European University Institute
Robert Schuman Centre for Advanced Studies

RSCAS Policy Papers

RSCAS PP 2007/02
MUSMINE - MUSLIM MINORITIES IN EUROPE

Islamic Finance in Europe

Rodney Wilson

EUROPEAN UNIVERSITY INSTITUTE, FLORENCE
ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

Islamic Finance in Europe

RODNEY WILSON

RSCAS Policy Papers No. 2007/02

ISSN 1830-1541

Printed in Italy in December 2007
European University Institute
Badia Fiesolana
I – 50014 San Domenico di Fiesole (FI)
Italy
www.eui.eu/RSCAS/Publications/
http://cadmus.eui.eu

Robert Schuman Centre for Advanced Studies

The Robert Schuman Centre for Advanced Studies (RSCAS), directed by Stefano Bartolini since September 2006, is home to a large post-doctoral programme. Created in 1992, it aims to develop inter-disciplinary and comparative research and to promote work on the major issues facing the process of integration and European society.

The Centre hosts major research programmes and projects, and a range of working groups and ad hoc initiatives. The research agenda is organised around a set of core themes and is continuously evolving, reflecting the changing agenda of European integration and the expanding membership of the European Union.

Details of this and the other research of the Centre can be found on:
www.eui.eu/RSCAS/

Research publications take the form of Working Papers, Policy Papers, Distinguished Lectures and books. Most of these are also available on the RSCAS website:
www.eui.eu/RSCAS/Publications/

MUSMINE - Muslim Minorities in Europe

MUSMINE is an innovative research programme set up by the European University Institute (RSCAS) in collaboration with Ethnobarometer/Consiglio italiano per le Science Sociali (CSS). The Programme is co-directed by Valérie Amiraux and Alessandro Silj.

MUSMINE seeks to set up permanent research and training initiatives in relation to the presence of Muslim minorities in Europe. It serves as a meeting place and laboratory for experts and scholars in Europe currently addressing these questions, offering opportunities for systematic inter-disciplinary or cross-national exchanges. It also seeks to identify emerging problems and to stimulate research where information is lacking or incomplete.

The Programme aims at establishing itself as the European-level reference point and information repository for work in this area, taking as its task the diffusion of data and information on the Muslim minority presence in Europe to a wide range of interested audiences: academics, the media, the political sphere, NGOs, and relevant institutions at the local, national, and European levels.

For more information:
www.eui.eu/RSCAS/Research/MUSMINE/
www.ethnobarometer.org/

musmine
MUSLIM MINORITIES
IN EUROPE

ETHNO
BAROMETER

The Policy Paper Series

Abstract

Islam all too often resonates negatively in Europe, with a great part of non-Muslim public opinion uncomfortable with Islamic culture and values. Secular and Christian opinion is at best suspicious of *shariah*, Islamic law, and indeed often antagonistic. The notion of wanting to apply *shariah* principles to banking and finance is treated with scepticism if not outright hostility, especially as there is no concept of Christian or Jewish banking, even if there are some parallels between *shariah* financial principles and the teaching of the Old Testament.

Yet Islamic finance is thriving in Europe, and many major European banks perceive it as a profitable opportunity to generate new business rather than as a threat to existing business. Although Islam is sometimes viewed as prescriptive and concerned with restricting choice, Islamic finance is about widening choice, and in particular about providing alternatives to interest based finance. The aim is to develop financial products that are seen as ethical and within the realm of socially responsible investment.

The approach in this research is largely thematic and institutional rather than geographical, with the subject viewed from a European rather than an Islamic world perspective. It is perhaps appropriate to start by examining the role of Islamic finance in Euro-Arab banking relations. Much of the focus is on *shariah* compliant asset management, with a section on liquidity management without the use of conventional instruments such as treasury bills, and an extensive discussion of the structuring of Islamic *sukuk* securities. In the banking field the development of Islamic retail banking in Europe is reviewed, with a further section devoted to *shariah* compliant wealth management and private banking. Prospects for Islamic investment banking are also considered as well as the European experience of *shariah* compliant fund management. Finally future prospects for Islamic banking and finance in Europe are assessed, notably the provision of *shariah* compliant services for continental European Muslims, and the possible implications of Turkey's accession to the European Union will be examined, although there the fortunes of Islamic finance have been rather mixed.

Keywords

Islamic finance, *shariah,* Euro-Arab banking

Introduction

Islam all too often resonates negatively in Europe, with much non-Muslim public opinion uncomfortable with Islamic culture and values. Secular and Christian opinion is at best suspicious of *shariah*, Islamic law, and indeed often antagonistic. The notion of wanting to apply *shariah* principles to banking and finance is treated with scepticism if not outright hostility, especially as there is no concept of Christian or Jewish banking, even if there are some parallels between *shariah* financial principles and the teaching of the Old Testament.[1]

Yet Islamic finance is thriving in Europe, and many major European banks perceive it as a profitable opportunity to generate new business rather than as a threat to existing business. Although Islam is sometimes viewed as prescriptive and concerned with restricting choice, Islamic finance is about widening choice, and in particular about providing alternatives to interest based finance. The aim is to develop financial products that are seen as ethical and within the realm of socially responsible investment.

The approach in this paper is largely thematic and institutional rather than geographical, with the subject viewed from a European rather than an Islamic world perspective. It is perhaps appropriate to start by examining the role of Islamic finance in Euro-Arab banking relations. Much of the focus is on *shariah* compliant asset management, with a section on liquidity management without the use of conventional instruments such as treasury bills, and an extensive discussion of the structuring of Islamic *sukuk* securities. In the banking field the development of Islamic retail banking in Europe is reviewed, with a further section devoted to *shariah* compliant wealth management and private banking. Prospects for Islamic investment banking are also considered as well as the European experience of *shariah* compliant fund management. Finally future prospects for Islamic banking and finance in Europe are assessed, notably the provision of *shariah* compliant services for continental European Muslims, and the possible implications of Turkey's accession to the European Union will be examined, although there the fortunes of Islamic finance have been rather mixed.

The Islamic financial activities of major European banks will become apparent from the discussion, as will the Islamic finance operations of some of the Arab banks with subsidiaries and branches in Europe. The achievements of the European based exclusively Islamic banks will also be reviewed, notably those of Islamic Bank of Britain and the European Islamic Investment Bank.

The Role of Islamic Finance in Euro-Arab Banking Relations

Islamic finance has become a key dimension of the relationship between Arab banks and their European counterparties.[2] While the Arab banks imported most of their conventional financial products from Europe in the past, now European banks are importing *shariah* compliant products from the Arab World, not only for their overseas Arab clients, but more significantly for the growing Muslim population of Europe. Thanks to the emergence of Islamic banking, knowledge transfers in finance have become a two way process rather than simply a one sided affair. European banks have as much to learn from the Arab World as the latter have from Europe as interdependence replaces dependence.

The increasing spread of *shariah* compliant finance, and the dynamism of the economies where it is important, is making the Euro-Arab financial relationship more a partnership of equals in the twenty first century. In contrast for much of the nineteenth and twentieth centuries the Arab economies

1 Rodney Wilson, *Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought*, Palgrave Macmillan, London, 1997, pp. 32-34 and pp.124-128.

2 This section is based on an address given by the author to the Union of Arab Banks in Brussels on 29 June 2007.

underperformed those of Europe, and one explanation for this underperformance was the development of a financial system in the region based on *riba* that was never fully accepted given its inherent conflict with Islamic values. Fortunately now pious Muslims have a real choice, as *shariah* compliant products have been developed over the last three decades to serve most of their financial needs, and these products are at least as efficient as their conventional counterparts.

The United Kingdom has been the gateway for Islamic finance to enter Europe, partly reflecting the role of London as the leading international financial centre, but also as a consequence of the exposure of leading British banks to the Arab and wider Islamic World and their knowledge of these markets. It was the Arab joint venture banks that first brought Islamic finance to London in the early 1980s as Islamic banks in the Gulf found that re-depositing on a *murabahah* basis could be an effective tool for liquidity management, with the marks-ups generated from trading activity on the London Metal Exchange.

The United Kingdom has also hosted the first Islamic retail bank in Europe, the Islamic Bank of Britain which started operations in September 2004, and the European Islamic Investment Bank, which opened for business in 2006. The leading conventional banks have also become involved in serving the local retail market for Islamic financial services, notably HSBC and Lloyds TSB, both of which provide Islamic deposit facilities and housing finance using *shariah* compliant structures.

It is of course internationally that European banks have made the greatest contribution to Islamic finance with Barclay Capital partnering Dubai Islamic Bank for the world's largest *sukuk* issuances, Standard Chartered making a notable contribution to Islamic finance through its networks in the Gulf, Pakistan and Malaysia, Deutsche Bank in pioneering capital protected funds in the Gulf and UBS in developing *shariah* compliant wealth management services to name just some examples. It is the operations of these major European banks that will be also reviewed here.

Early Islamic Trade Finance Operations of Major European Banks

It was the involvement of European banks in the Gulf that first resulted in them encountering demands for Islamic finance. These date back over eighty years, as it was in the 1920s that the Eastern Bank, the predecessor of Standard Chartered, was asked by the ruler of Bahrain that the bank's proposed branch on the island would only be allowed if it avoided all interest based transactions.[3] At the same time the National Handelsbank of the Netherlands, the predecessor of ABN-Amro, was allowed to establish itself in Jeddah to provide money changing services for pilgrims from Dutch Indonesia, the condition being that it avoided all interest based transactions.[4]

For the next fifty years most of the European banks involved in the Muslim World carried out their business using interest, as indeed did their local counterparts, within financial systems where governments believed religion had no role to play. By the late 1970s however the perceptions of European bankers was starting to change, largely as a result of the emergence of Islamic banks in the Gulf, with the Dubai Islamic Bank the first to be established in 1974, followed by the Kuwait Finance House in 1977 and the Bahrain Islamic Banks in 1978. All these banks were extensively involved in *shariah* compliant trade finance, especially of imports from Europe, using a structure known as *murabaha*, whereby an Islamic bank would purchase an imported good on behalf of a client, and then resell the good to the importer for deferred payments covering the costs of the purchase plus a mark-up representing the bank's profit.[5] As the bank was involved in a real trading transaction which

3 Rodney Wilson, 'Financial Development in the Arab Gulf: The Eastern Bank Experience, 1917-1950,' *Business History, Vol. 29, No. 2, 1987, pp. 178-198.*

4 Rodney Wilson, *Banking and Finance in the Arab Middle East,* Macmillan, London, 1983, p. 87.

5 Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, John Wiley and Sons, Singapore, 2007, pp. 87-90.

involved ownership risks this justified its profit, unlike interest on a conventional loan where there was only the credit risk of default.

As the payments by the Islamic banks would be made to the European exporter's bank those bankers involved started to learn about Islamic finance. In a conventional trading transaction usually the exporter's bank would demand a letter of credit from an importer's bank that would guarantee the payment.[6] With *murabaha* however, as it is an Islamic bank, and not the import distributor or agent who is making the payment, letters of credit are arguably unnecessary, as well regulated banks are less likely to default than individual corporate clients. This potentially lowered the costs of trade financing, but European banks acting on behalf of their exporting clients were only prepared to wave the requirement for their *shariah* compliant counterparties to provide letters of credit if they were satisfied that these Islamic banks could meet their payments obligations. To be confident in the timely payment of receivables European banks needed to find out more about Islamic banking and understand how Islamic financing techniques worked.

Shariah **Compliant Liquidity Management in Europe**

All banks need to maintain liquid assets to meet depositor withdrawals and financial obligations to other institutions including banks. Rather than merely holding cash, which yields no return, usually liquid assets are held as treasury bills or repos, repurchase obligations on which a financial institution which holds these monetary instruments earns interest.[7] Islamic banks cannot hold such instruments, as interest is regarded as *riba*, which is explicitly prohibited in the Holy Koran.[8] This presented a challenge for Islamic banks, as they were required by regulators to hold liquid assets as part of prudential risk management requirements, but there were no *shariah* compliant liquid instruments available which they could hold.

From 1980 onward a number of banks in London offered *shariah* compliant liquidity management services to Islamic banks from the Gulf and the Jeddah based Islamic Development Bank. This involved inter-bank wholesale operations, with banks in London providing overnight deposit facilities for the newly established Islamic banks in the Gulf. The major institutions involved were the joint venture Arab banks in London, such as Saudi International Bank and the United Bank of Kuwait. They accepted deposits on a *murabaha* mark-up basis, with the associated short term trading transaction being conducted on the London Metal Exchange.[9]

The margins were very small on these buying and selling transactions, but they were sufficient for the banks in London to offer the Islamic financial institutions in the Gulf and Jeddah a return which was comparable to that on conventional treasury bills. The attraction of London was the financial expertise available and the low risk transactions facilitated by the London Metal Exchange because of the depth of the market. The joint venture counterparties were not directly involved in the trading, but rather engaged specialist brokers, notably Dawnay Day, which soon acquired the knowledge of the *shariah* issues that concerned their Gulf clients.[10]

Although the provision of *murabaha* facilities as an instrument for liquidity management remains significant, the real transactions involved result in it being a relatively costly means of ensuring *shariah* compliance. A preferable and less costly solution is for Islamic banks to hold modified

6 Alan C. Shapiro, *Multinational Financial Management*, John Wiley and Sons, New York, 1999 (sixth edition), pp. 392-397.

7 Shelagh Heffernan, *Modern Banking*, John Wiley and Sons, Chichester, 2005, p. 59.

8 *Sura* 2:275

9 For a wider discussion of liquidity management issues see Youssef Shaheed Maroun, 'Liquidity management and trade financing', in Simon Archer and Rifaat Abdel Karim, *Islamic Finance: Innovation and Growth*, Euromoney Books, London, 2002, pp. 163-175.

10 www.dawnayday.com/Display.aspx?&MasterId=019b5780-e3.

treasury bills that satisfy *shariah* requirements.[11] Progress has been slow in developing such instruments, and the trading of securities based on *bai' dayn* debt contracts, which is allowed by Shafii scholars in Malaysia, is not permitted by more conservative schools of Islamic jurisprudence, including those whose opinions prevail in the Gulf.[12] European *shariah* scholars tend to follow the more conservative interpretations in the Gulf and South Asia associated with the Hanafi and Malaki schools of Islamic jurisprudence rather than the Shafii School which prevails in Malaysia and Indonesia.

How to manage liquid assets remains a major matter of controversy in Islamic finance, not least because many Islamic banks continue to have liquidity well in excess of regulatory requirements.[13] Although the Islamic Financial Services Board has provided guidelines for regulators on liquidity management, it does not specify what instruments should be used.[14] In Bahrain *salam sukuk* securities have been developed which serve the same function as treasury bills, but as these are asset backed, the issuance and redemption involves buying or selling a claim to the underlying real asset rather than simply acquiring or disposing of debt.[15] This has been approved by the more conservative *shariah* scholars in the Gulf as a preferable alternative to *bai' dayn* debt contracts and the *bai' bithaman ajil sukuk* traded in Malaysia which are backed by financial rather than real assets. A *salam* contract involves a payment for a real asset to be delivered in the future, with the timing of delivery and the precise details of the asset specified in the contract. In the case of Bahrain the issuer is the government, the assets are commodities such as aluminum used by the country's smelter and the time to maturity is ninety days. Islamic financial institutions purchase the *salam sukuk* and on maturity are reimbursed after ninety days with a mark-up representing their return on the asset. On receipt of these funds they relinquish their rights to the underlying asset which reverts to the government as the issuer. At present *salam sukuk* are not traded on a secondary market, even though Bahrain has a Liquidity Management Centre established for *sukuk* trading, as the *shariah* scholars view them as financial instruments and are concerned about the link with the underlying asset.[16] This is a major limitation for *salam sukuk*, as treasury bills and repos are usually widely traded in secondary markets, resulting in greater liquidity.

Sukuk Issuance and Trading in Europe

At present there are no *salam sukuk* available in Europe although most countries have active treasury bill and repo money markets. This presents a problem for Islamic banks in Europe that have to continue to rely on *murabaha* inter-bank deposits for their treasury management. There is an opportunity to develop markets in Islamic securities in Europe which would attract institutional *shariah* compliant investment from the Middle East as well as serving Islamic banks in Europe. London is an obvious location given the depth and breadth of its financial markets, especially as the Islamic Bank of Britain and the European Islamic Investment Bank are listed on the Alternative Investments Market (AIM). Developing a market in *salam sukuk* is problematic however unless tradability is allowed by the *shariah* scholars, as merely having issuance is not a substitute for an Islamic money market.

---

11 Osman Babikir Ahmed, *Islamic Financial Instruments to Manage Short-Term Excess Liquidity,* Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1997, Research Paper No. 41, p. 77.

12 *Resolutions of the Securities Commission Shariah Advisory Council,* Kuala Lumpur, 2nd edition, 2006, pp. 16-19.

13 Tariqullah Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in the Islamic Financial Industry,* Islamic Research and Training Institute, Islamic Development Bank, Jeddah, 1997, Occasional Paper No. 5, pp. 146-147.

14 Islamic Financial Services Board, *Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services,* Kuala Lumpur, December 2005, pp. 20-22.

15 Rodney Wilson, 'Overview of the *sukuk* market', in Nathif J. Adam and Abdulkader Thomas, (eds.) *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk,* Euromoney Books, London, 2004, pp. 6-7.

16 Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance,* John Wiley and Sons (Asia), Singapore, 2007, pp. 183-184.

The pioneering *sukuk* in Europe was by the German Federal State of Saxony-Anhalt which raised €100 million through an issuance on 31st July 2004. The *sukuk* is for five years using an *ijara* leasing structure with a floating return based on the six month Euribor rate plus one percent. In other words in financial terms it is identical to a floating rate note but because of the *ijara* structure the payments to the investors represent rent rather than interest or *riba* which is prohibited under *shariah*. This is not merely the renaming of the return, but rather having a structure that is recognized as distinctive under national law, and in the case of the Saxony-Anhalt *sukuk*, German law. Like other German state debt instruments the *sukuk* was listed in Luxembourg, with an additional listing in Bahrain to attract Gulf investors. Citigroup Global Markets was the arranger for the *sukuk*, and the *shariah* advisory board of Citi Islamic Investment Bank in Bahrain vetted the legal documentation for *shariah* compliance. The *sukuk* was rated –AA by S&P and –AAA by Fitch with the state of Saxony-Anhalt acting as guarantor.[17] The Kuwait Finance House, the second largest Islamic bank in the Gulf, acted as lead manager for the issue, with its visibility and reputation helping ensure that other Islamic financial institutions would invest in the *sukuk*.

As *sukuk* have to be asset backed, the solution under German law was to establish a 'Dutch' foundation, which corresponded to the classical Islamic concept of a *waqf*. The Ministry of Finance then transferred usufruct rights to its building to the foundation, which served as the underlying asset.[18] When the *sukuk* is traded investors are buying and selling rights to the real underlying asset which is permissible under *shariah*, rather than simply paper debt instruments which cannot be traded in the view of Gulf *shariah* scholars as already indicated. Effectively the structure is a sale and lease back arrangement, with the foundation serving as a special purpose vehicle, (SPV), which is wound up on termination of the *sukuk*, when the usufruct rights revert back to the Ministry of Finance which no longer pays rent to service the investors. In this respect it is different from a *waqf* religious endowment trust which exists in perpetuity rather than for a definitive period. The idea for the *sukuk* followed an earlier road show during 2001 when German states tried to ascertain if there was a market for near sovereign issuers in the Gulf countries, with institutions there suggesting that any offering would attract more attention if it was *shariah* compliant rather than being structured as a conventional bond or floating rate note.[19]

Most of the *sukuk* issued in the Gulf and South East Asia are for corporate clients rather than sovereign *sukuk*, but corporate issuances have been slow to start in Europe. The Swiss company, EnergyMixx AG announced on 15 August 2007 that it had appointed Faisal Private Bank and the law firm Vinson Elkins to advise it on a suitable *sukuk* structure to fund a power plant project in the Gulf, but the structure and the terms have still to be decided.[20] A relatively small corporate *sukuk* worth $26 million was arranged in April 2005 by ABC Islamic Asset Management in London and the Abu Dhabi Commercial Bank on behalf of Al Safeena Ltd of London.[21] The English Law firm Norton Rose advised on the structure together with Voisin and Co. of Jersey, as the trust structure governing the *sukuk* was registered under Jersey's offshore laws. This was the first Islamic security to be used to finance shipping, as the asset used was a Very Large Crude Carrier (VLCC), Venus Glory, which was chartered to a Saudi Arabian shipping company.[22] An *ijara* structure was used for the *sukuk*, with the

---

17 'Saxony-Anhalt sukuk to be offered', *Eastern Oracle*, August 2nd 2004. (cited in *Islamic Finance Information Service*, ISI Emerging Markets: subscription website http://site.securities.com)

18 Michael Saleh Gassner, '*Sukuk* breathes new life into federal state', *Islamic Banking and Finance Magazine,* December 2004.

19 Michael Saleh Gassner, 'How a *sukuk* was developed in the state of Saxony-Anhalt', *Islamic Banking and Finance Magazine,* December 2004.

20 *Islamic Finance Information Service*, ISI Emerging Markets: subscription website, 13 September 2007.

21 'ABC Islamic and ADCB co-underwrite $26 million 'Al Safeena' *sukuk*', *Islamic Finance Information Service*, ISI Emerging Markets: subscription website, 17 April 2005.

22 'Norton Rose acts on first ever Islamic bond for the shipping sector', *Islamic Finance Information Service*, ISI Emerging Markets: subscription website, 26 April 2005.

tenor being five years and the return a fixed six percent payable quarterly with the return of the principle on maturity. A fixed return is unusual on an *ijara sukuk*, which in this case means in financial terms it is equivalent to a bond rather than a floating rate note. Normally a *murabaha* structure with a mark-up would be used for a fixed return *sukuk*, but as *murabaha* is a short term instrument, arguably an *ijara* structure is preferable for a period of five years. A larger corporate *sukuk* worth $261 million was used to finance the purchase of the Sanctuary Building in London in 2005.[23] Taylor Wessing, the international law firm, advised on the structuring, the clients being Bahrain based Taib Bank and Hong Kong based Dominion Asset Management, represented in the United Kingdom by Pelham Associates. This *sukuk* was also based on an *ijara* structure, but with a variable return linked to LIBOR, the London Inter-Bank Offer Rate, rather than a fixed return.

Turkey, an aspiring European Union member, has more Islamic bank branches than any other European country, although the role of *shariah* compliant finance in its banking system remains marginal. It is an active member of the Jeddah based Organization of the Islamic Conference (OIC) and subscribes to and has received *shariah* compliant funding from the Islamic Development Bank, the aid agency of the OIC. At present all of Turkey's government debt is funded through conventional bill, bond and note issuance involving interest based payments, but since September 2005 consideration has been given as to whether some debt should be funded through *sukuk* securities.[24] As always in Turkey the issue has been complicated by political considerations, given the tensions between the AK, the moderate Islamist governing party, which supports Islamic finance, and the former president, and upholder of Turkey's secularist constitution, who was at best skeptical towards the notion of finance being *shariah* compliant. The tensions between Islamists and secularists in Turkey are long standing, and Islamic banking and finance is viewed from the perspective of political symbolism, rather than being simply about financial choices.[25] The change in Turkish law necessary for the issuance of *sukuk* has been made more likely since the decisive election win by AK in 2007 under the Prime Minister, Recep Tayyip Erdogan, and the appointment of his political ally, Abdullah Gül, as President.

It is inevitably London that has the most potential as a centre for *sukuk* issuance in Europe given its established reputation in Islamic banking, the depth and breadth of its financial markets and a regulatory framework that encourages rather than inhibits financial innovation. There has been over three decades of official support, initially by the Bank of England, and from 1997 onwards by the Financial Services Authority as it took over regulatory responsibility for banking, including Islamic banking. However the Treasury has only been marginally involved, largely through granting tax concessions to ensure a level playing field for *shariah* compliant housing finance, rather than viewing Islamic finance as a vehicle for raising revenue.

During 2006 the idea of London serving as a centre for *sukuk* issuance was first raised at an Islamic finance conference in June, which was attended by the then Chancellor of the Exchequer, Gordon Brown, and his deputy Ed Balls.[26] As they became involved this gave the cause of sukuk issuance political momentum which has propelled subsequent developments. Three factors appear to be positively influencing developments. The first is to ensure that British Muslims see that their government is open and responsive to the opportunities that Islamic finance offers. There is a political desire to ensure that British Muslims feel included rather than excluded, not least because Muslims who are United Kingdom nationals may vote, and their support is crucial to ensure that the Labour Party maintains control of key marginal constituencies. A second factor is to ensure that the City of

---

23 *Islamic Finance Information Service*, ISI Emerging Markets: subscription website, 24 August 2005.

24 Farhan Bokhari, 'Turkey weighs up benefits of Islamic bond', *Financial Times,* 27 September 2005.

25 Filiz Baskan, 'The political economy of Islamic finance in Turkey: the role of Fethullah Gülen and Asya Finans', in Clement M. Henry and Rodney Wilson, (eds.), *The Politics of Islamic Finance,* Edinburgh University Press, 2004, pp. 216-239.

26 Mustak Parker, 'Waterloo sunset', *Islamic Business and Finance* Magazine, London, 1st April 2007.

London continues to play a major international role in Islamic finance and attracts business for investment banks and law firms, which results in well paid jobs. The government has established a Working Group on City Competitiveness to ensure that London's leading role in international finance is consolidated and enhanced, and the encouragement of Islamic finance is viewed as part of this strategy. Third although government debt is relatively modest in relation to gross domestic product (GDP) in the United Kingdom and funding can be secured easily, there is a desire to diversify funding sources to keep costs low and attract attention to Sterling as a stable and attractive currency for international investors, including Muslim institutions and individuals concerned with *shariah* compliance.

On 23rd April 2007 the Treasury announced that it would be undertaking a feasibility study of the potential for sovereign *sukuk* issuance by the British government, the am being to include a statement of progress in the pre-budget report for 2007.[27] On 16 August 2007 the first meeting of the Islamic Finance Experts Group was convened in London, an official body established to advise the Treasury and the Financial Services Authority on issues relating to Islamic finance, including *sukuk* issuance.[28] Issues being considered include who and how *shariah* compliance will be ensured, the structure and size of the issuance, the period to maturity and the pricing. *Shariah* assurance could imply the Treasury either appointing its own *shariah* board or outsourcing compliance, both options having advantages and disadvantages. The structure is most likely to be based on an *ijara* leasing contract, with the payments to the *sukuk* holders being rents. As with other *ijara* based *sukuk* the government would establish an SPV which would hold the asset, a piece of state owned land, for the duration of the *sukuk* that is anticipated to be five years. The government rental payments for the use of the asset would be paid through the SPV to the investors with the tax treatment the same as for conventional securities.[29] Rents would be benchmarked to either the London Inter-Bank Offer Rate (LIBOR) or Bank of England Minimum Lending Rates (MLR), the expectation being that the actual rents paid would be at a discount to LIBOR or MLR reflecting the high quality of the government paper issued and its implicit AAA rating as the United Kingdom government always meets its financial obligations. The pricing would be in line with conventional government debt instruments, and it is anticipated that the same financial institutions will take up the offer as hold the conventional equivalent. The prime aim is not to attract Gulf capital inflows, but rather to establish a benchmark for high quality Islamic debt that can be used as a base for the higher pricing of future more risky corporate *sukuk* issuance in London.

There was some disappointment that no *sukuk* announcement was made in the Chancellor of the Exchequer's pre-budget statement of October 2007, but given the complexity of the legal and technical issues to be resolved, the omission at this early stage was not surprising.[30] The Chancellor Alistair Darling indicated that further announcements would be made in 2008, and that a report identifying key issues in the *sukuk* issuance would be announced, including the tax treatment of assets transferred into and from the SPV.[31] It was also proposed that National Savings and Investment (NS&I), the British government savings scheme, would offer *shariah* compliant products to retail investors through the national post office branch network.

Islamic Retail Banking in Europe

As the main source of support for Islamic banking has always come from ordinary Muslims, and the development of Islamic finance can be regarded as a populist movement rather than an initiative from

27 Mustak Parker, 'UK government serious about *sukuk*', *Arab News*, Jeddah, 27 April 2007.

28 'City Minister Kitty Usher chairs Islamic Finance Experts Group meeting on feasibility study into government *sukuk*,' *Islamic Finance Information Service*, ISI Emerging Markets: subscription website, 16 August 2007.

29 Mohammed Amin, 'Promoting Islamic finance: the new UK tax law on *sukuk*', *New Horizon,* July-September 2007, pp. 40-41.

30 'Sukuk not feasible', *Islamic Finance News,* 12 October 2007, p. 4.

31 Mushtak Parker, 'UK Islamic bond plan progressing', *Arab News,* Jeddah, 15 October 2007.

governments, it is not surprising that retail Islamic banking has been the dominant activity.[32] The world's largest Islamic financial institutions, the Al Rajhi Bank of Saudi Arabia and the Kuwait Finance House, primarily provide retail, personal and private banking products, as do the Dubai Islamic Bank and Bank Islam Malaysia. In Europe Islamic finance has also been a bottom up rather than a top down movement, although it is only in the United Kingdom that the regulator, the Financial Services Authority, has actively facilitated the development of the industry. Yet France and Germany have much larger Muslim populations than the United Kingdom, where the total was only 1.8 million when Islamic retail banking started in the 1990s and still remains below two million today.[33]

As Muslims are no different to non-Muslims in their needs and demands for financial services, not surprisingly Islamic banks and conventional banks offer *shariah* compliant retail products that mirror those provided to ordinary clients. Current account or transactions deposits are always offered, as these facilitate payments through cheques, standing orders, direct debits and most importantly debit cards for use at point of sale or through automated teller machines. Of course as conventional current accounts pay little or no interest, some observers may question the need for special *shariah* compliant current accounts. Such accounts however are provided using *wakala* trust structures, where the financial institutions guarantees that the amounts deposited will not be used for interest based financing, or under the *qard hassan* principle, where the depositor provides the bank with in interest free loan on the understanding that no *riba* will be charged when the finance is utilized. In the United Kingdom both Lloyds TSB[34] and HSBC Amanah[35] offer *shariah* compliant current accounts.

Banks providing *shariah* compliant retail financial services in Europe all offer a range of savings and investment products. The Islamic Bank of Britain offers a treasury account, where those who have £100,000 or more to invest can place their funds for fixed periods ranging from 1-24 months, with higher returns offered for longer time deposits.[36] The deposits are structured on a *murabaha* basis, with the funds used to buy and sell commodities on the London Metal Exchange, with the client being paid a mark-up reflecting the trading profit. The profit rate is pre-determined, eliminating risk for the client, and the bank covers its position in the commodity exchange by agreeing the sale price at the time of purchase. Such transactions are permissible under *shariah*, as the hedging does not involve the use of derivatives such as futures and options, but rather real trading transactions involving physical commodities.

Savings accounts are also offered where no minimum balance is required but returns are significantly lower than with the treasury placements. The Islamic Bank of Britain offers three instant access accounts, an internet direct access account paying 3 percent in September 2007, a young persons account paying 2.5 percent and a undetermined savings account using a passbook with branch deposits and withdrawals paying 2.0 percent. It also offers term savings deposits with minimum notice periods for withdrawals, the 30 day account paying 3.25 percent, the 90 day account 3.50 percent and the 180 day account 3.75 percent.[37] These accounts are based on a *mudaraba* structure, with the depositor sharing in the profits of the bank rather than earning interest. It should be noted that the percentage returns indicated are target rates, which are not guaranteed, as under a *mudaraba* structure returns cannot be pre-determined.

---

32 Rodney Wilson, 'The growth of Islamic banking and product development among Islamic retail banks', in Sohail Jaffer, (ed.) *Islamic Retail Banking and Finance: Global Challenges and Opportunities*, Euromoney Books, London, 2005, pp. 18-28.

33 Rodney Wilson, 'Challenges and opportunities for Islamic banking and finance in the West: the United Kingdom experience', *Thunderbird International Business Review*, Vol. 41, Nos. 4/5, 1999, pp. 421-444.

34 http//:www.lloydstsb.com/current_accounts/Islamic_account.asp

35 http://www.hsbc.co.uk/1/2/personal/current-accounts/more/amanah-finance

36 http://www.islamic-bank.com/islamicbanklive/CommodityDeposits/1/Home/1/Home.jsp

37 http://www.islamic-bank.com/islamicbanklive/IAProfitsRates/1/Home/1/Home.jsp

With *mudaraba* the profit rate declared on which returns on deposits are based should be related to the profitability of the financial institution.[38] However most Islamic banks, including the Islamic Bank of Britain, maintain a profit equalization reserve into which a proportion of bank revenue is paid rather than being distributed to depositors. The aim is to maintain a reserve fund, from which a profit share can be paid, even in years when the bank generates less profit.[39] The cost to depositors is that they receive less in the more profitable years. This profit smoothing, which is encouraged by regulators, including the Financial Services Authority, enables Islamic banks to stay competitive with conventional banks, with the option of increasing profit rates when interest is rising and other financial institutions pay more to depositors. Islamic banks are often criticized by strict Muslims for benchmarking profit rates to interest indices, but legally the returns they pay are profits, not interest, and as Islamic banks only account for a minute share of bank deposits in most markets, they are price takers, not price makers.

There is a potential conflict between *mudaraba* depositors and shareholders in an Islamic bank, as higher dividend payments to the latter may be at the expense of profit share payments to the former. However if the *mudaraba* depositors are not sufficiently rewarded, not many will be attracted to the bank, which will adversely affect the bank's growth and its long run profitability. In other words the market can provide a solution, without the need for regulatory intervention. *Mudaraba* is regarded as an equity type arrangement, but it is not the same as equity investment, as it is the shareholders who own the bank and enjoy voting rights, not the *mudaraba* depositors. However while the shareholders may receive very variable dividends, and suffer capital losses as well as gains, returns to the *mudaraba* depositors fluctuate less, but they do not benefit from capital gains. Under *shariah* the nominal capital value of *mudaraba* deposits cannot be guaranteed, but in practice it is never written down as it is the shareholders dividend that is cut or eliminated when losses occur, with *mudaraba* depositors also higher in the pecking order with regard to claims in the case of insolvency.

In addition to offering *mudaraba* accounts which entitle the depositor to a share in the bank's profits, a number of Islamic banks provide specified *mudaraba* accounts where the funds deposited are allocated to a single company with the agreement of the depositor. The Islamic bank in these cases acts as an agent, charging an arrangement and annual management fee, with the depositor sharing in the profits of the specified company. The returns will normally be more volatile than those in general investment accounts, as bank profits will partly depend on its competency in risk and debt portfolio management. The depositor expectation would however be for a higher return with a specified investment account. So far such accounts are not offered in Europe, but they have proved popular elsewhere, notably with Jordan Islamic Bank depositors.[40]

Islamic banks cannot provide overdraft facilities or personal loans on which interest is payable, but rather structured financing facilities for specific purposes usually involving the acquisition of physical assets. In markets such as Europe however many retail clients want cash loans, so that they can shop around for the best price, rather than relying on *murabaha* facilities, where an Islamic bank purchases a commodity on behalf of a client, who then purchases the commodity from the bank for a larger payment including a mark-up, with settlement being on a deferred payments basis. To avoid tying financing to particular trading transactions, and provide greater flexibility, a number of Islamic banks, including the Islamic Bank of Britain, offer a *tawarruq* facility.[41] This involves an initial *murabaha* transaction, and a simultaneous reverse transaction, where the client sells the commodity received to a third party nominated by the Islamic bank, in return for a cash sum being deposited in his or her

---

38 Mervyn K. Lewis and Latifa M. Algaoud, *Islamic Banking,* Edward Elgar, Cleltenham, 2001, p. 48.

39 Islamic Financial Services Board, *Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering only Islamic Financial Services,* Kuala Lumpur, December 2005, pp. 19-20 and pp. 25-26.

40 Jordan Islamic Bank, *Annual Report 2006,* Amman: www.jordanislamicbank.com/annualreport.html

41 http://www.islamic-bank.com/islamicbanklive/PFGenerateCash/1/Home/1/Home.jsp

current account.[42] The effect is identical to an overdraft or personal loan with the client repaying on a deferred payments basis, but the legitimacy under *shariah* is that the financing is asset backed and involves trading rather than a straight loan. The legal rights and obligations under English law, as well as under *shariah*, are distinctive, but because *tawarruq* mirrors conventional financing, it has many critics.[43]

In most European countries, especially in the United Kingdom and France, most people, including Muslims, want to own the home they live in, and are prepared to take out substantial mortgages for this purpose, with this becoming their largest single financial commitment. As conventional mortgages are based on interest on the amounts borrowed, the challenge in Islamic finance was to develop satisfactory *shariah* compliant alternatives. The first Islamic mortgages in Europe were offered in 1988 by Al Baraka Bank to Gulf Arabs for properties in London, with the mortgages structured through an *ijara* rental contract, whereby the bank purchased the property, and the client repaid by monthly instalments and in addition paying rent to the bank, which was based on the implicit rental value of the property as agreed through an independent valuation.[44] After the Al Baraka Bank reverted to becoming an investment company it ceased to provide housing finance and the United Bank of Kuwait, which already provided conventional mortgages, started to offer mortgages based on *murabaha* from 1997, and the following year housing finance based on *ijara* contracts, the latter being the equivalent to a variable rate mortgage, while repayments and the mark-up for the *murabaha* mortgage was fixed. Both were perceived as expensive, not least because stamp duty had to be paid twice, initially when the bank purchased the property and subsequently when the client purchased from the bank. It was only after the 2004 budget in the United Kingdom, when the Chancellor of the Exchequer announced the abolition of the double stamp duties on these mortgages, that *shariah* compliant housing finance became more competitive.

Following the stamp duty relief, Al Buraq, the Islamic retail finance subsidiary of the Arab Banking Corporation, devoted more energy and resources to marketing *shariah* compliant home finance. As a result it has become the leading player in the United Kingdom market. Al Buraq does not have a branch network, but it markets its Islamic home finance through Bristol and West,[45] a former building society purchased by the Bank of Ireland, with a substantial branch network, including in areas with significant Muslim populations. In addition the Islamic Bank of Britain offers Al Buraq *shariah* compliant home finance through a white labeling agreement under which they receive a fee for every client signed up. The Arab Banking Corporation has a large base of *shariah* compliant deposits which can be used to finance the Islamic mortgages, unlike Islamic Bank of Britain, whose deposit base is small. Lloyds TSB also offers Al Buraq mortgages,[46] as although it is one of the largest banks in the United Kingdom, with enormous deposits, these are conventional and pay interest, and hence cannot be used to fund *shariah* compliant housing finance.

Al Buraq's Islamic mortgages are based on a combined *ijara* and *musharaka* structure with the bank and the client entering a partnership, and the bank paying up to 90 percent of the capital and the client at least 10 percent. Repayments are scheduled up to 25 years, with the client paying rent to the bank for its share of the property, this being the main element in the bank's profit.[47] Most young clients are more concerned with their initial monthly payments rather than payments after 10 or 20 years, as by then their financial circumstances should have improved as their careers progress.

42 Harvard Law School Islamic Legal Studies Programme, *Workshop on Tawarruq*, 1st February 2007, London School of Economics. Included papers presented by Mohamed A. Elgari and Mohammad Nejatullah Siddiqi.

43 Mahmoud A. El-Gamal, *Islamic Finance: Law, Practice and Economics*, Cambridge University Press, 2006, pp. 70-73.

44 Rodney Wilson, 'Islamic banking in the West', in M. Kabir Hassan and Mervyn K. Lewis, *Handbook of Islamic Banking*, Edward Elgar, Cheltenham, England and Northampton, Massachusetts, 2007, p. 420.

45 http://www.alburaq.co.uk/homefinance.asp

46 http://www.lloydatsb.com/mortgages/islamic_home_finance.asp

47 http://www.alburaq.co.uk/homefinance_howdoesitwork.asp

Therefore to ensure the initial payments are competitive, only very small repayments are made at first, the major servicing element being the rent. After several years repayments increase as rent diminishes, but the aim is to backload rather than frontload total monthly payments so that they increase rather than decrease over time. Actual repayments can be tailored to the needs of individual clients and their future income prospects. Most types of property are acceptable for *shariah* compliant mortgages including leaseholds with more than 70 years of life.[48] Self certification of income is permitted, and Islamic mortgages are also available on a buy to let basis.[49] The major competitor to Al Buraq in *shariah* compliant housing finance is HSBC Amanah which offers a similar financing structure.[50] Their mortgages were seen by some as more expensive, but the terms have become more favourable as they have sought to increase market share.

Islamic Wealth Management in Geneva

Europe has been an important destination for capital flows from the Middle East for over sixty years, with increasing funds originating from the Gulf since the first oil price boom of the 1970s. A significant proportion of these flows came through government owned national investment funds, such as the Kuwait Investment Authority and the Abu Dhabi Investment Fund. The aim was to re-cycle so called petroleum-dollars into financial assets that could provide future income and capital appreciation, so that future generations in the oil rich states in the Gulf could continue to enjoy prosperity once oil supplies became depleted.[51] All of this investment was conventional, with returns and risk the major concerns, not *shariah* compliance, indeed much was channeled into treasury instruments which paid interest.

It was mostly private investors from the Gulf who were concerned with *shariah* compliance, but in the 1970s and 1980s there were limited possibilities for ensuring that investment in Europe was compliant. The Euro-Arab joint venture banks had clients wanting to invest in a *shariah* compliant manner, but they did not have any instruments to offer, limited expertise on the subject and no *shariah* boards to provide guidance. Some informal shariah compliant advice was offered by London based institutions such as the Saudi International Bank and United Bank of Kuwait, but in the 1980s their expertise was limited in this area.

The major early development was the establishment in 1981 of the Dar al Maal al Islami Trust in Geneva,[52] largely due to an initiative by Prince Mohamed Al Faisal, the member of the House of Saud and one of the leading long term supporters of Islamic finance who was responsible for the founding of the Faisal Islamic Banks of Egypt and the Sudan.[53] Dar al Maal al Islami is perhaps best described as an investment company rather than a bank, although it continues to own 37 percent of the capital of the Faisal Islamic Bank of Egypt as well as a 41.7 percent shareholding in Ithmaar Bank, a Bahrain based investment bank with extensive links to Kuwait and Saudi Arabia and the Faisal Bank of Pakistan.[54] Its most significant connection is with its wholly owned subsidiary, the Islamic Investment Company of the Gulf, a Bahamas based company that is a significant force in *shariah* compliant wealth management.

---

48 http://www.alburaq.co.uk/residential_acceptable_types.asp

49 Mushtak Parker, 'ABC rolls out Islamic mortgage setup in UK', *Arab News*, Jeddah, 4 October 2007

50 http://www.hsbc.co.uk/1/2/personal/current-accounts/more/amanah-finance

51 Rodney Wilson, *Trade and Finance in the Middle East,* Macmillan, London, 1977, pp. 128-136.

52 Rodney Wilson, 'Islamic banking and its impact on the international financial scene', in Muazzam Ali, *European Perceptions of Islamic Banking,* Institute of Islamic Banking and Insurance, London, 1996, p. 118.

53 Rodney Wilson, *Islamic Finance*, Financial Times Publications, London, 1997, pp. 35-38.

54 www.ithmaarbank.com/news_press.htm

Dar al Maal al Islami has had a varying record for profitability, but following a restructuring in 2005 its business seems to be on a much sounder footing, with a net profit of over $52 million recorded.[55] Funds worth almost $2 billion are managed by Dar al Maal al Islami, largely raised by from high net worth individually by the Islamic Investment Company of the Gulf. The funds are deployed in *shariah* compliant investments internationally, but with a focus on Europe and emerging markets through the Geneva operation. The *Shariah* Board of Dar al Maal al Islami meets annually in Cairo under the chairmanship of Dr Nasr Farid Mohamed Wasel to reviews all investments. The major potential for Dar al Maal al Islamic for raising funds is in the Saudi Arabian market where in 2007 it launched Ethraa Capital in co-operation with the Kingdom based company, Atheeb Trading and the Kuwait Investment Company. At the time of writing Ethraa is waiting to see if its license application has been approved by the Saudi Arabia Capital Markets Authority.

Having an operational presence in Geneva, the world's largest wealth management centre, undoubtedly gives Dar al Maal al Islami an advantage over some of its Gulf rivals who do not have a European presence. The attraction of Switzerland is not so much its banking laws ensuring client confidentiality in these days of 'know your customer' requirements, but rather the local skill pool in asset management, low staff turnover and management continuity compared to other financial centres, and the emphasis on building long term relationships with clients of high net worth. Wealth management has become a highly specialized activity, involving the cultivation of long term client relationships, and the provision of specialist advisory and execution services,[56] activities in which Swiss banks excel. Comparable institutions such as Investment Dar[57] and the International Investor of Kuwait[58] or Arcapita of Bahrain,[59] which have a mandate to ensure all their investments are *shariah* compliant, have arguably a stronger marketing presence in the Gulf, but they lack the capacity and skill set to invest in Europe in a sustained manner, apart from one off transactions such as the acquisition of Aston Martin, the British luxury car manufacturer by Investment Dar. Such direct investments are not a substitute for building up a wider portfolio to ensure risk diversification. Arcapita has a wider portfolio of direct investments in Europe, including Paroc, a pharmaceutical company, Roxar, a firm that provides technical solutions to the oil and gas industry and Vogica, a French kitchen and bathroom supplier. However exactly what the investment strategy is for such diverse businesses remains far from clear.

Many *shariah* compliant investors of high net worth deal directly with European banks, notably with UBS of Switzerland the leading provider of *shariah* compliant wealth management services.[60] UBS had a fully owned *shariah* compliant subsidiary in Bahrain, Noriba Bank, which until 2005 had a high profile at Islamic finance conferences, but UBS felt it would be more attractive to Gulf clients to market its own brand rather than have a separate identity for Islamic finance operations. Hence it re-launched its Gulf operation, and in 2006 opened a branch in the Dubai International Financial Centre with thirty experienced banking professionals assigned to the office. A totally integrated service can be provided between the Dubai office and the Geneva headquarters, drawing on all the expertise in the latter while providing the *shariah* compliance locally in the Gulf.

UBS provides *shariah* compliant deposits for individuals of high net worth through a commodity *murabaha* facility similar to that offered by the Islamic Bank of Britain. This is a fixed term investment of up to a year, with UBS in Jersey acting as the buyer and UBS Zurich as the agent. The

---

55 Dar Al Maal Al Islami Trust, *Annual Report*, 2006, Cairo, p. 7.

56 Dimitris N. Chorafas, *Wealth Management: Private Banking, Investment Decisions and Structured Financial Products*, Butterworth-Heinemann Elsevier, Oxford, 2006, pp. 3-15.

57 www.inv-dar.com

58 www.tii.com/en/about/overview.htm

59 www.arcapita.com

60 www.ubs.com/1/e/wealth_mgmt_ww/islamic_finance.html

purchase of the base metals is settled through a spot transaction but the sale price is through deferred payments at a mark-up with the depositor sharing in the profit from the mark-up. The minimum deposit is $250,000 with a variety of currencies accepted including Swiss Francs, Euros, Sterling and US Dollars.[61] Early withdrawals are not possible as the funds are tied up in the underlying trading transaction, and as there is no secondary market in the deposit certificates, the deposits are illiquid until maturity. Investors however enjoy returns in line with market rates on conventional time deposits.

Structured Islamic investments are offered by UBS using foreign exchange BLOC (buy low or cash) certificates which are well established in the Swiss market.[62] This provides investors with exposure to currency movements, usually Euro/Dollar transactions, and the possibility of making gains. A minimum investment of $50,000 is required with the investor who believes the Euro will appreciate receiving a pre-determined return in Dollars if the Euro rises over the cap limit quoted. If the Euro depreciates, the investor receives Euros rather than Dollars, and will make a Dollar loss, but the price will still be better than the forward price of Euros for the maturity period.[63] Most *shariah* scholars consider options and futures trading to be *haram*, but the *shariah* board of UBS has approved BLOC certificates, which are held to maturity and not traded. The certificates provide a useful hedging instrument for importers in the Gulf with significant Euro exposure reflecting the importance of European suppliers for these economies. Euro/Dollar exchange rate changes have become more of a problem for importers in the Gulf in recent years given that most Gulf currencies remain pegged to the US Dollar with oil exports and payments also US Dollar denominated.[64]

Private banking and wealth management services usually include succession planning as funds get passed from generation to generation. Under *shariah* there is a fixed formula for the division of estates on death, with specific provisions for spouses and children and the will of the deceased only applying to one third of the inheritance.[65] Complicated legal issues arise when there are conflicts between *shariah* and national laws and in all European jurisdictions Muslims who want their estate to be divided in accordance with *shariah* must make a will as the default position under both English common law and civil codes is not *shariah* compliant. Many law firms have standard templates that can be adapted to the particular circumstances of individual clients to ensure that their European assets are divided in accordance with *shariah* when they die.

UBS has provision for a personal *shariah* trust as a succession planning solution for Muslim families of high net worth.[66] The aim is to consolidate assets within a legal structure which is *shariah* compliant, including assets held in multiple jurisdictions, which does not necessarily have to include Switzerland. Other European banks offer similar private banking services, notable BNP Parisbas which has dedicated private banking teams in its Middle Eastern branches in Bahrain, Abu Dhabi, Dubai, Kuwait, Riyadh, Doha and Beirut as well as at its 'solutions centre' in Geneva.[67] Its private banking business, including that for Muslims seeking *shariah* compliance, is located in Geneva rather than its Paris head office.

61 www.ubs.com/1/e/wealth_mgmt_ww/islamic_finance/deposits.html

62 www.ubs.com/1/e/wealth_mgmt_ww/islamic_finance/fxbloc.html

63 www.z-forex.com/education/structured-products.html

64 Mohamed A. Ramady, 'Rude awakening awaits speculators', *Arab News,* Jeddah, 1st October 2007, Babu Das Augustine, 'Market sees new OPEC price plan', *Gulf News,* Dubai, 2nd October 2007.

65 Rodney Wilson, *Economics, Ethics and Religion: Jewish, Christian and Muslim Economic Thought,* Palgrave Macmillan, Basingstoke, 1997, pp. 117-118. The relevant verse in the Holy Koran is *sura* 4:11-12.

66 www.ubs.com/1/e/wealth_mgmt_ww/islamic_finance/trusts.html

67 www.bnpparibas.com/en/journalists/print.asp?Code=ADAY-...

Islamic Investment Banking

It is only during the last decade that investment banking has become significant in the Muslim world, and all of the largest Islamic banks, such as Al Rajhi Bank or the Kuwait Finance House, are retail rather than investment institutions. Investment banks are focused on financing mergers and acquisitions; the arranging of initial public offerings (IPOs) of shares when companies are floated; the securitization of assets, as well as bond and note issuance and the development of structured products and financial derivatives.[68] Most, but not all, of these activities are *shariah* compliant, but what makes investment banking potentially attractive from a *shariah* perspective is that most of their income is fee based, rather than being dependent on interest, as with conventional retail banks.

There is only one exclusively *shariah* compliant investment bank in Europe, the European Islamic Investment Bank, (EIIB) which was established on 11 January 2005.[69] The EIIB obtained its license from the United Kingdom's Financial Services Authority on 8 March 2006 and has its headquarters in the City of London, Europe's major investment banking centre. Its initial financial backing was from Gulf investors, but like Islamic Bank of Britain, it was admitted to the London Stock Exchange Alternative Investment Market (AIM) where its shares were listed for its IPO. This raised capital worth £73 million, giving the bank a capital base of £184 million, which is of course very small in relation to most major investment banks.

The EIIB is focused on three business areas with specialized divisions: treasury and capital markets, asset management and corporate finance and advisory.[70] The treasury and capital market division provides spot foreign exchange rate quotes and the Islamic equivalent of forward quotes for transactions which must be undertaken as futures trading is not permissible under *shariah*. It also quotes *sukuk* prices in London, and is involved in inter-bank commodity *murabaha* and *wakala* money market transactions mostly through the London Metal Exchange. The capital markets remit covers *sukuk* securitization and structured trade finance and the bank is hoping it can play a leading role in Sterling and Euro corporate *sukuk* issuance. Asset management services include the provision of property investment, structured product and private equity funds although all of these products is at an early stage of development within EIIB. The corporate finance services involve advising on capital raising opportunities, mergers and acquisitions and cross border private equity placements, with the focus on businesses based in the Gulf but with financial interests, including subsidiaries, in Europe.

The market for investment banking services is highly competitive and the leading European investment banks have of course much more expertise and resources than niche operators such as EIIB. In contrast to wealth management and private banking where the stress is on building long term client relationships, in investment banking clients are more likely to shop around for the best deal when awarding their mandates. Several leading European investment banks have secured the services of *shariah* advisors or appointed *shariah* boards so that they can compete for investment banking business in the Gulf and South East Asia which involves Muslim clients or institutions concerned with *shariah* compliance. Deutsche Bank has been particularly active through its specialist Islamic banking operation based in Dubai. It has provided investment structures that facilitate the issuance of shariah compliant securities that offer investors access to alternative asset classes.[71] Together with Merrill Lynch and Morgan Stanley, Deutsche Bank launched 14 structured products in August 2007 which are traded on the Dubai International Financial Exchange (DIFX). Returns are linked through DIFX TraX that gives investors exposure to shares listed on the Dubai Financial Market and the Abu Dhabi Securities Market, as well as commodities including oil.[72] Earlier in June 2007 Deutsche Bank joined

68 Shelagh Heffernan, *Modern Banking,* John Wiley & Sons, Chichester, 2005, pp. 19-24.

69 European Islamic Investment Bank, *Annual Report and Accounts,* London, 2006, p. 4.

70 European Islamic Investment Bank, *Our Business,* London, 2006, pp. 3-8.

71 www.db.com/press/en/content/press-releases-2007-3347.htm

72 DIFX Press Release, Dubai, 28 August 2007.

forces with Dubai Islamic Bank to issue five year capital protected notes with the returns linked to the Deutsche Bank – Goldman Sachs Asset Management ALPS Index.[73] Deutsche Bank also pioneered a shariah compliant profit rate swap with Dubai Islamic Bank, the equivalent to a variable and fixed interest rate swap through a transaction worth $500 million.[74]

French investment banks have also been actively involved in Islamic finance, notably Société Générale and Calyon, the investment banking subsidiary of Credit Agricole. Société Générale arranged refinanced the Taweelah desalination plant in Abu Dhabi through its Islamic banking unit in Dubai with a $150 million share being *shariah* compliant and the remaining $390 million share including conventional bonds and corporate lending.[75] Calyon has been active with its affiliated bank, Banque Saudi Fransi, in syndicated Islamic financing. Its largest deal to date in June 2007 was the arrangement of a $2.9 billion *shariah* compliant financing facility for Mobily, the Saudi Arabian mobile phone subsidiary of Etisalat, the UAE telephone company.[76] This was based on a *murabaha* fixed mark-up pricing arrangement, as was an earlier $150 syndicated facility for the Alliance Bank, one of the leading financial institutions in Kazakhstan, Central Asia.[77] The *shariah* board of Abu Dhabi Islamic Bank provided the compliance advice, as Calyon does not have its own *shariah* board.

***Shariah* Compliant Fund Management**

Funds represent an ideal vehicle for Muslim investors as the fund manager can assume responsibility for *shariah* compliance whereas an individual investing directly in assets cannot easily know if they are compliant. In many respects the principles of Islamic fund management are similar to ethical fund management, as both types of investment rely on pre-determined screening criteria to determine what it is legitimate to fund. There are two types of screens used for *shariah* compliant investment, sector screens and financial screens.[78]

Unacceptable sectors to invest in include brewing and distilling and the production and distribution of other alcoholic beverages, pork production and distribution, gambling and casino operations and media companies whose output includes material seen as offensive, including pornography.[79] In practice this rules out a wide range of companies, as for example hotels chains with gaming operations are excluded, as are supermarket companies selling alcohol, although some more liberal *shariah* scholars may not object to the latter if it is a secondary segment of the business. Conventional banks are the most significant sector screened out because of their dealings in interest and it is this exclusion that has the greatest significance for returns on *shariah* compliant equity investment. Empirical studies have shown that *shariah* compliant investments out-perform the market when bank shares fare badly but under-perform when conventional bank profits are healthy.[80]

The financial screens are designed to avoid exposure to heavily leveraged companies or those having excessive interest earnings. Hence, using the criteria developed by the Dow Jones Islamic Market Index, companies that have borrowing in excess of one third of their market capitalisation are

---

73 'DIB launches DB structured notes', *Trade Arabia Banking and Finance*, Dubai, 14 June 2007.

74 'Deutsche Bank closes first Islamic collar profit rate swap with Dubai Islamic Bank', *ISI Emerging Markets Press Release*, London, 3rd October 2007.

75 www.sgcib.com/deal-focus.rha?c=deal-focus{unid=64AA780BF11046BFC1256E...

76 www.calyon.com/news/corporate-investment-bank/etisalat-mobiliy-murabaha-refer...

77 www.calyon.com/news/corporate-investment-bank/references-2007141

78 Rodney Wilson, 'Screening criteria for Islamic equity funds', in Sohail Jaffer, *Islamic Asset Management: Forming the Future for Shariah Compliant Investment Strategies,* Euromoney Books, London, 2004, pp. 38-40.

79 FTSE, *Ground Rules for the Management of the FTSE Global Islamic Index Series*, London, October 2001, p. 6.

80 The Dow Jones Islamic Indices or FTSE Islamic Indices have been compared to total market indices and banking sector indices to appraise performance.

excluded, as are companies that derive more than one third of their income from interest, as is the case with most conventional banks.[81] Companies whose ratio of conventional receivables exceeds 45 percent of their market capitalisation are also excluded, the argument being that such companies are in practice offering conventional lending, as the revenue from the receivables will include a premium reflecting market rates of interest.

Islamic funds have been offered in Europe for over two decades, the pioneering fund being offered by Kleinwort Benson in 1986 and the most publicised being Flemings Oasis Fund launched in 1996 which was closed after the take-over by Chase of Flemings.[82] The challenge for Islamic equity funds in Europe was to attract sufficient investment to achieve viability, which proved difficult for stand alone offerings. The funds currently available are mostly offered by those large multinational banks that have a portfolio of *shariah* compliant services for their clients. HSBC Amanah for example offers three funds from Dublin and one from Luxembourg, European centres that have attracted offshore fund business. Those offered from Dublin include an American equity fund, managed by Wellington, an Asia-Pacific Fund managed by Aberdeen Asset Management and a Pan-European Fund managed by Pictet Asset Management. The fund management outsourcing to specialist managers enhances performance, the aim of HSBC Amanah being to provide its existing Muslim clients with more choice. For each of the funds the initial charge is 3.25 percent, the annual management fee 1.85 percent and there is in addition a switching charge of 1 percent for those wishing to move to other HSBC funds. The minimum investment is only $10,000 with daily dealing, the leading holdings of the pan-European fund being BP, Royal Dutch Shell, GlaxoSmithKlein, Total and Novartis.[83] Exposure to European oil companies is thought to appeal to Gulf investors.

The only independent shariah compliant fund offered in Europe is by Oasis, a South African based financial services group with extensive ties with the Gulf. Their Cresent Global Equity Fund, which was launched from Dublin, is valued at almost $37 million. Nearly half of the fund's exposure is to European equities, with the United States accounting for less than one third. The major sectors for investment are retailing, healthcare, manufacturing industry and information technology. The fund has performed well since inception, with an annualised return of 14.5 percent in dollar terms, well above the 2.6 percent annualised returns from the Dow Jones Islamic Market Index.[84] The appreciation of the Euro has undoubtedly helped performance given the higher exposure to European stock than is the case for most global equity funds, whether conventional or Islamic.

The major *shariah* compliant funds managed from London are offered by Deutsche Bank and Scottish Widows, the fund management and subsidiary of Lloyds TSB. The Deutsche Islamic Equity Builder Certificates have been offered since January 2003 and are marketed in the UAE by Emirates Islamic Bank, and white labelled in Saudi Arabia by the National Commercial Bank, the largest provider of *shariah* compliant funds worldwide, as Alahli Islamic Equity Builder Certificates. *Shariah* compliance is provided by the *shariah* board of the National Commercial Bank in Jeddah. Although managed from London the certificates are listed in Frankfurt. There are four certificates available based on the United States, the Asia-Pacific region, Europe and a Global fund combining the other three. The Asia Pacific Certificates have given a return of 139.6 percent since inception, the European Certificates a return of 83.9 percent and the United States Certificates a return of 57.6 percent.[85] The

81 Dow Jones, *Guide to the Dow Jones Islamic Market Index,* New York, June 2005, p. 6.

82 Rodney Wilson, 'Islamic fund management', in Muhammad Anwar and Mohamad Aslam Haneef, (eds.), *Studies in Islamic Banking and Finance in the 21st Century: Theory and Practice,* International Islamic University of Malaysia, 2005, pp. 227-233.

83 HSBC Ammanah Pan-European Equity Fund, Report, Dublin, 31st December 2006.

84 Oasis *Fund Facts: Crescent Global Equity Fund, Fourth Quarter 2006,* Dublin, March 2007.

85 National Commercial Bank Investment Services, *Fact Sheet: Alahli Islamic Equity Builder Certificates,* Jeddah, 25 December 2006.

appreciation of the Euro undoubtedly accounts for the superior performance of the Euro Certificates in dollar terms relative to the United States Certificates.

The Scottish Widows Islamic Global Equity Fund was launched in October 2005 the aim being to provide a fund that could be offered to Lloyds TSB Muslim clients both in the United Kingdom and in the Gulf from their Dubai branch. Scottish Widows Investment Partnership is one of Europe's leading asset managers with funds worth £97.8 billion being managed. The Islamic Global Equity Fund was valued at $19.3 million, with its major shareholdings including Intel, Pfizer, Bayer, Rolls Royce, OCC Petrol, China Mobile and Merck.[86] The annual management charge is 1.5 percent, which is very competitive for an Islamic fund given the additional costs incurred with *shariah* compliance. Scottish Widows and Lloyds TSB also market the Children's Mutual *Shariah* Baby Bond which qualifies for a tax free lump sum for children and young people once they become 18. The United Kingdom government also contributes to this saving scheme by providing vouchers worth £500 all parents in receipt of Child Benefits.[87] Up to £100 per month can be paid into the fund which can generate a considerable sum which the young person can use on maturity after their 18th birthday to cover further education costs, a deposit on a apartment or other expenses. The *Shariah* Baby Bond is also marketed by the West Bromwich Building Society, which has a substantial branch network in the Midlands, where many British Muslim families reside.[88]

London is also a centre for *shariah* compliant property and leasing funds, although these are all closed ended, with only a few institutions and individuals of high net worth subscribing, rather than the general public as with the open ended equity funds. The property and leasing funds are usually less liquid, with the investment typically locked in for periods of 3 to 5 years and only limited facilities for redemptions, usually with exit penalties. ABC Islamic Asset Management is the leading player in the market through funds that invest in the student, healthcare and residential property markets as well as club transactions and private portfolio management where the bank forms partnerships with small groups of investors and provides leverage through *murabaha* and *ijara* structures, with the largest residential property project being in Leeds where almost £60 million was invested.[89] The total value of the United Kingdom *shariah* compliant commercial property portfolio exceeds £329 million, with the property restricted to *halal* use which excludes tenants such as betting shops or alcohol vendors. Although the leasing funds are offered and managed from London the assets are worldwide, examples being G.E. Quartz Japan whose operating equipment leases were financed and the Burlington Northern Santa Fe Railroad in the United States where the leases covered railway equipment and rolling stock.

86 Scottish Widows Investment Partnership, *Islamic Global Equity Fund Report*, London, September 2007.

87 Children's Mutual Shariah Baby Bond Stakeholder Child Trust Fund Account, *Key Features*, London, 2007, pp. 3-6.

88 www.westbrom.co.uk/westbrom/news?id=1484

89 Arab Banking Corporation, *Islamic Asset Management*, London, 2007, p. 3.

Future Prospects for Islamic Finance in Europe

Although Islamic banking and financial services have been offered from Europe for almost three decades in many respects the industry is still in its infancy. Much of the business activity has been focused on *shariah* compliant institutions from the Gulf and Muslim investors of high net worth, but this has resulted in activity being somewhat cyclical and linked to oil market developments.[90] The impact on Europe's resident Muslim population has been marginal, and mostly confined to the United Kingdom, even though France and Germany have much larger Muslim populations, with that of France exceeding five million. The Gulf and wider Muslim world is likely to continue to generate substantial Islamic finance business for London as an international financial centre and Europe's leading investment banks and asset managers, but the longer term prospects are more likely to be shaped by developments within Europe and further European Union enlargements. There are two major issues, the first being whether retail Islamic banking services can be provided for continental Europe's Muslim population and if this is desirable. Secondly there is the issue of European Union enlargement to encompass countries and regions with long established Muslim populations in the Balkans, and Turkey, the most populous state in Europe, with over 72 million Muslims.

Although the European Union functions as a single market, banking and financial regulation is devolved to member states. In the United Kingdom the Financial Services Authority has played a pro-active role with respect to Islamic banking and finance and been broadly supportive, but that has not been the position elsewhere in Europe, where central banks and other regulatory authorities have shown little interest. There is also a negative perception of *shariah*, especially amongst right wing and nationalist politicians, which potentially inhibits the spread of Islamic banking and finance. What is not always appreciated is that *shariah* compliance in finance is a choice, and not about the imposition of *shariah* on those, including Muslims, who want to lead secular lives and manage their financial affairs in a conventional manner. Some critics assert that Islamic finance is simply another facet of segregation and places Muslim banking in a ghetto, but those who rebut this argument point out, as shown earlier, that many leading European banks are now heavily involved in Islamic finance. There is certainly potential to develop more *shariah* compliant savings and financing products for Europe's Muslim community, as well as distribute Islamic *takaful* insurance which remains in its infancy in Europe, despite the involvement of firms such as Allianz and Prudential in the *takaful* industry in the Gulf. At present the worldwide value of *takaful* premiums amounts to $1.7 billion, but less than one percent of this is spent in Europe.[91]

The greatest potential for Islamic finance in Europe is undoubtedly in Turkey where Islamic banking has been established since the 1980s although it remains on the fringes of the financial system, accounting for less than five percent of deposits, and opinions on its merits are politicised as already indicated. Turkey currently has six special finance houses, as Islamic banks in the country are designated, most being under joint Gulf and Turkish ownership. The largest *shariah* compliant bank, Ihlas Finance House, collapsed during the financial crisis of 2001-2002, but depositors were compensated through Central Bank and the Ministry of Finance which helped maintain public confidence in the special finance houses. The leading institutions are Kuveyt Turk Participation Bank, which was established in 1989, and is majority owned by Kuwait Finance House and the Kuwait Social Security Fund,[92] and Bank Asya, which is under majority Turkish ownership, and dates from 1996.[93] Kuveyt Turk has a network of 79 branches while Bank Asya has 111 branches spread

---

90 Farmida Bi, 'The global development of Islamic finance', *Business Islamica*, Dubai, September 2007, pp. 64-67.

91 Susan Dingwall and Ffion Flockhart, 'The potential for *takaful* in Europe', *Business Islamica*, Dubai, September 2007, pp. 38-42.

92 www.kuveyturk.com.tr/en

93 www.asyafinans.com.tr/en

throughout the country, but with the largest number in Istanbul and Ankara. Both banks receive most of their deposits through profit sharing *mudaraba* accounts, and Kuveryt Turk, like its Kuwait parent, is heavily involved in leasing finance using an *ijara* structure.

Turkey has the greatest potential for expansion of banking in Europe, including Islamic banking, as the fastest growing economy, with GDP growth averaging 7.5 percent over the period from 2004 to 2006; and although this slowed to 5.7 percent in 2007, growth is expected to accelerate to 6.2 percent for 2008.[94] Turkey of course starts from a low base given its per capita GDP of under $8,000, but it has attracted foreign direct investment of almost $10 billion annually since 2005 and remittances, mainly from Turks working in the European Union, average almost $ 1 billion annually.[95] Turkey can serve as a bridge between the European Union and the wider Muslim World and in the longer term it is likely to be Istanbul, not London, which becomes Europe's leading centre for Islamic banking and finance.

94 OECD, *Economic Outlook*, Paris 2007, p. 32.

95 World Bank, *Turkey Data Profile*, Washington DC, 2007.

Glossary of selected terms

Bai' bithaman ajil: purchase with sale at a mark-up which is not disclosed

Bai dayn: trading in debt instruments

Qard Hassan: an interest free loan, including by a depositor to a bank

Ijara: operational leasing contract

Mudaraba: profit sharing partnership with only one of the partners providing the finance and the other having a return for risk sharing or entrepreneurial activity. Usually applies to bank deposits

Murabaha: purchase and sale for a mark-up which is disclosed

Riba: interest or usury

Salam: purchase of a commodity for future delivery with the price paid in full in advance. Usually the commodity is subsequently sold for a higher price, prior to, or at delivery, with the margin representing the profit

Shariah: Islamic law as revealed in the Holy Koran and the *hadith*, the sayings and deeds of the Prophet Mohammad

Sukuk: Islamic securities

Takaful: Islamic insurance usually provided on a mutual basis

Tawarruq: the ultimate purchaser in a *murabaha* transaction sells the commodity obtained spot for cash. It is equivalent to a cash advance or personal loan.

Wakala: trust, usually applied to a bank deposit or a trust fund

Waqf: Islamic religious endowment

Selected reading on Islamic banking, economics and finance

Books

Chapra, M. Umer, The Future of Economics: An Islamic Perspective, Islamic Foundation, 2000.

El-Ashker, Ahmed and Wilson, Rodney, Islamic Economics: A Short History, Brill Academic Publishers, 2006.

El-Gamal, Mahmoud A, Islamic Finance: Law, Economics and Practice, Cambridge University Press, 2006.

Iqbal, Zamir and Mirakhor, Abbas, An Introduction to Islamic Finance: Theory and Practice, Wiley, 2007.

Iqbal, Munawar and Molyneux, Philip, Thirty Years of Islamic Banking: History, Performance and Practice, Palgrave Macmillan, 2004.

Kuran, Timur, Islam and Mammon: The Economic Predicaments of Islamism, Princeton University Press, 2006.

Lewis, Mervyn and Algaoud, Latifa, Islamic Banking, Edward Elgar, 2001.

Nomani, Farhad and Rahnema, Ali, Islamic Economic Systems, Zed Books, 1994.

Tripp, Charles, Islam and the Moral Economy: The Challenge of Capitalism, Cambridge University Press, 2006.

Vogel, Frank and Hayes, Samuel, Islamic Law and Finance, Kluwer Law International, 1998.

Warde, Ibrahim, Islamic Finance in the Global Economy, Edinburgh University Press, 2000.

Readers and edited volumes

Hassan, M. Kabir and Lewis, Mervyn K., *Handbook of Islamic Banking,* Edward Elgar, Cheltenham, England and Northampton, Massachusetts, 2007.

Henry, Clement and Wilson, Rodney, *The Politics of Islamic Finance,* Edinburgh University Press and Columbia University Press, New York, 2004. (reprinted by Oxford University Press, Karachi, 2005)

Iqbal, Munawar and Llewellyn, David, *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk,* Edward Elgar, 2002.

Iqbal, Munawar and Wilson, Rodney, *Islamic Perspectives on Wealth Creation*, Edinburgh University Press and Columbia University Press, New York, 2005.

Professional Publications

Adam, Nathif J. and Thomas, Abdulkader, (eds.) *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk,* Euromoney Books, London, 2004.

Archer, Simon and Karim, Rifaat Abdel (eds.) *Islamic Finance: Innovation and Growth,* Euromoney Books, London, 2002.

Jaffer, Sohail, (ed.) *Islamic Asset Management: Forming the Future for Sharia Compliant Investment Strategies,* Euromoney Books, London, 2004.

Jaffar, Sohail, (ed.) *Islamic Insurance: Trends, Opportunities and the Future of Takaful*, Euromoney Books, London, 2007.

Jaffer, Sohail, (ed.) *Islamic Retail Banking and Finance: Global Challenges and Opportunities,* Euromoney Books, London, 2005.

Websites

Islamic Finance Information Service
http://sitesecurities.com/ifis

Institute of Islamic Banking and Insurance, London
www.islamic-banking.com

Islamic Development Bank, Jeddah
www.isdb.org

Islamic Finance News, Kuala Lumpur
www.islamicfinancenews.com

