unrestricted model all customers get the same profit ratio. In the restricted model the ratio is defined beforehand in a contract, together with the permitted investment alternatives. To ensure that payouts remain constant over time and do not fluctuate too much in accordance with the investment activities, Islamic banks usually hold what are known as "profit balance reserves." In good times, profits are stored in these pools, so that customers continue to be paid even in bad times, when the mutual investment activities are less successful.

There are discussions among Shariah scholars, however, as to whether or not payouts at a fixed date or in a fixed amount are similar to interest payments at conventional banks and thus comparable to *riba*. Also, many customers, even Muslims, are so used to plain vanilla savings accounts that they have difficulties in understanding a flexible yield on their savings account or even the possibility of a savings account generating losses. Furthermore, in most Western countries banks have to secure funds in savings accounts from losses and have to insure them against loss. So from a Western financial authority's point of view, a Shariah-compliant savings account that is generating profits *and* losses might not be accepted as a savings account, while a plain vanilla savings account might not be accepted by a Shariah scholar due to the *riba* element. A solution might be for the customer to sign a waiver, stating either a) that he accepts losses and thus has a fully Shariah-compliant account or b) that he does not accept losses and so has an account with diminished Shariah validity. This is how the UK's Financial Services Authority (FSA) has dealt with this challenge in the wake of the establishment of the Islamic Bank of Britain.

3.1.3. Other Types of Account

For corporate customers, there are also what are known as *Murabahah*-based accounts, such as *Murabahah* commodity deposits. With this sort of account, a customer uses his investment capital to buy raw materials, e.g., copper, from an agent. He then immediately sells the commodity at the actual market price to his bank. The Islamic bank pays him not only the market price, the so-called "spot price," but also the forward price. The latter is higher than the spot price because it contains, in addition, a premium, which includes the customer's desired profit as well as the bank's margin to cover its costs. The client will not get the money immediately, but only after an agreed period of time. In the meantime, however, the bank can immediately sell the raw materials on to another agent at the spot price and use the proceeds for other investments.

Figure 4
Example of an Islamic savings account



Source: Gassner/Wackerbeck: Islamic Finance.

3.2. Loans and Credits

3.2.1. Consumer Credit

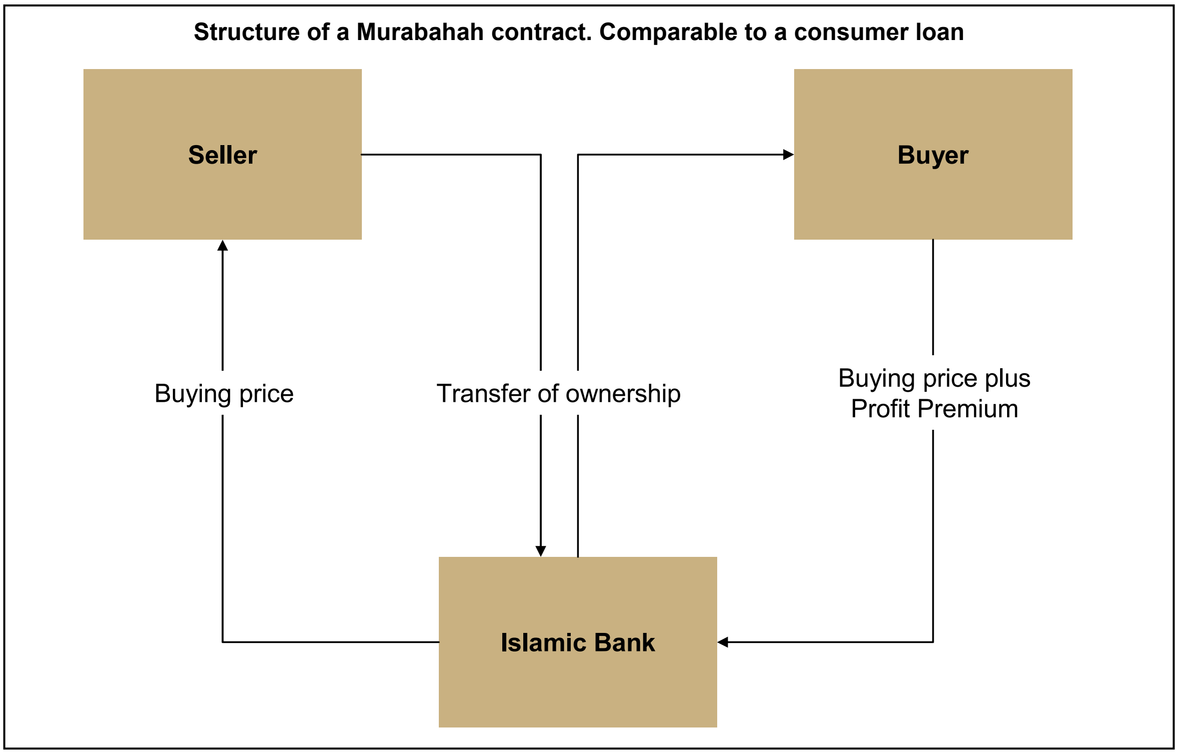
Many consumers simply lack the money to fulfill their wishes. That does not necessarily mean they must give up on the desired car, TV or new kitchen: they just have to finance their desires. Due to the prohibition on receiving or paying interest, Islamic financing differs considerably from the conventional forms of bank credit. In general, there are two techniques: *Murabahah* and *Ijarah*.

Murabahah is a financing technique that contains a profit margin that has been determined in advance. We will clarify this technique using the example of financing a car. Let's say a client would like to acquire a specific car, for which the acquisition price is €20,000. After the bank has successfully checked the client's creditworthiness, the client gives the bank the details of the desired car, including all options and extras. The bank then acquires the car for €20,000 and subsequently sells it to the client. In addition to the acquisition price of €20,000, the client pays the bank an agreed additional profit margin of, say, €1,000 to compensate the bank for the expenses incurred in the transaction. To make things less complicated, the bank can also ask the customer to buy the good as an agent for the bank.

The client repays the total amount to the bank in monthly installments over a period that has also been determined in advance, e.g., 36 months. The client is considered the owner of the car from the beginning (i.e., from the moment of acquisition from the bank).

Another financing technique is what is known as *Ijarah,* which could be considered as the Shariah-compliant equivalent of leasing. The main difference between *Ijarah* and *Murabahah* is that the bank remains the owner of the car throughout the period in which installments are paid. The monthly installments paid by the client to the bank are thus comparable to lease payments for the use of the car. An alternative to *Ijarah* is *Ijarah-wa-Iktina*, which is a kind of hire-purchase agreement, where the client automatically takes ownership of the car at the end of the installment period. While *Ijarah* can be compared to a conventional operating lease, *Ijarah-wa-Iktina* can be compared to a finance lease, where the installments are calculated to include not only the remuneration for the use of the car (i.e., the lease) but also the payments for the purchase of the car.

Figure 5
An Islamic consumer loan



Source: Gassner/Wackerbeck: Islamic Finance.

3.2.2. Credit Cards

Over the past years, credit cards have developed worldwide as a popular payment instrument. Especially for online shopping, credit cards are of huge importance. It is also possible to get a credit card from an Islamic bank. However, certain conditions must be met to ensure compliance with the Shariah.

First, technically speaking, the credit card has to be some sort of "charge card." A "charge card" is a normal credit card where the client, after having used it, receives monthly invoices with all payments for the respective month. The total amount of the invoice will then be debited to the client's current account. Technically, this means that the client gets interest-free credit for the period between the actual purchase and the monthly debiting of his current account. Depending on individual creditworthiness, the Islamic bank grants the client a credit limit. The client is allowed to effect transactions each month up to this limit.

Revolving credit cards, in contrast (which are quite common, especially in the US and the UK), are not Shariah-compliant. With a revolving credit card, the client is assigned a credit limit based on his individual creditworthiness. In contrast to a charge card, the invoice amount is not debited to the customer's current account. Instead, the customer receives a loan for the amount spent and is charged interest on the loan. Revolving credit card business is highly profitable for traditional banks: interest rates of more than 20% a year are not uncommon. Because of the interest component and the high interest rates, which could well be termed "usury," revolving credit cards are not acceptable from a Shariah perspective.

3.2.3. Mortgages

The desire to be a homeowner and, therefore, the demand for Shariah-compliant construction financing, is particularly high amongst Muslims. The basis for Shariah-compliant construction financing is another Islamic financing technique. In practice, *Murabahah* and *Ijarah*, but also *Musharakah*, are used for this purpose. *Murabahah* and *Ijarah* generally work as described with consumer credits. In Europe, construction financing is also often based on the *diminishing Musharakah* concept, where the client and the Islamic bank together constitute a *Musharakah* partnership for the purchase of the property. The client and the bank jointly contribute the capital for the purchase of the property, where the share of capital contributed by the client should as a rule be 25%. The remaining 75% of the required capital is contributed by the Islamic bank. Thus, 25% of the *Musharakah* partnership is held by the customer and 75%, by the Islamic bank. Subsequently, the *Musharakah* partnership acquires the property. Parallel to the purchase of the property, the customer is allowed to use the property and is obliged to pay monthly installments to the bank as remuneration.

However, these monthly installments are not the conventional interest and principal payments typical of construction financing. In fact, the installments consist of two components: the first is the lease payment to the Islamic bank in return for the use of the bank's 75% interest in the property. The second component is a payment for the acquisition by the client of the bank's shares in the *Musharakah* partnership. As a result, the client's shareholding in the partnership increases over the installment period, while the bank's shareholding decreases. The monthly installments payable to the bank decrease accordingly. Consequently, the client is able to apply a larger amount each month to the purchase of shares in the partnership, until eventually the property belongs entirely to the client.

There is one very important issue to be considered when applying the *diminishing Musharakah* to ensure Shariah compliance: the property in question must exist at the moment of purchase. *Murabahah*, *Ijarah* and *Musharakah* cannot be applied to properties that have yet to be built.

Under Islamic law, the object of contract, in this case the property, must exist already in reality (i.e., not only on paper) at the time of the conclusion of the contract.

3.3. Mutual Funds

Mutual funds are an important instrument for investing and accumulating wealth. In most cases, Islamic mutual funds are managed according to the *Mudarabah* principle. *Mudarabah* financing is a partnership involving one party who provides all of the funds (known as the *rab-ul-mal*) and one party that deals only with the management of the enterprise (known as the *mudarib*).

The *mudarib* is solely responsible for the administration of the enterprise, for which he receives a share of the profits, established in agreement with the *rab-ul-mal*. Shariah scholars argue that this form of commission-based payment is more efficient than a fixed salary since it encourages the *mudarib* to gain the highest profits possible.

Profits are shared by the partners. This also means that the investment company only receives payment when the fund has generated a profit. If the fund generated a loss, this must also be borne by the investment company. Thus, the salary of the fund manager is completely variable.

3.3.1. Equity-Based Funds

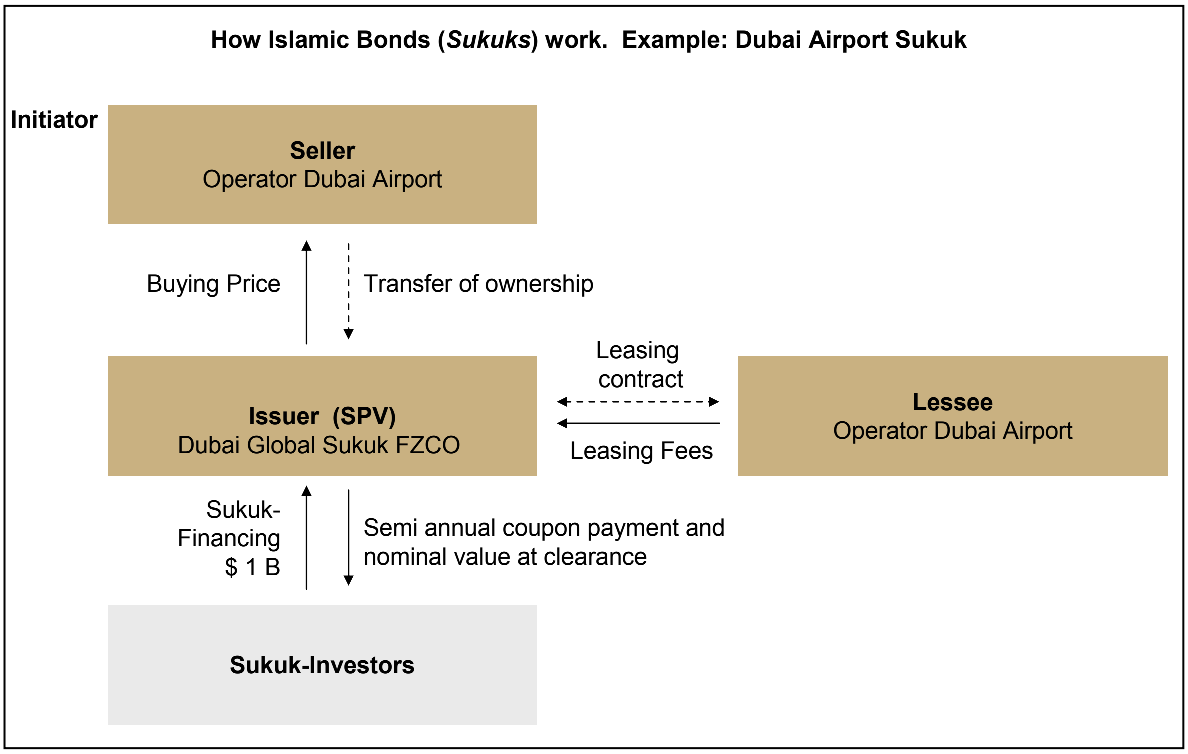
In a Shariah-compliant equity fund, the fund manager invests the fund's capital partly or completely in shares of corporations that are listed on a stock exchange and adhere to the Shariah rules outlined above.

Shariah equity funds are particularly suited to long-term wealth accumulation, for example, in the form of monthly payments of a fixed sum into the fund. For the private client, equity funds are useful for investing in the stock market without being exposed to the risk that handling a limited variety of stocks would entail. Investment funds store hundreds of shares in their portfolio and so can distribute risk over a huge amount of positions. Therefore, through an investment fund, a private client can invest in a huge selection of shares, just like a professional investor. Equity funds have high revenue potential, historically over a period of five years. Moreover, a well-managed equity portfolio yields the highest return in comparison to all other asset classes. Nevertheless, stocks are sometimes prone to high volatility, so on a short-term basis, an equity-based fund has a greater risk factor than a fixed income fund or a savings account.

3.3.2. *Ijarah* Funds and *Sukuk* Funds (Fixed Income Funds)

In conventional finance, fixed income funds, based on obligations and bonds, offer a less risky alternative to equity funds. Bonds are debt vouchers, issued by governments and corporations to raise money. Interest is paid on a yearly basis and at the end of the lending period (the "maturity" of the bond), the face value of the money lent out is paid back to the creditor. Fixed income funds bundle several bonds to increase variety and thus reduce risk. To enable believing Muslims to invest in an asset similar to a fixed income fund with the same risk and return profile, special investment vehicles have been designed that provide investors with an alternative to conventional bonds, but nonetheless adhere to the prohibition of interest. These are called *Sukuk* funds.

Figure 6
An Islamic bond: the *Sukuk*



Source: Gassner/Wackerbeck: Islamic Finance

Sukuk are Shariah-compliant financial instruments that can be compared to conventional notes or bonds. Dubai Airport, for example, was financed by a Shariah-compliant *Sukuk* transaction. Of the many categories of *Sukuk*, the most common in the market are *Ijarah Sukuk*, which are backed by leases and are often guaranteed by sovereign or regional governments. *Ijarah* funds are structured around a specific asset, such as a building, property or infrastructure facility. The asset itself is sold to a special-purpose entity (SPE/SPV), which then issues the *Sukuk* to fund the asset's purchase price. The special-purpose entity then leases the asset and receives periodic lease payments. At maturity, or in the event of dissolution, the special-purpose entity sells the asset back to the original seller at a predetermined price that includes any outstanding amounts still owned under the terms of the *Ijarah* fund.

In the above example of Dubai Airport, the issuer (the SPV) receives $1 billion financing from *Sukuk* investors and uses this sum of money to buy the airport from the operator of Dubai Airport. With the money received, Dubai Airport can finance its constructions and expansions. The airport operator, as a lessee, pays the leasing rates for the money received to the SPV, which makes semi-annual coupon payments to the *Sukuk* investors, comparable to the coupon payments of conventional bonds. At maturity, the $1 billion is paid back to *Sukuk* investors as well.

In an *Ijarah* fund, a large number of transactions are bundled and the payments resulting from these transactions – like the leasing rates – are passed on to the *Sukuk* fund investor.

3.3.3. Real Estate Funds

Real estate funds invest in tangible assets such as houses and the construction of blocks and so are very popular with Muslim investors. If a client does not have the financial capacity to buy a property, he or she can participate in the wealth creation potential of the real estate market by investing in a real estate fund. Investment in real estate is in general permitted by the Shariah, as long as no forbidden activities are carried out inside the buildings (e.g., producing weapons, serving alcohol, prostitution). The structure of a real estate fund can be designed – in the same way as equity funds – in accordance with the principles of *Mudarabah* or *Wakalah*.

3.4. Risk and Insurance

Insurance is a major component of a risk management strategy for private households. Unfortunately, it is not possible to insure against the occurrence of a loss or damage, but insurance helps coping with its financial consequences. Additionally, insurance-linked pension plans are important instruments for building up provisions for retirement. Personal risk management is also becoming increasingly important for believing Muslims. The issue, however, is that conventional insurance policies infringe Shariah law for the following three reasons:

1. Insurance includes elements of interest (*riba*), as conventional insurers usually invest a large share of their capital in interest-bearing securities (bonds).

2. Insurance includes elements of uncertainty and speculation (*gharar*), because when an insurance contract is signed, it is unknown both whether and when a claim could occur and what the amount of the claim would be. From an Islamic legal point of view, the subject matter of the contract is a claim. However, as the claim does not actually exist when the contract is signed, it cannot, under Islamic law, be the subject matter of the contract.

3. Insurance includes elements of gambling (*maysir*). It is prohibited in Islamic finance to sign a contract when both parties already know at the beginning that one of them will win and the other will lose – especially as it is not known who will be the winner or loser. Thus, a typical conventional life insurance policy is regarded as a bet on life and death and as such is prohibited in Islamic law.

The Shariah-compliant alternative to conventional insurance is called *Takaful*. Due to the specific construction of a *Takaful*, the policyholders are also the owners of the *Takaful* fund. Every premium is paid into the *Takaful* fund and any claims are paid out of it. The insurance company, in this case the so-called *Takaful* operator, is merely the manager of this *Takaful* fund. This means that the participants (policyholders) in a *Takaful* insure themselves against possible losses, so that there is no risk transfer from policyholders to the insurance company, as there is in conventional insurance.

Apart from the Shariah-compliant components outlined above, the *Takaful* operator does practically the same as a conventional insurance company, i.e., it advises its clients, collects contributions (premiums), pays claims out of the *Takaful* funds and arranges for reinsurance.

4. Islamic Banking - the Way Forward

While there are many Islamic banks in the Arabian Gulf countries, the Middle East, Malaysia and Indonesia, the number of Islamic banks in Europe is still small, despite the huge Muslim population of more than 15 million.

Whereas the UK already has five Islamic banks (BLME, IBB, EIIB, QIB and Gatehouse)[4] and France, together with Qatar Investment Bank, is currently in the process of setting up the legal structure for Islamic banking, large Muslim markets such as Germany, with almost 4 million Muslims, still lack an Islamic banking player.

While some experts say that it is only a matter of time until an Islamic bank emerges in Germany, critics point to the challenges Islamic banking players face in Western markets, given that legal requirements such as harmonization, standardization, regulation and financial service authority approval and accounting issues and steering and planning questions such as risk and liquidity management have not yet been fully defined in a Shariah-compliant way. There is also the question of whether *riba*/interest-related indices such as the LIBOR or EURIBOR[5] or conventional government bond yields can be used as benchmarks for profits on loans and investments, especially as the Islamic banking money market is nowhere near large enough to serve as a comparable benchmark. Concerning governance, the question of whether a Shariah scholar is part of the management team or "just" an advisor of the management board also remains to be clarified. Talent management and HR are another big issue, as there is still a scarcity of Islamic banking experts who are also savvy in managing a bank within a Western banking environment.

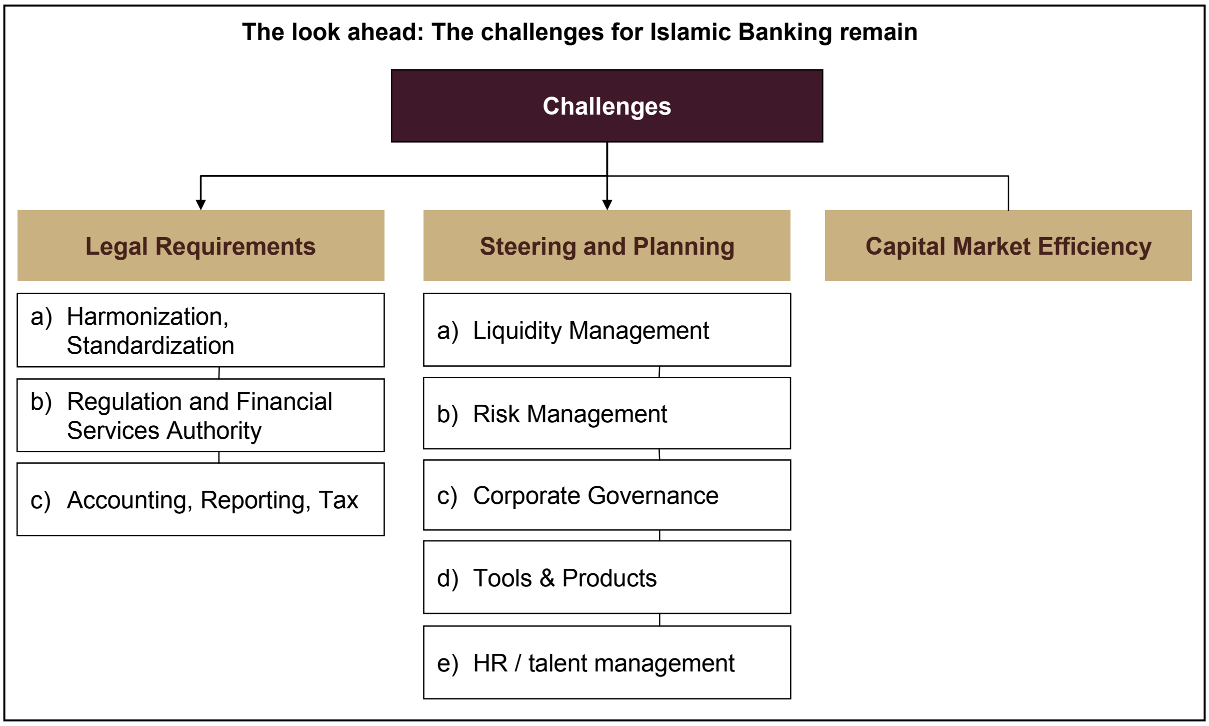
The biggest challenge facing Islamic banking in Europe is that it is an emerging market case within a developed economy, which needs an entrepreneurial and innovative approach – an approach which, since the crisis, the cash-strapped conventional banks seem to lack. The chances are therefore quite high that either an Islamic bank from the GCC will open a branch in Germany, together with a German-based management team, or that a newly founded bank, adopting a greenfield approach, will emerge.

Overall, with the current banking model having come into question after the crisis and with the need to channel payments and investments from East to West in a Shariah-compliant way, the opportunities for Islamic finance in Europe are better than ever.

[4] Bank of London and the Middle East, Islamic Bank of Britain, European Islamic Investment Bank and Qatar Investment Bank.

[5] London Interbank overnight offered rate/Euro zone Interbank overnight offered rate.

Figure 7
Challenges for Islamic finance in the Western world



Source: Gassner, Wackerbeck: Islamic Finance, Cologne, 2010.

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