EGIC
Euro-Gulf Information Centre

4636-16/1004

Understanding Islamic Finance in Europe

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Islamic finance (a.k.a. Islamic banking) is, at its core, a financial system that complies with Islamic religious law. It has, over the past decades, blossomed into a 2.1 trillion USD industry with assets expected to expand to some 3.4 trillion USD by the end of 2018. Captivated by this potential, the global financial community is actively exploring opportunities in this niche sector. At a time of growing economic uncertainty, Islamic banking appears to be one of a select few financial sectors for which projections remain optimistic. The reason for such optimism are found in the practices' structural principles, which offer an altogether different perspective to the boom-bust cycles that ultimately produced the economic train-wreck of 2008.

But what is Islamic banking? What makes it different from other banking and investment institutions? The following points represent some key elements to the banking practice:

1. Islamic banking forbids the collection of interest on monies borrowed. As a result, Islamic banks are extremely sensitive to market shifts and must pursue efficient risk management strategies—they are substantially more exposed to the real economy than conventional banks.
2. In terms of profit and loss-sharing, parties to a transaction share both the risks and the rewards that may be attached to it. Excessive losses are minimised because of the intrinsic risk aversion of the banking practice (re: see below).
3. There is a clear prohibition of speculation in Islamic banking. While risks may be taken, it is only allowed when all terms and conditions are clearly known to all parties. In other words, there is a ban on secret information—transparency is a central pillar in Islamic finance.
4. Islamic banking demands the use of asset-backing—each transaction must relate to a tangible, underlying asset, a point that further reinforces the connection between Islamic banks and the real economy.

The comparison between Islamic financial instruments and more conventional institutions is striking. In fact, Islamic finance has been at the centre of several recent studies in Europe, notably by the European Commission and the European Central Bank, which highlighted both the challenges and opportunities offered by the Shari'a-compliant financial system. First, empirical evidence into the risks associated with Islamic finance as opposed to those faced in the conventional financial system have revealed Islamic financing is less than half as risky as conventional financing. Other issues investigated are efficiency and profitability and the stability and resilience of Islamic institutions. In this regards, studies that predate the economic crisis did not find meaningful differences between Islamic and conventional banks in terms of efficiency, while studies including more recent data tend to stress that, during the crisis, Islamic banks encountered more difficulties in maintaining the same level of profitability as conventional banks. This finding is most probably rooted in the concept of profit and loss sharing, as well as in the strong link between Islamic finance and the real economy—badly hit during

the economic crisis. However, it also points to the necessity of strengthening resilience and stability mechanisms in the Islamic system. Similar issues plague ethical investments which, various studies have found, share several features with Islamic finance, even though the latter seems even more community-oriented. Finally, a major difference between conventional finance and Islamic finance can be found in the issue of monetary policy, whose operational framework in the Western system is centred on interest rates. This is clearly at odds with the prohibition of interest payments prescribed in Islamic law. Consequently, ad hoc instruments are more widely deployed for a Shari'a-compliant monetary policy. Challenges, such as this, explain why incorporating Islamic instruments and principles into conventional finance in open market economies can be a long and bumpy process. Indeed, the establishment of "Islamic windows" into conventional financial systems is often the preferred compromise, especially in Europe.

Prominent in the Gulf States, as well as countries in South-East Asia (most notably Malaysia), that account for most of the Islamic banking market in Europe, Islamic finance has progressed slowly since its initiation in the early 1980's. The share of Europe as a region in global Islamic finance assets remains marginal with data from 2014 showing that regional Islamic banking assets (excluding those under Islamic non-banking institutions) accounted for a mere 0.5% of the global total. Islamic funds domiciled in European jurisdictions fared slightly better, cumulatively holding some 14.4 billion USD in assets (2014) and accounting for 20% of the Shari'a-compliant assets worldwide. However, figures are expected to rise quickly, as financial regulators in a number of European states – from Ireland to France to Malta – have issued frameworks facilitating the registration of Shari'a-compliant investment schemes.

An encouraging sign is the establishment of the Global Islamic Finance and Investment Group – a group that includes ministers, central bank governors, regulators, and the chiefs of major Islamic financial institutions – was established following London's World Islamic Economic Forum in 2013. The group's primary aim is to identify key global opportunities and challenges facing Islamic finance and ways to develop a global Islamic finance market. The inaugural meeting was held in London in 2014, highlighting the leading role of the UK's capital in advancing Islamic finance in Europe.

Indeed, London seems to have set its sights on becoming the West's centre for the Islamic finance industry, standing with Dubai and Kuala Lumpur as global hubs for Islamic finance. In 2014 the UK became the first non-Muslim country to issue an Islamic bond, called *sukuk*, in a monumental £200m-issuance. The bond attracted wider investment from the Muslim region to the City of London. There are currently six Islamic banks in Britain, while more than 20 lenders offer Islamic financial products and services—more than any other Western country.

This move, followed by Luxembourg, reignited Europe's interest in Islamic instruments. Once the preliminary challenges are overcome, a number of factors would tend to support Islamic finance's further development in the region, and in particular the increased emphasis on alternative financial solutions following the financial crisis and the substantial appetite for attracting liquidity from emerging markets. On the other hand, European domiciles for Islamic fund managers can be very appealing for and attractive combination of tax benefits, regulatory sophistication and operational efficiency.

There are many other elements of Islamic finance and banking practises that are important for Europeans to know and understand. We at the EGIC welcome comments and questions in relation to Islamic banking and will be happy to further elaborate on any of the key points raised in this info-sheet.