



EUROPEAN BUSINESS SCHOOL
International University Schloß Reichartshausen



DEPARTMENT OF FINANCE

WORKING PAPER SERIES



No. 12-2004

October 2004

Islamic Banking Credit Products in Germany and in the United Kingdom

Ina Burghardt

Carolin Fuß

Endowed Chair for Banking and Finance

EUROPEAN BUSINESS SCHOOL
International University Schloß Reichartshausen

65375 Oestrich-Winkel, Tel.: +49/6723/69-215

Islamic Banking Credit Products in Germany and in the United Kingdom

Ina Burghardt^a

Carolin Fuß^b

Abstract

In numerous Muslim countries, banking in accordance with religious principles, so-called “Islamic Banking”, has enjoyed a growing popularity over the past decades. On an international scale, however, Islamic Banking is currently still a niche market. Many researchers and experts predict a strong growth of Islamic Banking activities, which is also to touch Western countries, as more and more Islamic Banking products are being offered outside the Muslim world. In this paper, we analyse whether the predictions about a prosperous future of an international Islamic Banking market can be justified by evidence from the German and the United Kingdom (UK) markets. We focus on Islamic Banking credit products, since their characteristic features are heavily influenced by the condemnation of interest in Islamic law.

After presenting the most prominent examples of Islamic Banking credit products, we use—among other sources—interviews with bankers to analyse the German and the UK markets for these products from both a supply and a demand perspective. We show that the Islamic population in Germany mainly stems from secularised Muslim countries, where the influence of religion on commercial and banking law is low. Therefore, we do not identify any particular need for German Muslims to actively demand Islamic Banking credit products in Germany. As a result, the offerings of such products are very limited in their availability and variety. Quite the opposite holds for our findings of the UK analyses. In general, life of British Muslims is much more strongly influenced by Islamic traditions, that also impact financing decisions. Accordingly, the demand for Islamic Banking credit products is higher, which leads to a greater supply of these instruments. This paper ends with a discussion on elements, that need a stronger consideration, in order to enable a sustainable future growth of Islamic Banking not only in Muslim countries, but in the entire world.

JEL classification: F34, F36, R11

Keywords: Islamic Banking, Banks, Interest, Credit Products

Data availability: Information provided by our interview partners can be obtained from the authors upon request.

^a Dresdner Kleinwort Wasserstein, Analyst, ina.burghardt@drkw.com.

^b Endowed Chair for Banking and Finance, Research Assistant, carolin.fuss@ebs.de.

1 Introduction

With growth rates of 10 to 15 percent per annum and a volume of USD 180 billion to 250 billion in terms of global assets under management, the Islamic finance industry is growing rapidly and has emerged to become an established niche market with sophisticated product offerings.¹ Islamic Banking is no longer restricted to Muslim countries, but it is present worldwide and is provided by Islamic as well as by international Western, so-called conventional, banks.² The industry attracts an increasing number of investors, who want to handle their financial transactions in accordance with the “Shariah”, the Islamic law, which stipulates a strong focus on religious beliefs and ethical values. As MOORE (1997) writes about the Islamic finance industry, “it is an industry, that has its origins in the fundamental beliefs of Islamic society and is founded on principles set out in the Qur’an over 1,400 years ago”³. The essential, most popular characteristic of Islamic Banking is its prohibition of the charging and paying of interest, aiming at making money work as capital and not as debt. Investors are urged by the Shariah to share in the risk of an investment; a passively acquired return on capital is regarded as exploitative vis-à-vis the borrower and is therefore not allowed.⁴ Consequently, formally interest-free financing techniques need to be applied in Islamic Banking, in order to cater to the needs of religious Muslims as alternatives to the conventional loan business. In line with its worldwide expansion, first Islamic Banking credit products have been launched for the Muslim communities in European countries.⁵ This development emphasises the recognition of Islamic Banking as a still small, yet credible part of the finance sector with an inherent growth potential.

This study gives an overview of the background and characteristics of Islamic finance and describes the financing techniques in Islamic Banking with a special focus on Islamic credit products (chapter 2). To analyse their interest-free character, the different structures of such products are examined, and their fields of application are presented (chapter 3). A specific emphasis is put on the German and British market for Islamic Banking credit products both from a supply and a demand side. This helps to analyse the current state of Islamic Banking in these countries, and it serves to elaborate the potential developments of such a market (chapter 4). Furthermore, current challenges faced by the industry are presented (chapter 5).

¹ Cf. GASSNER (2003), p. 732.

² Cf. IQBAL/LLEWELLYN (2002), p. 1.

³ MOORE (1997), p. 1.

⁴ Cf. RICHTER (2000), p. 12; cf. HASSOUNE (2003).

⁵ Cf. WILSON (2002), pp. 199-200.

2 Islamic Banking – Background and characteristics

2.1 An introduction to Islamic Banking

Broadly defined, Islamic Banking is “banking in accordance with the rules of Islamic law”⁶. Islamic Banking is rooted in the Muslim world, where it describes a form of banking and finance, that prohibits the payment of interest (“Riba”, as interest is called in Arabic language).⁷ The prohibition of Riba is fixed in the Shariah, the traditional Islamic law, which in return was established by to the interpretation of the Qur’an representing the driving fundamental for religious Muslims.⁸ The interest-free form of finance is achieved via the application of techniques like “Murabaha”, “Ijara” or “Mud arabah”, which will be described in detail in chapter 3. Besides the prohibition of Riba, the Shariah forbids any business with companies, that make money out of tobacco, alcohol, drugs, weapons, pork, interest charging or paying institutions such as banks, insurance or mortgage companies, gambling, pornography, child labour and environmentally harmful activities because of their moral and ethical unacceptability.⁹ In this context, it is irrelevant, whether business in these industries describes the core business of a company or just a sideline. This is underlined by the example of the German airline Lufthansa, which is highly unpopular among Islamic investors, as alcoholic beverages are being served on-board.¹⁰ The same applies to Disney, that is avoided by Islamic bankers due to its putatively socially irresponsible movies. Additionally, Islamic banks and Muslims are not allowed to enter into a business relationship with companies, that display a debt-to-asset-ratio of 33 percent and above.¹¹ Similarly, business with firms having a net interest income of more than 5 percent of balance sheet profit is considered “haram” (unlawful).¹²

Over the past decades, Islamic Banking has emerged with growth rates of roughly 10 to 15 percent per annum to become an internationally accepted discipline¹³. Therefore, Islamic Banking is no longer restricted to its application in the Muslim world, although it still represents a niche market for Western countries due to its limited size in terms of volume.¹⁴ Islamic Banking is provided by both fully Islamic banks as well as by banks and finance companies concurrently offering conventional finance and Islamic Banking products in a dual system.¹⁵ When the term “Islamic Banking” is mentioned in the course of this paper, it can thus refer to either of these two forms.

⁶ BÄLZ (2001), p. 242.

⁷ Cf. PREMCHAND (1999), p. 17; cf. section 2.3.3.1.

⁸ Cf. LERCH (1994), p. 12; cf. section 2.2.1.

⁹ Cf. KAHF (1999), p. 449; cf. BANSMER/PFEIL (2003), pp. 22ff.

¹⁰ Cf. SPROTHEN (2003), p. 24.

¹¹ Cf. DIEM MEIER (2002), p. 80.

¹² Cf. SPROTHEN (2003), p. 24.

¹³ Cf. DIEM MEIER (2002), pp. 80ff.; cf. GASSNER (2003), p. 732.

¹⁴ Note: Muslim countries, in the context of this paper, refer to countries in Africa, the Middle East (including Turkey), the Indian subcontinent and Southeast Asia displaying a high density of a Muslim population. Western countries refer to Europe and the United States (US); cf. SAEED (1996), p. 1.

¹⁵ Cf. section 5.1.

2.2 Origins and evolution of Islamic Banking

2.2.1 Religious roots

“The basic concept of wealth in Islam is that man was created as a vicegerent of God [...], holding all its wealth in trust [...]. [...] [Man] has the duty to optimise his use of God’s gifts for the good of society and this means that ownership, as known in the West, does not exist”¹⁶. In Islam, God restricts how individuals are allowed to gain wealth. Wealth can either be attained through the use of labour and natural resources or through the exchange of goods, the remittance of rights, open grants and inheritance.¹⁷ The abovementioned quotation of BUCKMASTER (1996) illustrates the strong impact of religion on business ethics in the Muslim world, which have been in existence for over 1300 years now.¹⁸ In fact, Islam is described, according to LE GAI EATON (1994), as the “submission to God in peace”¹⁹.

The essential foundation of Islamic religion and the source of all, as correctly defined Islamic behaviour, is the Qur’an, which was initially received by Mohammed from Allah, the former being a businessman born in 570 B.C. The Islamic era is stated to have begun in 522 B.C., when Mohammed moved out of Mecca. By the time of Mohammed’s death, Islam described a movement, that was characterised by special forms of communitarian, governmental and regulatory frameworks and institutions formed with reference to the interpretation of the Qur’an. The outstanding importance of the Qur’an, to which divine qualities are attributed by religious Muslims, can be seen in the fact, that Muslims believe that the Qur’an is God’s revelation to man and God’s word.²⁰

However, the Qur’an does *not* constitute a code of law, but it rather comprises decisions and allusions clarifying the reasons for these deeds. It is the Shariah that constitutes the actual Islamic law, which was derived by Islamic lawyers out of four sources: the Qur’an, the “Sunna” representing a collection of the quotations, practices and traditions of Mohammed, the “Ijmaa” describing the consensus of Islamic scholars, and the “Qiyas”, which are the analogy conclusions of Islamic scholars on undecided cases based on the Qur’an. The Shariah is divided into three sub-groups: the first thematic group contains family law, the law of succession and the law of religious rituals; the second category of the Shariah is composed of constitutional, criminal, and fiscal law, and the third sub-group contains the law of the “Muamalat”, which refers to the law of economic transactions.²¹ Particularly the latter is a foundation of Islamic Banking, because each individual financial transaction is reviewed by a religious supervisory board, which represents—next to the board of commissioners and the

¹⁶ BUCKMASTER (1996), p. 33.

¹⁷ Cf. WIENEN (1999), p. 40.

¹⁸ Cf. DIEM MEIER (2002), pp. 80ff.

¹⁹ Cf. LE GAI EATON (1994), in WIENEN (1999), p. 36.

²⁰ Cf. WIENEN (1999), pp. 36-38.

²¹ Cf. AMERELLER (1995), pp. 20-26; cf. PREMCHAND (1999), pp. 17-18.

board of auditors—an essential function of Islamic banks. The religious supervisory board only approves transactions, that it considers to be in accordance with the Shariah.²²

The Shariah is acknowledged as a “general principle of law” by the International Court of Justice since 1938, which further helped to pave the way for Islamic Banking.²³

2.2.2 Historical developments in the twentieth century

In the first half of the twentieth century, Islamic Banking mostly consisted of theoretical concepts, but was not consistently applied in practice. The idea of Islamic Banking resulted out of the urge by the so-called “Ulama” (scholars of religion) to resist and to challenge the existence of Western interest-based banks in Muslim countries, the rationale behind this resistance being mainly the condemnation of Riba.²⁴ It was particularly in Egypt, that the influential Muslim Brotherhood argued from 1930 onwards that “since Islam provides Muslims with a comprehensive ideological framework within which to conduct all affairs of life, [Muslims] should include their economic affairs within that framework”²⁵. However, it was only in 1963 that, thanks to the undercover efforts of AHMAD EL NAJJAR, the first bank acting in accordance with Islamic rules was established in the Egyptian town of Mit Ghamr. The experiment was realised secretly, because EL NAJJAR feared that his efforts could be interpreted as an attempt to promote Islamic fundamentalism, which had been an open opposition to the political power at that time. Acting on a rather small scale, the Mit Ghamr Savings Bank was based on profit-sharing²⁶ and the prohibition of interest. EL NAJJAR’s approach led, along with other attempts in India and Malaysia, to a model of Islamic Banking based on profit-sharing, that was sufficiently thought-out and comprehensive to be applied on a larger scale.²⁷ EL NAJJAR’s experiment, however, lasted only until 1967.

In addition to the revivalism of the Riba condemnation as one reason for the establishment of Islamic Banking, some authors mention the increasing oil-wealth of the Gulf states as another trigger of the growth of Islamic Banking in the 1970s. In fact, one can notice a steep increase in the number of Islamic banks after the rise of oil-prices in 1973, when well-heeled Muslims pondered over how to invest their funds.²⁸ As SAEED (1996) mentions, “almost all Islamic banks established in the 1970s in the Middle East were partly, and in some cases totally, funded by oil-linked wealth”²⁹. This applies for example to the Islamic Development Bank (IDB), established in 1974 by the Organisation of Islamic Countries, with total assets of approximately USD 2 billion. About 60 percent of IDB’s shares are held by oil-producing countries like Saudi Arabia, Kuwait, the United Arab Emirates and Libya. Most private sector

²² Cf. DAR/PRESLEY (2000), p. 7; cf. section 2.3.1.

²³ Cf. AMERELLER (1995), p. 20.

²⁴ Cf. SAEED (1996), p. 9.

²⁵ SAEED (1996), p. 9.

²⁶ Cf. section 3.2.

²⁷ Cf. ARIFF (1988), p. 46.

²⁸ Cf. SAEED (1996), p. 10; cf. PREMCHAND (1999), p. 11.

²⁹ SAEED (1996), p. 10.

commercial Islamic banks in oil-exporting countries are fully funded by wealth resulting from the oil business, such as the Dubai Islamic Bank, established in 1975, the Bahrain Islamic Bank of 1979, and the Faisal Banks of Bahrain, Niger and Senegal.³⁰

Within the years following the 1970s, the number of Islamic banks steeply augmented. In 1980, the International Islamic Bank for Investment and Development (IIBID) was founded, followed by the establishment of 24 Islamic banks and finance houses in several countries around the world between 1981 and 1985.³¹ In 1997, 144 financial institutions offering Islamic Banking existed.³² Besides this foundation of a variety of individual banks, the countries of Pakistan, Iran and Sudan have changed their financial systems entirely to a banking system running on an Islamic basis, which is fixed in these countries' respective constitution.³³ These moves were supported by the national governments and in part forced by the national Muslim Brotherhood groups.³⁴

2.2.3 Contemporary Islamic Banking

Today, Islamic Banking comprises a total estimated worldwide volume of USD 180 billion to USD 250 billion managed by 200 to 250 financial institutions in 70 countries all over the world.³⁵ It constitutes a dynamic market, that has overcome its experimentation phase, along with a demystification of the term "Islamic finance" over the past years. In the meanwhile, Islamic Banking is regarded as a form of financial intermediation alternative to conventional banking systems. DIAMOND originally described the concept of financial intermediation in 1984, coming to the conclusion that the advantage of financial intermediation has to be seen in the reduction of both information asymmetry and transaction costs between investors and borrowers.³⁶

Islamic banks obtain their main sources of funding from clients out of three different kinds of accounts: savings accounts, current accounts and investment accounts. While the holders of the first two account types are rather risk-averse and obtain only a moderate return, holders of investment accounts face a higher risk, since they do not only share in profits of the bank's investments, but also bear losses. Therefore, these accounts are the basis for profit-and-loss sharing in Islamic Banking.³⁷ Besides, Islamic banks have one common feature: their portfolios are highly concentrated on industries like trade, retail and the service sector, whereas other major industrial branches from the industrial and agricultural sector are frequently ex-

³⁰ Cf. ARIFF (1988), pp. 46-47; cf. SAEED (1996), pp. 10-11; cf. HENRY (1999), p. 360.

³¹ According to SAEED (1996), p. 15, Islamic banks and finance houses were established in Bahrain, Bangladesh, Denmark, England, Guinea, Jordan, Malaysia, Mauritania, Qatar, Senegal, Sudan, Switzerland, Tunisia and Turkey.

³² Cf. AINLEY (1997), p. 73.

³³ Cf. IQBAL/MIRAKHOR (1999), p. 383; cf. KAHF (1999), p. 451.

³⁴ Cf. SAEED (1996), pp. 14-15.

³⁵ Cf. AYUB (2002), p. 1; cf. GASSNER (2003), p. 732; cf. RÖTTGER (2003), p. 11.

³⁶ Cf. HARTMANN-WENDELS ET AL. (2000), pp. 114-146.

³⁷ Cf. MULJAWAN ET AL. (2002), p. 22; cf. HARON (U.Y.).

cluded.³⁸ The reasons for this concentration are not known. It can only be speculated that this low degree of diversification can so far be attributed to a lack of experience.

The countries of the Middle East are still at the centre of Islamic Banking activities. Among the providers of Islamic Banking products, however, one can also find a number of Western institutions, which have added “Islamic windows” to their conventional product offerings. Examples of such providers are the Hong Kong and Shanghai Banking Corporation (HSBC), Algemene Bank Nederland (ABN) Amro, Citibank, Banque Nationale de Paris (BNP) Paribas, United Bank of Switzerland (UBS) and Commerzbank. All of them have recognised that the Muslim population represents—with a proportion of 20 percent of the world population—a large potential customer base yet to explore. Europe has a population of roughly 15 million Muslims, whereof 3.5 million are living in Germany and 2.6 million of them having a Turkish origin.³⁹ It needs to be mentioned that, though, the number of Muslims, who are either *accepting* the payment of interest as a matter of fact in Western countries, or who are even *opposed* to Islamic Banking due to its alleged links to Islamic fundamentalism is not known.⁴⁰ This makes it impossible to correctly trace the real customer potential for Islamic Banking, which in return might put off some conventional financial institutions from entering the market of Islamic finance.

Since the year 2000, the number of Islamic Banking products has grown from approximately 40 to over 100 products with offerings particularly focusing on the fields of private banking and institutional clients.⁴¹ Products offered in accordance with Islamic Banking rules are described in detail in chapter 3. Generally speaking, the Islamic Banking products display an outstanding characteristic with the majority of products offered having short-term maturities.⁴² According to GAFOOR (1995), less than 10 percent of total assets went into medium- and long-term investments in 1988.⁴³ Similar facts are reported by a study by AGGARWAL/YOUSEF (1996) in HAMWI/AYLWARD (1999), who mention that more than 50 percent⁴⁴ of the total new financing activities of Islamic institutions flow into short-term mark-up financing, while the proportion for medium- to long-term financing activities is below 3 percent. The remaining percentage constitutes liquid reserves or other assets.⁴⁵ The reasons behind these findings are quite obvious: Islamic Banking is based on the acquisition of assets using

³⁸ Cf. HAMWI/AYLWARD (1999), p. 411. Whereas the concentration of Egyptian commercial bank portfolios in the Egyptian trade, service and financial sector is only 63 percent, Islamic banks are much less diversified with a concentration in these sectors of 90 percent.

³⁹ Cf. GASSNER (2003), pp. 732-734; cf. RÖTTGER (2003), pp. 11ff.

⁴⁰ Cf. HENRY (1999), pp. 359-360.

⁴¹ Cf. RÖTTGER (2003), p. 11.

⁴² Cf. AYUB (2002), p. 1.

⁴³ Cf. GAFOOR (1995).

⁴⁴ Note: IQBAL (1999), p. 543, estimates the share of short-term trade and sales instruments to be between 85 and 90 percent of all transactions.

⁴⁵ Cf. HAMWI/AYLWARD (1999), p. 411. The study by AGGARWAL/YOUSEF (1996) comprised the Faisal Islamic Bank Egypt, the Jordan Islamic Bank, Bank Islam Malaysia and the entire Iranian banking system. For the Bank Islam Malaysia, the proportion of short-term financing was 95 percent for the period 1983 to 1994.

investors' funds. However, the longer the maturity of a project, the longer it takes in profit-and-loss sharing partnerships to realise returns, and consequently, Islamic banks cannot pay a return to their investors as quickly as conventional banks can. Due to the extended lock-in of capital, uncertainty and risks are much higher in long-term Islamic Banking projects. Although effort is being put into effect to standardise products of Islamic Banking⁴⁶, each contract needs to be negotiated separately until now, which is time-consuming and requires an adequate expertise in assessing a project's potential risks and returns. The longer a project lasts, the more precise the assessment needs to be. Islamic banks often do not display sufficient experience in ensuring valid assessments.⁴⁷

2.3 Principles of Islamic Banking

Islamic Banking differs from conventional banking in a large number of applied principles, that mostly result from the strong religious and ethical focus of Islamic Banking. Some of these principles, such as the prohibition to invest into certain industries as well as the prohibition to engage in businesses which are highly leveraged, were mentioned in section 2.1. The following selection of principles in Islamic Banking serves to provide deeper insights into the most important rules of Islamic Banking, so as to give the reader a better understanding of the subsequent chapters on Islamic Banking credit products.

2.3.1 The religious supervisory board

As briefly mentioned in section 2.2.1, the religious supervisory board, which is also called the "Shariah committee", the "Shariah board" or the "Shariah supervisory board", is a widespread institution in Islamic banks, particularly of those in the Middle East. Such boards consist of scholars of the Islamic law, who fulfil the function of independent consultants in advising Islamic banks on whether their transactions are in accordance with Shariah rules. In order to carry out its function, the religious supervisory board is provided with the same information as regular auditors are. The board then certifies in the Islamic bank's annual report that business has occurred in accordance with the Shariah. Beyond this general attestation, management frequently approaches the Shariah board with particular questions on contracts and transactions, about which the management feels uncertain, if they comply with Islamic law.⁴⁸ In such cases, the religious supervisory board not only verifies, if the transaction is permissible with regard to the Shariah, but it also examines, whether the investment is well-chosen for a particular client, whether it creates value for the client and society, and whether the banker had been willing to undertake the same investment with his or her own money.⁴⁹ Since the approval of transactions, which can only be rejected in the case of a definite Shariah-non-compliance, depends on the board members' Shariah interpretation, investment decisions are

⁴⁶ Cf. IQBAL/MIRAKHOR (1999), p. 384.

⁴⁷ Cf. GAFOOR (1995).

⁴⁸ Cf. SAEED (1996), pp. 108-110.

⁴⁹ Cf. MOORE (1997), p. 30.

evidently exposed to subjectivity. PREMCHAND (1999) mentions that “if one were to ask a Shariah committee in the Middle East to issue a legal opinion for one Islamic bank, there is no guarantee that another Islamic bank’s Shariah committee will issue the same opinion for the same transaction”⁵⁰.

2.3.2 The understanding of money

Similarly to its functions in the Western world, money is regarded as a means of exchange and as a unit of value in the Islamic economy. Money serves to identify the value of a good. Money in Muslim countries, though, is neither looked at as a value storage nor as a medium of deferred value. The main underlying reason is the fact that money in Islam is reduced to purchasing power, which is therefore the only intended purpose of money. Consequently, Muslims are encouraged to spend money and not to save it.⁵¹ However, money in Islam has, unlike goods, no value in itself, which differentiates it from goods by several characteristics illustrated by PERVEZ (1995) in WIENEN (1999), “[...] money is liquid and has only negligible carrying or production cost and cannot be substituted, demand for money is only derived from the demand for goods, that it can buy and is not genuine, money does not depreciate as goods do, [and] money has no intrinsic value like goods, but is merely a product of social convention.”⁵² Notably, the aspect of inflation is ignored in this description.

Because of the strong focus on money as purchasing power, money in Islam is not to be equated with capital, but it only *becomes* capital, once it is ethically invested. This excludes the granting of loans, which does not require any personal effort and thus does not turn money into capital, but into debt. Accordingly, loans are not entitled to returns in the form of interest payments.⁵³

2.3.3 Fundamental prohibitions

2.3.3.1 Riba

Riba in Islamic Banking is an extensively discussed issue among various authors. As mentioned in section 2.1, charging and paying interest is not allowed in Islamic Banking. For the purpose of this paper, the general term “interest” as used in conventional banking is defined as “the price for the cession of money in the form of a loan, which must be repaid by the borrower to the lender”⁵⁴. The Arabic expression Riba is translated into English as “increase” or “addition”⁵⁵, and describes a fixed and predetermined return on capital via lending or borrowing money.⁵⁶ Riba is, regardless of the purpose of a loan⁵⁷, forbidden because of four different

⁵⁰ PREMCHAND (1999), p. 19.

⁵¹ Cf. U.A. (1995); cf. WIENEN (1999), pp. 44-45.

⁵² PERVEZ (1995) in WIENEN (1999), pp. 44-45.

⁵³ Cf. section 2.3.3.1; cf. U.A. (1995).

⁵⁴ RITTERSHOFER (2002), p. 1091.

⁵⁵ Cf. U.A. (2004a).

⁵⁶ Cf. U.A. (1995).

revelations in the Qur'an, which were also adopted by the Shariah: a first revelation underlines that "God deprives Riba of all blessing"⁵⁸, the second describes interest as the unjust appropriation of others' property, the third discourages Muslims from interest for their own welfare, and finally the fourth revelation urges Muslims to only ask for the principal sum when lending money.⁵⁹ Parts of these revelations are contained in the most frequently quoted verses 2:275-80 of the Qur'an in the context of Riba. Islamic bankers argue that interest is of an exploiting character and widens the gap between poverty and wealth, since the needy ones, who borrow money, need to pay interest, whereas the ones having abundant financial resources receive even more money out of interest inflows.⁶⁰ Additionally, investors in Islamic Banking strive to avoid Riba, because they consider it unethical to receive a return on capital without actively managing the funds involved. However, it must be noted that interest may not be confused with profit, with the latter being "halal" (legal) in Islamic Banking. In fact, Muslims regard profit-and-loss sharing as a desirable alternative to Riba, as in profit-and-loss sharing, the investor partly bears losses of the borrower. The method of profit-and-loss sharing is explained in detail in chapter 3 in the context of "Mudarabah" and "Musharaka".

As the countries of Iran, Pakistan and Sudan have chosen Islamic Banking as their constitutionally legal banking system⁶¹, these countries tried to completely ban the existence of Riba. Interestingly, this prohibition can only be realised on a national level, whereas external debt of these countries is serviced by interest payments like in a conventional banking system, in order to remain in the International Monetary Fund (IMF).⁶² In other Muslim countries, where conventional and Islamic Banking coexist, interest is legally allowed, but special Riba-free products are structured for Muslim investors.

2.3.3.2 Gharar

In addition to Riba, "Gharar" constitutes a second major prohibition in Islamic Banking as stated in the Shariah. Gharar can be translated into English as "uncertainty", "hazard" or "chance" and stands in opposition to moral security. The Institute of Islamic Banking and Insurance defines Gharar as a form of "deception through ignorance by one or more parties to a contract"⁶³. Gharar refers to the sale of a good, which is not present at hand, and whereof the outcome is not predictable. Some examples of Gharar are the sale of undeliverable goods, of goods either without a proper or with a wrong description or without a specified price, the sale without a permitted examination of the goods by the buyer, and the conditional contracting on an unknown event.⁶⁴ In the context of exchange, "Bay al-Gharar" signifies "trading in

⁵⁷ Cf. KASSEM/GREIL (2001), pp. 5ff.

⁵⁸ QUR'AN 2:275-80.

⁵⁹ Cf. AMERELLER (1995), pp. 47-48.

⁶⁰ Cf. PREMCHAND (1999), p. 21.

⁶¹ Cf. section 2.2.2.

⁶² Cf. PREMCHAND (1999), pp. 20-22.

⁶³ U.A. (2004a).

⁶⁴ Cf. U.A. (2004a).

risk". It must be noted that Islam does not generally forbid contracts involving a notion of risk.⁶⁵ However, contracts are deemed illegal based on the Shariah, if the estimated risk is assumed to be substantial, as some Muslims consider it to be the case for derivatives trading, short-selling and securities speculation.⁶⁶ This obviously represents a rather subjective and relativistic approach due to the impossibility to exactly measure risk. Four conditions have been elaborated by AL-DARIR (1997) for Gharar to invalidate a contract: "1. it must be major; 2. the potentially affected contract must be a commutative financial contract; 3. [...] Gharar must affect the principal components of the contract; and 4 [...] there is no need met by the contract containing Gharar, which cannot be met otherwise"⁶⁷. In fact, the concept of Gharar can be linked to the problems of information asymmetry and moral hazard in traditional contract theory dealing with principal-agent relationships.⁶⁸ While principal-agent theory proposes, among other mechanisms, incentive structures for the agent to conscientiously fulfil a contract, Islamic Banking recommends instruments of risk-sharing and cooperation as means to render contracts more efficient.⁶⁹

2.3.3.3 Maysir

The prohibition of "Maysir", which is translated into "gambling" in literature, can be regarded as the pure form of Gharar, as described in the previous section. Maysir contains a substantial amount of risk and is generally forbidden. The Qur'an states that "intoxication, games of chance, worship of idols, and divination by arrows are but an abomination, Satan's handiwork; avoid it then, so that you might prosper! By means of intoxicants and games of chance Satan wants only to sow enmity and hatred among you, and hinder you from the remembrance of God and from prayer [...]"⁷⁰. This quotation from the Qur'an shows that gambling is regarded as morally unacceptable, because it results from the will to win at the expense of others, and leads to hostile behaviour.

As mentioned in section 2.3.3.2, securities speculation is considered Maysir by some Muslims. However, this association may not be generalised, as EL-ASHAKAR (1995) defines speculation as "the practice of using available information to anticipate future price movements of securities, so that an action of buying or selling securities may be taken with a view to buying or selling securities, in order to realise capital gains and/or maximise the capitalised value of security-holdings"⁷¹. This definition illustrates that there is no general acceptance or negligence concerning securities speculation among Muslims.

⁶⁵ Cf. AL-SUWEILEM (2000), p. 65.

⁶⁶ Cf. PREMCHAND (1999), p. 23; cf. U.A. (2004b); cf. section 2.3.3.3.

⁶⁷ AL-DARIR (1997), pp. 44-51.

⁶⁸ Cf. IQBAL/MIRAKHOR (1999), p. 389.

⁶⁹ Cf. AL-SUWEILEM (2000), pp. 91-92, 96-97.

⁷⁰ QUR'AN 5:90-91.

⁷¹ EL-A SHAKAR (1995), pp. 79-114.

3 Financing techniques of Islamic Banking credit products

Chapter 2 has shown that the background and foundations of Islamic Banking are significantly different from those of interest-based economic systems. Consequently, Islamic Banking products need to be structured differently, so as to conform with Islamic law. This chapter serves to illustrate the financing techniques in Islamic Banking with a strong focus on credit product offerings (section 3.1). For the sake of completeness, participatory financing modes are also briefly explained (section 3.2), although they do *not* constitute typical credit products in Islamic Banking. Figure 1 clarifies, how financing techniques in Islamic Banking are subdivided.

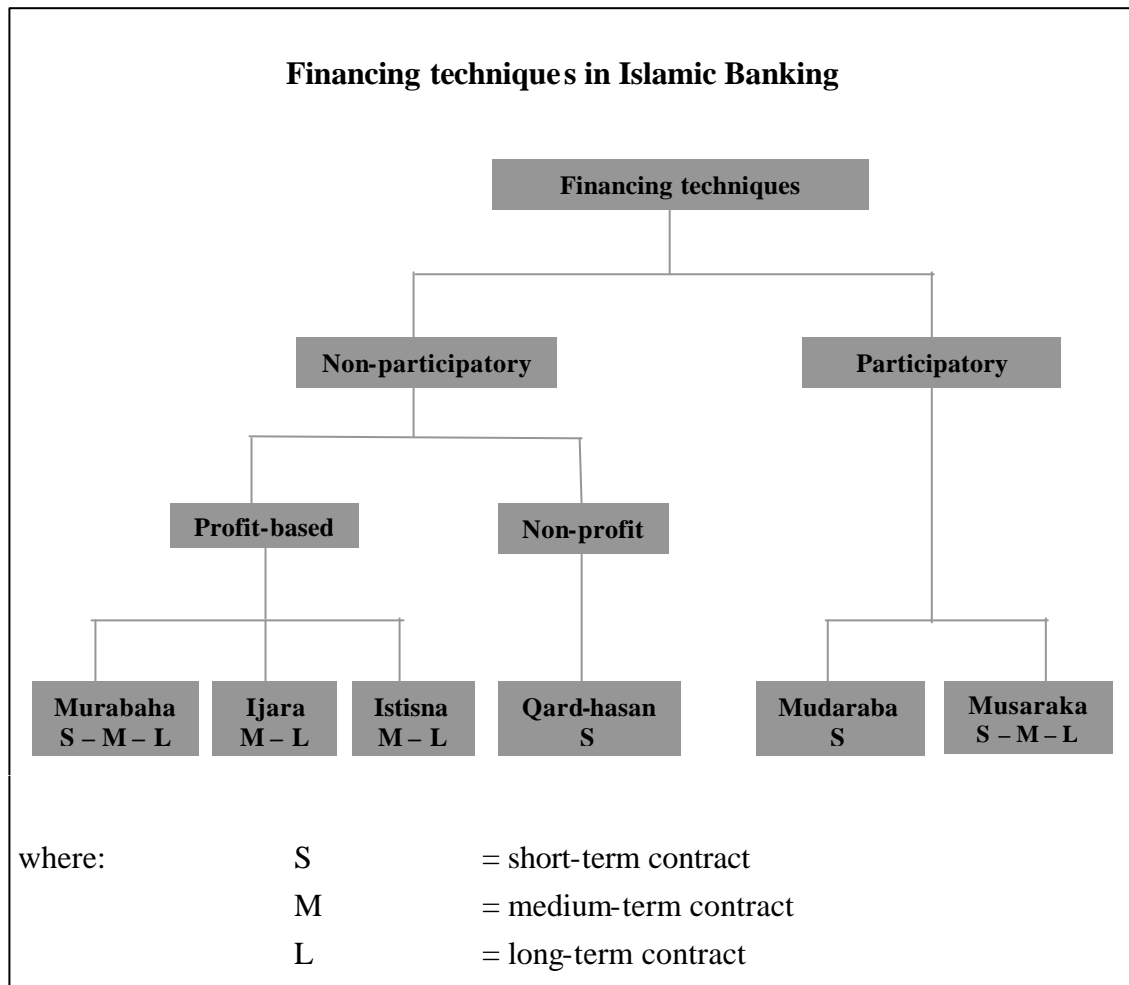


Figure 1: Financing techniques in Islamic Banking

Source: Authors.

3.1 Non-participatory financing modes

3.1.1 Concepts with profit intention

3.1.1.1 Murabaha

3.1.1.1.1 Procedure and fields of application

“Murabaha” represents the most common form of financing in Islamic Banking⁷², and is best translated by “mark-up” or “cost-plus financing”⁷³. Generally, Murabaha is a debt-like contract⁷⁴, that contains—in its most simple form—an agreement between the bank and its client. The bank buys goods for the client on the domestic market or from abroad, and the client in return buys the goods from the bank for the original price plus a mark-up at a later point in time. During the time the bank is in possession of the goods, the bank remains the nominal owner of the commodities and therefore carries the risk of losing the amount spent on the goods, if the client defaults.⁷⁵ MOORE (1997) has described the different steps of a Murabaha transaction, “the [...] client submits an order to the bank to purchase the goods [...]; the bank agrees to finance the purchase [...]; the bank prepares and sends an offer to the [...] client; the [...] [client accepts, binding him] to purchase the goods; the bank pays the supplier and purchases the goods using spot payment; the [...] [client] enters into a contract to buy the goods from the bank [by this time, the client typically pays a deposit]; the bank agrees with the [...] [client on] the selling price and the mark-up; the [...] [client] purchases the goods from the bank for immediate delivery with deferred payment [...]”⁷⁶. The repayment of the Murabaha deferred sale price, which is composed of the purchase price plus the mark-up (the Murabaha margin), can occur either in bulk or in instalments (“Bei bi thameen ajil” in Arabic language) according to a pre-specified repayment schedule.⁷⁷ The size of the mark-up depends on the type of goods subject to the contract, the credit rating of the client and the expenses the bank has incurred, but *not* on the time of the loan.⁷⁸ Notably, each Murabaha transaction must involve two separate contracts; one, in which the bank acquires the goods from a supplier, and a second, in which the bank sells the goods to the client.⁷⁹ As a result, financing of the client by the bank does not occur through the transfer of money, but through the transfer of a tangible asset. Any payment of Riba is thus avoided.⁸⁰ However, Islamic banks mostly require a security in the form of tangible property from the client, before the Murabaha contract is signed.⁸¹

⁷² Cf. HASSOUNE (2003); cf. U.A. (2004a).

⁷³ Cf. ARIFF (1988), p. 5.

⁷⁴ Cf. HAMWI/AYLWARD (1999), p. 409.

⁷⁵ Cf. GAFOOR (1995), p. 4; cf. SCHRADER (1998), p. 4; cf. HAMWI/AYLWARD (1999), p. 409.

⁷⁶ MOORE (1997), p. 33.

⁷⁷ Cf. HABIB (1989); cf. U.A. (2003a).

⁷⁸ Cf. SCHRADER (1998), p. 4; cf. IBRAHIM (2003), p. 13.

⁷⁹ Cf. U.A. (2004a).

⁸⁰ Cf. IBRAHIM (2003), p. 13.

⁸¹ Cf. SAEED (1996), p. 88.

An alternative structure to this ordinary Murabaha transaction is a Murabaha under a sell-and-buy-back arrangement. In this case, the bank's client directly approaches the seller of a commodity and buys the goods from the seller with the help of an interest-free loan from the bank. The client then sells the goods at its original value to his bank, which settles the loan, and enters with the latter into a contract agreement, to repurchase the goods back on a cost-plus basis at a specified point in time. The goods are therefore not stored at the bank, as for example for the reason of insufficient warehousing capabilities.⁸² This alternative structure of a Murabaha involves three obligatory contracts.

In case of default of the client, who enjoys a limited liability, contracts are typically extended without charging additional fees, because the risk of a default had already been priced, when the mark-up was initially calculated.⁸³ On the one hand, this is in accordance with the rule in Islam not to demand money from someone, who is in financial distress. On the other hand, business in Islam strongly relies on confidence in a way, that a client may not pretend his default, if this was not the case.

As mentioned in section 2.2.3, Islamic banks so far strongly focus on short-term financing. This is underlined by the fact that Murabaha transactions constitute a share of 80 to 90 percent of all transactions in Islamic Banking, making them the most common form of trade financing.⁸⁴ In fact, most Murabaha contracts have a life of only several weeks up to two years.⁸⁵ However, *Bei bi thameen ajil*, as applied in mortgage financing, can also be of a medium- to long-term duration.⁸⁶

Murabaha financing can generally be applied to any tangible good or commodity. It is demanded by private individuals as well as in the business finance. Private individuals mostly use Murabaha to finance automobiles and real estate. Corporations make use of Murabaha as an important financing tool, and they finance both their working capital, such as raw material and goods, and their fixed assets, such as equipment and machinery through Murabahas. However, Murabahas cannot finance a start-up company due to the higher risk profile of start-ups.⁸⁷

3.1.1.1.2 Benefits and criticism

The benefits of Murabaha transactions for the client stem from their short-term character, which makes them a convenient and unproblematic mode of financing. Also, the client is protected against exploitation by the bank, since the client is aware of the original price of the good and agrees ex-ante to the mark-up. Payments are therefore fixed unlike in conventional interest-based loans, where interest rates may fluctuate according to market rates. Finally, the

⁸² Cf. SCHRADER (1998), p. 4; cf. HENRY (1999), p. 363.

⁸³ Cf. SCHRADER (1998), pp. 4-5.

⁸⁴ Cf. U.A. (2004a).

⁸⁵ Cf. BÄLZ (2003), p. 22.

⁸⁶ Cf. SAIFUDDIN (2002), p. 2; cf. section 4.2.2.

⁸⁷ Cf. U.A. (2003a).

client remains independent of the bank, that has no influence on management decisions of the client's business. Some authors argue that Murabaha contracts prevent clients from investing borrowed money in unprofitable projects, because the bank buys the goods for the client. This, however, is questionable, since it would require an extensive assessment of the profitability of the investment by the bank. Although such an assessment would be a Shariah-conform procedure, it is hardly realisable due to the large number of Murabaha contracts. From the bank's perspective, Murabaha contracts are profitable because of their inherent mark-up, and they are relatively free of risk, unless the client defaults.⁸⁸

Although Murabaha is a common instrument in Islamic Banking, its mark-up feature has frequently been criticised. Critics argue that the mark-up added to the original cost of the good is equal to or even higher than the amount of interest, that a borrower would pay in conventional banking practice. Therefore, it is often stated that "mark-up" is just another designation for interest and is consequently not in line with Shariah principles.⁸⁹ Besides this criticism, the mark-up element is accused to be Gharar and thus haram of the bank to sell a good, which is not at hand, as in Murabahas under sell-and-buy-back arrangements. As described in the transaction steps by MOORE (1997), the client accepts the offer of the bank, in which he binds himself to purchase the goods *before* the bank has approached the supplier. Also, the deposit of the client is not repaid in case of default of the client, which may not be in accordance with Shariah law, that prohibits contractual penalties. Furthermore, the mark-up represents a fixed profit for the bank, that can be obtained without further effort, which should ideally not occur in Islamic Banking.⁹⁰ However, ARIFF (1988) argues that Murabaha retains its Islamic permissibility, because "the bank first acquires the asset and in the process, it assumes certain risks between purchase and resale. The bank takes responsibility for the good, before it is safely delivered to the client"⁹¹. This statement underlines the social responsibility of a Murabaha transaction as required by the Shariah, emphasising the strong confidence in the trading counterpart, which contributes to the Islamic legitimacy and acceptance of Murabahas.

3.1.1.2 Ijara

"Ijara", literally the Arabic word for "rent", which is explicitly allowed by the Shariah, is the leasing business in Islamic Banking, that recently enjoys an increasing popularity. Ijara is defined by the Institute of Islamic Banking and Insurance as "a contract, under which a bank [the lessor] buys and leases out for a rental fee equipment or property required by its client. The duration of the lease and rental fees are agreed in advance [with medium- or long-term contracts running up to 15 years⁹²]. Ownership of the equipment remains in the hand of the

⁸⁸ Cf. SAEED (1996), p. 78; cf. IBRAHIM (2003), p. 13; cf. NIVATPUMIN (2003).

⁸⁹ Cf. HENRY (1999), p. 358.

⁹⁰ Cf. AMERELLER (1995), p. 129.

⁹¹ ARIFF (1988), p. 5.

⁹² Cf. IQBAL (1999), p. 549; cf. U.A. (2004c), p. 1.

bank”⁹³. Unlike in a Murabaha, where the client pays the goods’ price plus a mark-up, the client in an Ijara pays for the lease, which is usually being compensated on a monthly or semi-annual basis.⁹⁴ Additionally, the client is also charged a single arrangement fee, a stamp duty and a valuation fee by the bank.⁹⁵ PREMCHAND (1999) mentions three potential problems concerning the application of Ijara, that all relate to the prohibition of Riba and Gharar.⁹⁶ First, penalty payments for a client (the lessee), who is not able to pay its rental fee on time, may not have an interest-bearing character, but they must—if at all, since penalties are not Shariah-conform—constitute a fixed amount. Second, in the case, that a rescheduling of a lease becomes necessary, “Shariah forbids the [ex-post] alteration of Ijara contracts. Instead, the parties involved need to agree to cancel the old agreement, and draw up a new one”⁹⁷, which is obviously costly and time-consuming. Third, the condemnation of Gharar proscribes selling the residual value of the leasing equipment in the form of a future purchase option. The rationale behind this is that selling and buying options represents a form of speculation.⁹⁸

Other than Ijara, that is mainly applied to the hiring of equipment assets, cars or buildings, a much more common form of leasing called “Ijara wa iqtina” exists. In Ijara wa iqtina, the client is not given an *option* to buy the property at the end of the leasing period, but he is put under an *obligation* to buy, which is legal. Therefore, Ijara wa iqtina is also referred to as a lease-or-hire purchase. In this case, payments consist—besides typical fees—of the lease payment plus the instalments for the purchase price.⁹⁹ This version is more convenient for the bank, because of the certainty to sell the goods at the end of the contract. Ijara wa iqtina resembles Murabaha contracts with a *Bei bi thameen ajil* feature. However, Ijara wa iqtina contracts generally leave the client with more freedom concerning the schedule of instalment payments.

3.1.1.3 Istisna

The financing technique of “Istisna” is translated by “progressive financing” for the manufacturing and construction of goods. In opposition to Murabaha, which is mainly used for *sales* from the bank to the client, Istisna is a similar concept for *purchase* financing, since the bank gradually buys a good from a supplier for its client. The Institute of Islamic Banking and Insurance defines Istisna as “a contract of acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of the job”¹⁰⁰. In fact, Istisna is structured similarly to a Murabaha, because it also consists of two separate agreements: the first contract is signed between the client and his bank about the purchase of a specified good,

⁹³ U.A. (2004a).

⁹⁴ Cf. HAMWI/AYLWARD (1999), p. 409.

⁹⁵ Cf. U.A. (2004d).

⁹⁶ Cf. section 2.3.3.

⁹⁷ PREMCHAND (1999), p. 29.

⁹⁸ Cf. PREMCHAND (1999), p. 29.

⁹⁹ Cf. ARIFF (1988), p. 5; cf. SCHRADER (1998), p. 5; cf. U.A. (2004e).

¹⁰⁰ U.A. (2004a).

the second between the bank and the supplier of the good. Whereas the client only starts repaying the bank—including a mark-up like in a Murabaha—when the good is delivered and put into operations, the bank pays the supplier according to the progress of work completed on the ordered good. The mark-up can be a fixed percentage or a floating rate. The IDB, for example, currently charges a mark-up for Istisna projects of 5.5 percent per annum or a floating six months LIBOR rate plus a 170 basis points spread. Istisna can be applied to any financing of complex goods, that need to be manufactured, examples being real-estate, telecommunication equipment and aircraft financing. Due to its frequent complexity, Istisna is mainly used in medium- to long-term transactions.¹⁰¹

Although Istisna represents a risky undertaking for the bank, as the client could withdraw from the contract before manufacturing is completed and before the good has been delivered, current contracts are structured in a way, that the client is bound to the agreement and has to pay penalty fees in the case of a non-performance of the contract.¹⁰² Once the supplier starts to manufacture the order, the contract can no longer be cancelled unilaterally.¹⁰³

3.1.2 Non-profit-based concept: Qard-hasan

“Qard-hasan” is a loan, which is provided free of any charges to needy clients, who only repay the principal at the end of the loan’s life. In Muslim countries, Qard-hasan is therefore mainly offered for welfare purposes to the less well-off in society such as farmers, entrepreneurs, or students, who do not qualify for other financing products. Due to the strong focus on confidence, solidarity and trust in Islam, these loans display high repayment rates.¹⁰⁴ Furthermore, MOORE (1997) states that Qard-hasan also helps to trigger a rise in economic productivity and in living-standards.¹⁰⁵ “A person is seeking a loan only if he is in need of it. Hence, it is a moral duty of the lender to help his brother, who may be in need. The borrower should not make an effort to take advantage of somebody else. [...] The reward of this act is with [...] God”¹⁰⁶.

Besides this, Qard-hasan is used for meeting short-term funding requirements. Whereas some Islamic banks only offer Qard-hasan to clients, who also have investment account with the bank, other banks provide any needy person with this form of an interest-free loan.¹⁰⁷

3.2 Excursus – Participatory financing modes

Participatory financing modes, although representing a growing market, currently comprise less than 10 percent of all transactions in Islamic Banking.¹⁰⁸ Notably, there is no unequivocal

¹⁰¹ Cf. U.A. (2004f).

¹⁰² Cf. BÄLZ (2001), p. 249.

¹⁰³ Cf. USMANI (U.Y.).

¹⁰⁴ Cf. PREMCHAUD (1999), p. 31; cf. GASSNER (2003), p. 732.

¹⁰⁵ Cf. MOORE (1997), p. 41.

¹⁰⁶ U.A. (2004a).

¹⁰⁷ Cf. U.A. (2004a).

difference between equity and debt financing in Islamic Banking, because even investment products resemble means of indirect credit delivery. However, they differ from credit products in their profit-and-loss sharing character, as will be shown in the following.¹⁰⁹

3.2.1 Mudarabah

“Mudarabah” is equivalent to conventional Western “trust financing”, designating a partnership between a bank and a commercial business. It therefore belongs to the category of equity-like, participatory contracts in Islamic Banking.¹¹⁰ The investing bank is known as the “Rab ul mal”, providing capital in the form of credit facilities for investment.¹¹¹ The commercial business, here particularly the management of the business, is called the “Mudarib”, which provides labour, skills, experience and effort. Since a Mudarabah contract is based on the principle of profit-and-loss sharing, profits are distributed between the investor and the business according to a ratio, that has been determined, when the Mudarabah contract was signed. Since an Islamic bank finances Mudarabah transactions with the help of its clients’ investment accounts, the bank’s clients also receive a proportion of the profit the bank makes with the Mudarabah financing. The account holders’ rate of return is thus determined in retrospect.¹¹² Any losses, which are limited to the amount of capital invested by the bank, and which accordingly induce the status of a of limited liability, are fully carried by the Rab ul mal. In return, the Mudarib is free of financial risk up to the amount of his capital commitment. Any further losses are to be carried by the Mudarib.¹¹³ An additional characteristic of a Mudarabah is mentioned by MOORE (1997): the money invested in a Mudarabah stems from just one investor, who is not allowed to interfere in the management of the business.¹¹⁴

This original form of Mudarabah has been revised and adjusted in contemporary Islamic Banking, as it was regarded as too risky for the investor with too strong a focus on confidence into the Mudarib. Today, Mudarabah is most frequently used for the buying and selling of goods by the Mudarib. Money is not directly paid to the Mudarib, but it is credited to a special Mudarabah account, and the financial statements of the Mudarib are closely examined. Also, contracts are very detailed and comprehensive, as, for example, the quantity and the type of goods are meticulously described, the duration—mostly short-term—of the contract and the liquidation date of the Mudarabah are fixed, and the payment to the bank is settled directly after a Mudarabah liquidation. Consequently, the initial risk and uncertainty of Mudarabah transactions are limited and losses for the Rab ul mal are unlikely to occur frequently.¹¹⁵

¹⁰⁸ Cf. section 2.2.3.

¹⁰⁹ Cf. BHAT (1999).

¹¹⁰ Cf. HAMWI/AYLWARD (1999), p. 409; cf. DRUMMOND (2001), pp. 98ff.

¹¹¹ Cf. MUKHTAR (2001); cf. INGSRISAWANG (2002); cf. HASSOUNE (2003).

¹¹² Cf. DRUMMOND (2000), pp. 4ff.

¹¹³ Cf. PREMCHAND (1999), p. 28.

¹¹⁴ Note: Mudarabah is also translated into a “silent partnership” in the sense of § 230 HGB (German commercial law) because of the bank’s prohibition to interfere in the management.

¹¹⁵ Cf. SAEED (1996), pp. 55-59.

Besides this business finance function of Mudarabah, it is also the basis for asset management practice in current Islamic Banking. Here, it must be noted that the designations of Mudarib and Rab ul mal are shifted: the Mudarib represents the asset manager, that is the bank, which invests the capital of the Rab ul mal.¹¹⁶ Capital is only ethically invested, referring to funds, that do not trade in so-called “sin stocks”.¹¹⁷ Also, a large number of Islamic investments are made in non-dividend paying, Shariah-conform stocks.¹¹⁸

The advantage of Mudarabah consists of its effective allocation of resources because—with the bank carrying the full financial risk—the bank’s funds are only being invested in businesses, which are profitable and seem to manage their resources the most efficiently.¹¹⁹ The criticism of Mudarabah transactions, however, addresses the fact that the investor is excluded from any decision making of the business while carrying the full financial risk.¹²⁰

3.2.2 Musharaka

“Musharaka” represents the second major profit-and-loss sharing technique in Islamic Banking and refers to areas like “partnership financing”, “project finance”, “joint stock ownership” or “private equity”.¹²¹ In contrast to Mudarabah, the bank in a Musharaka contract acts as one investor among others in financing a company. Capital is often provided against stocks of the business.¹²² In a Musharaka, a bank and a business contribute parts of the capital to a specific project. However, capital provision by the business is typically much smaller than the bank’s capital contribution. In a Musharaka, both profits *and* losses are shared by all parties involved, with a limited liability on the side of the bank to the amount of capital invested. The rationale for this limited liability is that in Islam “one cannot lose what one did not contribute”¹²³. Whereas the sharing of losses occurs according to the capital ratio invested, the ratio for sharing profits can be freely determined in the Musharaka contract, for example, if one party puts more effort into the project, this party receives a higher percentage of profits, than it would have earned relative to its capital contribution.¹²⁴ The bank is allowed, but not required, to influence the management of the business.¹²⁵

SAEED (1996) distinguishes three types of Musharaka: the commercial Musharaka, decreasing participation and permanent participation. In a “commercial Musharaka”, which is the most common form, the purpose of the transaction can be the purchase of plant, manufacturing

¹¹⁶ Cf. U.A. (2003a).

¹¹⁷ Cf. FRANCK ET AL. (2002), p. 37; cf. section 2.1: the Shariah forbids any business with companies, that make money from tobacco, alcohol, drugs, weapons, pork, interest charging or paying institutions such as banks, insurance or mortgage companies, gambling, pornography, child labour and environmentally harmful activities.

¹¹⁸ Cf. KASSEM/GREIL (2001), pp. 5ff.

¹¹⁹ Cf. CHAND (2000).

¹²⁰ Cf. PREMCHAND (1999), p. 29.

¹²¹ Cf. SAEED (1996), p. 59; cf. BÄLZ (2001), p. 247; cf. U.A. (2004e).

¹²² Cf. SCHRADER (1998), p. 5.

¹²³ U.A. (2004a).

¹²⁴ Cf. IBRAHIM (2003), p. 10.

¹²⁵ Cf. UPPAL (1999), p. 563.

equipment or commodities. Here, the transaction is fixed in its duration and capital provision is mostly short-term. Consequently, the liquidation of the project occurs quickly and capital turnover and returns are usually high. The second type of Musharaka, a Musharaka with “decreasing participation”, is mainly used for project financing in the industrial and agricultural sector and serves to transfer full ownership of the assets in the long-run to the business invested in. The bank’s invested capital is repaid in instalments and the bank receives a proportion of the project’s cash flows for a specified period of time. Profit-sharing can be exercised in three different manners: the bank can either receive its share of the profit on a regular basis (which is sometimes associated with prohibited Riba) and reacquire its capital out of the remaining profits of the partner, or the partner annually buys back a part of the bank’s share in the business including profits, or the partner repurchases the bank’s share in bulk after the termination of the Musharaka contract. All three forms are practiced by Islamic banks. Finally, in a “permanent participation Musharaka”, the bank actively contributes to the management of the business financed and shares in the profits and losses until the end of the Musharaka contract.¹²⁶

The criticism of Musharaka transactions is that the bank enjoys a status of limited liability, when it comes to losses, but receives a high return on capital employed in the case of profits, although, in most cases, the bank does not actively participate in the management of the company.¹²⁷ Also, Musharaka contracts allow the parties involved less freedom of choice than Mudarabah financing, where not all the parties need to invest capital, but the business is free to solely contribute labour.¹²⁸ Musharaka is increasingly popular for the financing of start-ups in the information technology (IT) sector, because investments in IT are regarded as ethical and therefore conform with Islamic law.¹²⁹

4 Islamic Banking credit products in Germany and the UK

4.1 The German market

A large growth potential is attributed to the German market for Islamic Banking credit products.¹³⁰ As briefly mentioned in section 2.2.3, this belief is generally based on the fact that Germany displays—with a Muslim population of roughly 3.5 million—a major potential demand for Islamic Banking products. In the following, the current German market for Islamic Banking credit products is analysed. First, the suppliers of these products are identified and evaluated. Second, the angle of view is shifted from the vendors’ to the clients’ side with a strong focus on the potential demand by the Turkish population in Germany. Finally, the regulatory framework for Islamic Banking credit products in Germany is discussed.

¹²⁶ Cf. SAEED (1996), pp. 62-65; cf. U.A. (2004a).

¹²⁷ Cf. BÄLZ (2001), p. 247; cf. IBRAHIM (2003), p. 11.

¹²⁸ Cf. AMERELLER (1995), p. 121.

¹²⁹ Cf. BÄLZ (2001), pp. 247-248.

¹³⁰ Cf. GASSNER (2003), p. 734-735.

4.1.1 Empirical evidence from the supply side

In order to identify current suppliers of Islamic Banking credit products in Germany, a compilation of banks, that are most likely to offer such products, is drawn up on the basis of two criteria: first, the bank shall originally be based in a country with a high Muslim population and shall have a branch in Germany. Second, this branch shall actively operate in Germany in January 2004 as recorded by the “Verband der Auslandsbanken in Deutschland” (“Association of foreign banks in Germany”).¹³¹ For the purpose of this paper, these branches were contacted by telephone and were asked, if they currently offer Islamic Banking credit products in Germany. The following Table 1 illustrates the results of these investigations.

Foreign banks from Muslim countries operating in Germany

Institution	Country of origin	Location in Germany	Islamic Banking credit product offering in Germany
ABC International Bank	Bahrain	Frankfurt	[yes]
Akbank TAS	Turkey	Frankfurt	no
Arab Bank	Jordan	Frankfurt	no
Bank Melli Iran	Iran	Hamburg	no
Bank Saderat Iran	Iran	Frankfurt	no
Bank Sepah Iran	Iran	Frankfurt	no
Europäisch-Iranische Handelsbank AG	Iran	Hamburg	no
Isbank GmbH	Turkey	Frankfurt	no
Misr Bank Europe GmbH	Egypt	Frankfurt	no
National Bank of Pakistan	Pakistan	Frankfurt	no
Oyak Anker Bank GmbH	Turkey	Koblenz	no
Yapi Kredi Bank AG	Turkey	Frankfurt	no
Ziraat Bank Intern. AG	Turkey	Frankfurt	no

Table 1: Foreign banks from Muslim countries operating in Germany

Source: Association of foreign banks in Germany; own investigations.

Out of 13 banks interviewed, the only financial institution in Germany theoretically offering Islamic Banking products is the Arabic Banking Corporation International Bank plc, Zweigniederlassung Frankfurt, referred to as “ABCIB” in the following. However, ABCIB, which is operating in Frankfurt since 1984, successfully completed just one transaction, that was structured in accordance with Islamic Banking rules on demand of a client. Although the exact transaction date could not be determined in the course of the interview, it has been arranged more than six years ago and consisted of a project financing for a client in Jordan. It is also questionable, if the transaction was structured in the form of an Islamic credit product or as a profit-and-loss sharing Mudaraba or Musharaka. Furthermore, ABCIB Frankfurt does not

¹³¹ Information provided via e-mail by the Association of foreign banks in Germany, January 12, 2004.

possess an Islamic Banking licence, so that this transaction was structured in cooperation with ABCIB Bahrain. An approach of an aircraft financing for a different client was undertaken some years later, but was not completed because of disagreements with the client. The interview with the representative of ABCIB revealed the fact, that the demand for Islamic Banking credit products in Germany is apparently very low.¹³²

All other banks contacted are not active in this field of business in the German market. Despite the popularity of Islamic Banking in their home countries, Iran and Pakistan respectively, and despite the large number of Turkish Muslims in Germany, even the branches of banks from Iran, Pakistan and Turkey do not offer Islamic Banking credit products in Germany. The interviews conducted suggest—apart from the lack of demand, which is examined later—five main reasons for this situation, namely the focus on different areas of activity, the small scale of business in Germany, reversal developments in their country of origin, the avoidance of an association with Islam and the undetermined legal framework for Islamic Banking in Germany. These reasons are elaborated in the following.

First, most of these institutions regard their function in Germany as that of a regular commercial bank, providing export-import financing assistance to corporate customers in the form of conventionally-structured letters of credit. They also advise their clients on currency issues for cross-border transactions with their countries of origin. Obviously, these branches profit both from their extensive network of relationships with banks and customers in their countries of origin, and from their experience in trading with these countries.

Second, with the exception of Turkish Akbank, Isbank and Oyak Anker Bank¹³³, all banks operate on a small to very small scale in Germany. At the National Bank of Pakistan, Frankfurt, for example, currently work 16 employees, and none of the banks surveyed, except for Akbank, Isbank and Oyak Anker Bank, has a workforce of more than 40 employees in Germany, which does not allow for offering a broad range of financial products to customers. Along with this small dimension of business, branches are—for the majority—established in just one location in Germany, mostly in Frankfurt, as shown by Table 1. Since the success of business activities in Muslim cultures highly depends on mutual confidence and a close customer contact, preferably in the mother tongue, German branches of banks from Muslim countries do not display sufficient capacity in terms of distribution channels and customer proximity for a broad-band offering of Islamic Banking credit products.

Third, especially Turkish banks in Germany see the reason for the low dissemination of Islamic Banking products in Germany in the relaxation concerning the Riba prohibition in Tur-

¹³² Information provided via a telephone interview with ABCIB, January 22, 2004. Please refer to section 4.1.2 for possible explanations of this lack of demand.

¹³³ Note: Akbank has German branches in Berlin, Essen, Frankfurt, Hamburg, Hannover, Munich and Stuttgart, cf. U.A. (2004g). Isbank has German branches in Cologne, Düsseldorf, Frankfurt, Gelsenkirchen, Hamburg, Karlsruhe, Mannheim, Munich, Nürnberg and Stuttgart, cf. U.A. (2004h). Oyak Anker Bank has German branches in Augsburg, Berlin, Bonn, Frankfurt, Koblenz and Mannheim. Information provided via a telephone interview with Oyak Anker Bank, January 29, 2004.

key, where an official interest rate exists since 1983.¹³⁴ Consequently, the Turkish branches consider it unrealistic to offer interest-free products in Germany, while interest is accepted in Turkey and the majority of banks in Turkey grant loans on an interest basis.

Fourth, in fact, a particular dislike of Islamic Banking was detected at Turkish banks. A comment from an employee at Isbank, Frankfurt, saying literally “We at Isbank have nothing to do with Islam!”¹³⁵, and a similar statement from an employee at Akbank, Frankfurt, saying “We do not offer Islamic Banking and are not interested in doing so!”¹³⁶, show that these bankers repel an association with Islam. A representative of Oyak Anker Bank, Koblenz, mentioned that financial products with a very strong focus on religion will not successfully integrate into the German market.¹³⁷ Notably, Turkey is a secularised country, where religion and government are to be strictly separated. Rather, Turkish banks in Germany offer services like current and savings accounts to their clients, that correspond to the products offered by German commercial banks. In Turkey, however, five major finance houses do offer Islamic Banking credit products.¹³⁸ They are briefly introduced in section 4.1.2, in order to analyse, if they receive a major demand from Germany-based Turkish clients.

Fifth, a commonly mentioned reason by several banks from different countries in the course of this survey is the assumed non-compatibility of Islamic Banking credit products with German banking law.¹³⁹ Section 4.1.3 analyses the correctness of this statement in more detail.

Research was extended to the five major German banks¹⁴⁰ as well as Citibank Germany¹⁴¹ and HSBC Amanah Finance¹⁴², which were asked, if they offer Islamic Banking credit products on the German market. None of these banks is currently doing so and plans in this direction could not be revealed.

However, the German federal state of Saxony-Anhalt currently plans the issuance of a EUR 100 million Islamic bond (“Sukuk”), which will probably be issued in the course of spring 2004, and which will be the first Islamic bond ever placed in Europe. It is already being considered to increase the bond’s volume of EUR 100 million, because informal demand is apparently very high. Saxony-Anhalt has some experience in conducting business with the Muslim world, since it issued a bond in Bahrain in 2001. The structure of this new Sukuk is planned as follows: property rights owned by the federal state of Saxony-Anhalt are transferred to a trust company in the Netherlands, which is established for the purpose of this pro-

¹³⁴ Cf. U.A. (2004).

¹³⁵ Information provided via a telephone interview with Isbank, January 20, 2004.

¹³⁶ Information provided via a telephone interview with Akbank, January 20, 2004.

¹³⁷ Information provided via a telephone interview with Oyak Anker Bank, January 29, 2004.

¹³⁸ Information provided via e-mail by Ziraat Bank International, January 19, 2004.

¹³⁹ Note: German banking law refers to the “Kreditwesengesetz (KWG)” (German Banking Act), the “Mindestanforderungen an das Kreditgeschäft (MaK)” (Minimum Requirements in Credit Transactions) and to an extent to the “Handelsgesetzbuch (HGB)” (German commercial code).

¹⁴⁰ Note: the five major German banks researched are Deutsche Bank, Dresdner Bank, Commerzbank, HypoVereinsbank and Westdeutsche Landesbank.

¹⁴¹ Information provided via a telephone interview with Citibank Germany, January 20, 2004.

¹⁴² Information provided via e-mail by HSBC Bank Middle East Limited, January 5 and 9, 2004.

ject, so as to avoid corporate tax. Next, property is ceded to this trust company for a time frame of 30 years. The Dutch foundation will then issue the Sukuk with a time to maturity of 5 years, after which the federal state of Saxony-Anhalt can either receive back the property free of cost or issue a new Sukuk placement. With the bond being structured like a cross-border-leasing, investors are not being paid forbidden Riba, but they receive a part of the leasing instalments made by the federal state of Saxony-Anhalt according to their capital commitment. Plans still need to be accepted by Saxony-Anhalt's ministry of finance and the financial board of the parliament.

The prospect of this project is currently viewed rather critically. On the one hand, it would broaden the investor base and make Saxony-Anhalt better known to investors. On the other hand, the trust company in the Netherlands is regarded with suspicion, as this structure's sole purpose is to avoid tax payments by the federal state of Saxony-Anhalt. Also, there is a high degree of uncertainty concerning the religious influence of Islam on this project.¹⁴³

Apart from this endeavoured bond issue, the only Islamic Banking product offered in Germany are the "AlSukoor" fund shares distributed by the Commerzbank¹⁴⁴. However, these are clearly not credit products and are therefore not further analysed in the course of this paper.

In line with the current inexistence of Islamic Banking credit products in Germany—apart from products theoretically offered by ABCIB Frankfurt—neither the Deutsche Bundesbank nor the "Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)" ("Federal Institute for Financial Services Supervision") possesses detailed information on Islamic Banking activities. Whereas the Deutsche Bundesbank is not able to systematically analyse Islamic Banking products because of the non-existing duty of notification for financial institutions offering Islamic Banking¹⁴⁵, the BaFin so far has never dealt with an Islamic Banking credit product offering in Germany, and—as a result—has no experience in this field.¹⁴⁶ In fact, the term "Islamic Banking" is still unknown to most people from German financial institutions interviewed for the purpose of our analyses.

4.1.2 Analysis of the current and potential demand

The following section aims to determine, whether Germany really contains the abovementioned demand potential for Islamic Banking due to its large Muslim population. Currently, 3.5 million Muslims are living in Germany, whereof 2.6 million have a Turkish origin.¹⁴⁷ Consequently, the Turkish population is in the centre of the following investigations.

Concerning the preferences of Turkish Muslims in Germany with respect to financial products, just one single research study has been conducted so far. It is a survey by the "TNS Em-

¹⁴³ Cf. BIELENSTEIN (2003); cf. BARTSCH (2004), p. 8.

¹⁴⁴ Cf. U.A. (2004i).

¹⁴⁵ Information provided via e-mail by the Deutsche Bundesbank, January 21, 2004.

¹⁴⁶ Information provided via a telephone interview with the BaFin, January 13, 2004.

¹⁴⁷ Cf. GASSNER (2003), p. 734.

nid” polling institute from the summer of 2000 entitled “German Banks and Insurances from a Turkish point of view”. The study was structured in a way that 1,001 computer assisted telephone interviews were conducted between May 9 and June 24, 2000, with randomly chosen Turkish adults living in Germany, who were at that time at least 15 years old. The interviews were held in Turkish language, in order to avoid the influence of language barriers on the sample selection. A summary of the results is given in the following: while 63 percent of the Turkish population in Germany had savings accounts in 2000, 42 percent and 25 percent had credit cards and building society savings agreements or securities accounts respectively. Of those German Turks having bank accounts, a majority of 53 percent were customers of local savings banks, followed by 24 percent being customers of major German banks (11 percent were clients of former Deutsche Bank²⁴) and the Volks- and Raiffeisenbanken, where 17 percent held their accounts. Surprisingly, only 14 percent of German Turks were customers of Turkish banks. These results are in line with the overall preferences of banks by the entire German population: according to the Deutsche Bundesbank, roughly 44 percent of private individuals are clients of savings banks, followed by 29 percent of regional banks, 20 percent of major German banks, 7 percent of state banks and only 0.2 percent at branches of foreign banks.

A test of the degree of familiarity with Turkish banks confirmed the results of the TNS Emnid study described above. Merely 28 percent of German Turks knew Isbank, followed by Akbank with 24 percent and Ziraatbank with 22 percent. Other Turkish banks were largely unknown, whereas 7.5 out of 9 German financial institutions were known by the Turkish population (98 percent knew savings banks), and the satisfaction with these German institutions was high (with only 12 percent of participants being dissatisfied). In the year 2000, German Turks had on average 1.3 bank accounts per capita.

This study was not repeated by TNS Emnid in the years following 2000 because of the difficulties, particularly in the form of language barriers and cultural background, to approach the Turkish population. As reported by a representative at TNS Emnid, the quality of information, that is filtered out of these surveys, is rather low, as long as the interviewer is perceived as not being part of the Turkish population. TNS Emnid also considered to realise a survey in Germany on the topic of Islamic Banking, but the institutions, which were contacted for this research project, were not cooperative enough, to successfully participate.¹⁴⁸ Similar statements were made by the polling institute “smart research”, that has so far not been active in empirical research on the banking sector. Also, the “Gesellschaft für Sozialforschung und statistische Analysen mbH Forsa” and the “Statistisches Bundesamt” do not have any data in this field.¹⁴⁹

¹⁴⁸ Information provided via a telephone interview with TNS Emnid, January 21, 2004.

¹⁴⁹ Information provided via a telephone interview with TNS Emnid, January 21, 2004; via a telephone interview with smart search, January 21, 2004; via e-mail by the Gesellschaft für Sozialforschung und statistische Analysen mbH Forsa, January 22, 2004.

The TNS Emnid study shows that the majority of the Turkish population in Germany accept conventional financing modes. There does not seem to be an evident religious conflict of accepting Riba because of the high percentage of German Turks having interest paying savings books. However, since Islamic Banking credit products are not offered in Germany, it was examined—for the purpose of this paper—, if German Turks tend to approach so-called Turkish “finance houses” located in Turkey, so as to obtain credit products in accordance with Islamic Banking from them. Generally, Turks living in Germany still have a tight connection to Turkey and therefore might prefer Turkish banks located there.¹⁵⁰ Five major Turkish private finance houses¹⁵¹ are in existence, namely Albaraka Turk, Asya Finans, Anadolu Finans, Family Finans and Kuveyt Turk.¹⁵² While Anadolu Finans and Family Finans do not provide product information in English, the remaining three finance houses offer Islamic Banking products as those introduced in chapter 3. One can distinguish two pillars of their product offerings, retail and corporate banking. On the retail banking side, Turkish private finance houses provide consumer mark-up financing (Murabaha) and leasing (Ijara). On the corporate banking side, these institutions offer mark-up transactions for the support of production (Murabaha), leasing (Ijara) and profit-and-loss participatory financing (Mudarabah and Musharaka).¹⁵³ When asked via e-mail about their percentage of customers from Germany, only Asya Finans sent a reply saying that they do not have customers in the retail business from Germany, which is attributed to the know-your-customer policy at Asya Finans. Direct access to the Turkish community in Germany is thus not available to these finance houses. In the corporate business, clients from outside Turkey are mainly asking for support in their export-import business in the form of letters of credit, which are not an Islamic Banking product.¹⁵⁴

Altogether, a significant demand for Islamic credit products in Germany cannot be detected. All banks interviewed were generally of the opinion that the demand for Islamic Banking credit products in Germany is negligible. This may be due to the fact that the Muslim population in Germany is very homogeneous with a high concentration of Turkish Muslims, who apparently have no conflicts of accepting Riba. In fact, interest is legal in Turkey since December 16, 1983.¹⁵⁵ Apart from Turkey, Germany’s ties with the Arab world are traditionally weak. Here, language barriers—among others—are a major issue. Consequently, suppliers on the German market are currently not considering to offer Islamic Banking credit products.

¹⁵⁰ Cf. MORITZ (2001).

¹⁵¹ Note: “private finance house” or “special financial institution” are the Turkish equivalent for Islamic Bank(ing). Information provided via e-mail by Asya Finans, January 21, 2004.

¹⁵² Information provided via e-mail by Ziraat Bank International, January 19, 2004.

¹⁵³ Cf. U.A. (2004j); cf. U.A. (2004k); cf. U.A. (2004l).

¹⁵⁴ Information provided via e-mail by Asya Finans, January 21, 2004.

¹⁵⁵ Cf. U.A. (2004l).

4.1.3 The German regulatory framework for Islamic Banking

Because of the current quasi non-existence of Islamic Banking in Germany, the regulatory framework for Islamic Banking is not precisely determined and is only rarely discussed in literature. However, one can raise some points of departure with respect to these products.

First, the key feature of Islamic Banking credit products, which is the temporary ownership of the goods by the bank, requires some consideration with regard to the increased risk for the bank. To recall, Murabahas and Ijaras have a two-contract structure, that is necessitated by the rule in Islamic law, that one may not sell what one does not own. Accordingly, in order to reduce the eminent risk of a temporary asset ownership by the bank, Murabaha contracts are approached to be structured as closely as possible like a conventional letter of credit, where the bank pays the price of the goods against receiving the documents, which are then directly passed on to the client in return for the money.¹⁵⁶ This does not eliminate temporary ownership, but it reduces it to a short time interval, whereupon property rights are directly transferred to the client.

Second, transportation insurance for the goods is another controversial issue. Here, it is the client, who should carry any transportation risk and who is responsible for the insurance. Although Islamic law does not allow commercial insurances due to their speculative and thus Gharar character, Islamic forms of cooperative insurance, so-called "Takaful", meanwhile exist.¹⁵⁷ Since Murabahas are often transactions involving international contract parties, Murabahas are frequently structured on the basis of English law. It was the first time on February 13, 2002, that a Western court, namely the High Court London, ruled on a case of a Murabaha transaction. In brief, the issue was that an Islamic bank located on the Bahamas had signed a Murabaha contract with a client about the supply of rough diamonds from Hong Kong. The bank bought the diamonds from the supplier, but the diamonds never reached the client, who was not willing to pay for the lost shipment. The High Court London decided that the client was obligated to pay the bank, regardless of whether or not the supplier fulfilled his obligations. It was the client alone, who carried the risk of non-fulfilment of the contract. This case shows that the court has foregone an interpretation of Islamic law, because the client was forced to pay for something, that he did not receive. The rationale behind this decision was that the client had chosen the supplier without the participation of the bank. If the bank was to be held responsible for such non-fulfilment, no financial institution would be willing to offer Murabaha transactions any longer.¹⁵⁸

Third, it is debatable how Islamic Banking credit products are to be dealt with in terms of capital adequacy regulation. Normally, loans granted in Germany are to be backed by a pro-

¹⁵⁶ Cf. OLFERT (2001), pp. 180-181.

¹⁵⁷ Cf. BÄLZ (2001), p. 246-247.

¹⁵⁸ Cf. BÄLZ (2003), pp. 22-23.

portion of the bank's capital.¹⁵⁹ In Islamic Banking, though, the loan itself is replaced by a mark-up transaction with a temporary asset ownership by the bank. Also, at Islamic banks, the clients' investment accounts bear a part of the losses, that can result out of a contractual partner's default. Since banks operating on the basis of Islamic Banking principles in Germany need to respect German law¹⁶⁰, they have to follow the Basel Capital Accord, whose challenges will be described in section 5.3. The issue of capital adequacy regulation is an open question for Islamic Banking in Germany and has so far not been discussed in literature.

Altogether, the regulatory framework for Islamic Banking credit products in Germany is to be further specified. A legal prohibition of such products in Germany could however not be determined.

4.2 The UK market

4.2.1 Empirical evidence from the supply side

Various active providers of Islamic Banking products are present in the United Kingdom (UK). However, most of them are operating in the fields of asset management and investment banking, such as ABCIB Islamic Asset Management or Global Islamic Finance by HSBC Investment Bank plc. In the field of Islamic Banking credit products, two market players could be identified, namely Ahli United Bank and HSBC Amanah Finance, whose product offerings are described in the following. Other providers, like Barclays and the newly formed Islamic House of Britain, which is currently applying for a banking licence, might follow shortly in providing Shariah-conform banking services.¹⁶¹

4.2.1.1 The Manzil scheme

“Manzil Home Purchase Plans” were introduced by the Ahli United Bank, formerly United Bank of Kuwait, London in 1997.¹⁶² Contracts at Manzil are structured under UK law and products are supervised by the Shariah board at Manzil consisting of two scholars of the Islamic law. Manzil represents the first approach to property financing according to the Shariah in the UK, and currently two ways of Islamic mortgage financing—namely Murabaha and Ijara—are offered.¹⁶³

As of the Manzil scheme, Murabaha is applicable for the purchase of houses or flats with a contract life between 5 and 15 years. The client chooses the property, that he wishes to buy, agrees on the purchase price with the seller, and then approaches Manzil. Manzil accepts the

¹⁵⁹ Note: the current capital adequacy ratio is set at 8 percent by the Basel Capital Accord, that took effect in 1992. In the New Basel Accord, to be introduced in 2007, capital adequacy is to be determined as a function of the inherent risk of the respective loan.

¹⁶⁰ Cf. Art. 27 I EGBGB.

¹⁶¹ Cf. U.A. (2003b).

¹⁶² Note: Ahli United Bank acquired a 47 percent stake in the Kuwait-based Bank of Kuwait and the Middle East (BKME) in 2002; cf. U.A. (2003c), p. 2.

¹⁶³ Cf. U.A. (2004m).

deal, if an extensive verification of the client's bank statements, credit search and requested references from the employer, other banks, current lenders and the landlord show positive results. The property is bought in the name of Ahli United Bank, before it is immediately sold to the client at a pre-determined higher price. The mark-up is calculated depending on the value of the property, the number of years the client wishes to repay and the amount of the first instalment, which is made on the day the property is sold, and which should amount to a minimum of 20 percent of the purchase price. Regular monthly payments follow until the end of the contract life. Amounts spent on the property by Manzil have an upper limit of 2.5 times the gross annual income of a sole applicant or 2.5 times the higher income plus 1 time the lower income for joint applicants.

The second method applied is Ijara, which is in fact the more popular product at Manzil, since it provides the client with more flexibility by allowing to repay early in bulk or to make several payments on a regular basis. Ijara contracts run between 7.5 and 25 years and generally, payments are fixed from April to April. Additional payments are allowed once a year. Also, Manzil promotes Ijara, as it is suitable for replacing an existing conventional interest mortgage. Concerning the procedure of Ijara, the client chooses the property, agrees on the purchase price with the seller and approaches Manzil. Manzil sells the property to the client as delineated in the promise-to-purchase document. Here, the purchase price between the client and the bank is the same as between the seller and the bank. Simultaneously, the client enters into a lease contract with Ahli United Bank on the same property. The monthly payments, which are automatically debited, therefore consist of the lease/rent payment plus the monthly instalment for the property. Property may be fully purchased from Manzil by the client at any time, in which case, the balance of the purchase price is being paid. Comparable to a Murabaha transaction, the bank verifies the client's bank statements and various other references. Income multiples for the upper limit granted are 3 times the annual income for a sole applicant and 3 times the higher income plus 1 time the lower income for joint applicants.

Various fees are charged for either Murabaha or Ijara financing, for example a valuation fee, a local search fee, a land registry fee, a solicitor's fee, an arrangement fee and a stamp duty. For all transactions, property must have a minimum value of GBP 50,000 and a minimum demanded finance amount of GBP 40,000.¹⁶⁴

In response to a strong customer demand, Manzil now offers a third financing technique for so-called "buying-to-let" property. In buying-to-lets, the client does not purchase the property for his own purposes, but to rent it to a third party. In this case, the property is held by the client solely for investment reasons. The bank incurs a greater risk in a buying-to-let transaction, since the tenants and their paying habits remain unknown to the bank. Because of the higher risk, Manzil spends less on the property as the following calculation will show: 20 percent to 25 percent are deducted from the estimated gross rental income. This deduction con-

¹⁶⁴ Cf. U.A. (2004m).

tains managing agent charges, periods when a property is empty, service charges, ground rent as well as maintenance expenses. The net rental income is then expected to be greater than the forecast Manzil payments by at least 115 percent.

Value of property	100,000.00 GBP
Gross rental income p.a.	9,000.00 GBP
Net rental income p.a. (75%)	6,750.00 GBP
Monthly net rental income	562.50 GBP
Monthly net rental inc/1.15	489.00 GBP
Current Manzil pricing	69,000.00 GBP
Monthly payment due	489.00 GBP
Contract life	11.76 years

Table 2: Buying-to-let calculation (Manzil scheme)

Source: Manzil homepage; own illustration.

Once introduced, the Manzil scheme was discussed with the Bank of England, which was satisfied with the plans, and therefore gave its approval. In the meanwhile, the scheme became as well applicable in Wales and Scotland. Mortgages are distributed by independent financial advisors and solicitors, who are close to the Muslim community, for example by speaking Urdu or Arab languages. This is a well thought-out strategy, because in this way, the Manzil scheme allows for a close customer contact, while overcoming language barriers and creating confidence. An entry into the mortgage financing business also represents a good approach fulfilling the desire of many Muslims in the UK to own property.¹⁶⁵ However, the first instalment of a minimum of 20 percent of the purchase price is rather high. Furthermore, the client needs to agree to pay various fees due to the temporary ownership of the bank. Products are therefore rather expensive¹⁶⁶, but a high demand at Manzil shows that Muslims in the UK are willing to pay these fees in return for obtaining a mortgage financing in accordance with the Shariah.

¹⁶⁵ Cf. WILSON (2002), p. 200.

¹⁶⁶ Cf. SCHÖNAUER (2003), pp. 21ff.

4.2.1.2 HSBC Amanah Finance

HSBC Group has established HSBC Amanah Finance in Dubai in 1998 with the aim to serve the United Arab Emirates' market with Islamic Banking products in both retail and corporate banking. In the meanwhile, HSBC Amanah Finance is present in Dubai, London (since 2003), New York, Riyadh and Kuala Lumpur. All products offered are supervised by an independent Shariah supervisory committee, which—for the UK—is composed of three scholars of the Islamic law, whereof two interestingly also form the Shariah board at Ahli United Bank, London, described above. On the side of retail banking, HSBC Amanah Finance offers Islamic house mortgages, based on the principles of Ijara. As it is typical for an Ijara contract, the client chooses the property, which he wants to buy, approaches the seller and agrees with the latter on a price. In a next step, the client applies to HSBC Amanah Finance for an Islamic house mortgage, where a financing contract is signed, if the client's application meets the required criteria.¹⁶⁷ HSBC Amanah Finance prepares the legal documents, which are sent to the client, who promises to lease the property from HSBC Amanah Finance, once he signs the HSBC Amanah Finance letter. Rent and on-account payments are due on the 25th of each month, when money is automatically collected from the client's interest-free HSBC Amanah bank account. Ownership of the property is transferred from HSBC Amanah Finance as soon as all on-account payments are made and when the tenancy is completed.

In the Middle East, Ijara and Murabaha financing have been extended to the financing of vehicles and other goods.¹⁶⁸ Although so far not offered in the UK, HSBC Amanah Finance provides Murabaha financing in the fields of corporate banking for the trading of commodities, non-precious metal, oil, textiles, machinery and goods made to order. For liquidity management purposes, products with short-term maturities similar to conventional treasury instruments have been invented. A short-term Murabaha programme for the financing of commodity trades, Islamic commercial papers and Islamic Sukuk (bonds offering returns dependent on the underlying risk of the product) are being offered.¹⁶⁹

4.2.2 Muslims in the UK

As opposed to Germany, the Islamic Banking market is much more established in the UK, because of the 19th century British colonial expansion, which led to far-reaching contacts to Muslim communities. First Muslim populations in the UK can be traced back 300 years.¹⁷⁰ Roughly 1.8 million Muslims are living in the UK, forming one of the most diverse Muslim communities in the world. About half of the Muslim population originally has a Pakistani or a

¹⁶⁷ Note: types of homes, that qualify for HSBC Amanah Finance are freehold domestic residential properties (no flats) in England and Wales, leasehold domestic residential properties with an unexpired lease term of a minimum of 50 years and the term of the finance and local authority right to buy properties; cf. U.A. (2004b).

¹⁶⁸ Information provided via e-mail by HSBC Bank Middle East Limited, January 9, 2004.

¹⁶⁹ Cf. U.A. (2004b).

¹⁷⁰ Cf. HALLIDAY (1992).

Bangladeshi background. The other half is composed of Muslims from the Middle East, Africa, Southeast Asia, Europe and the Caribbean.¹⁷¹ These communities developed—according to LEWIS (1994)—in four phases, “first the pioneers, then what is known as ‘chain migration’ of generally unskilled male workers, followed by migration of wives and children and finally the emergence of a British-born generation”¹⁷². Today, half of the Muslim population lives in London in a way that one out of eight Londoners is Muslim.¹⁷³ As opposed to Germany, where the majority of Muslims strive to be integrated in society by partly giving up their customs and practices, British Muslims generally aim at the opposite: they desire to keep up their faith and traditions in their daily lives and therefore actively demand to handle their finances in the sense of the Qur’an. This also applies to generations born in the UK. The advantage of Islamic Banking vendors in the UK is that half of the Muslims in the UK live in London, which facilitates to approach the community because of its concentration and renders product distribution easier. In addition, language barriers as an obstacle to get in touch with the Muslim community are invalid in the UK, since Muslims either grow up speaking English or have been taught English in their home countries. High product demand for the Manzil scheme and at HSBC Amanah Finance show that Muslims are interested in Islamic Banking instruments and are willing to exchange their interest-based loans for Islamic Banking credit products. In the UK, some Muslims donate their interest income, in order to purify the money. Overall, ANDREW HUXTON, former CEO at Barclays, estimates the long run potential market share for Islamic Banking products in the UK to be approximately 4 percent.¹⁷⁴

The British government is very favourable towards a development of Islamic Banking in the UK, which is underlined by a recently passed change of law rendering Murabaha financing more attractive. Since Murabaha property financing has been subject to a double taxation with stamp duty being paid, once the bank bought the property, and for a second time, when the bank transferred the property to its client, Islamic Murabaha transactions were at a disadvantage in comparison with conventional mortgage financing. In the spring of 2003, the British ministry of finance decided as the first Western country to repeal this double taxation, which automatically rendered Islamic property financing competitive with Western mortgages.¹⁷⁵ Similarly, data is currently being collected on the risk of Islamic mortgage structures, so as to review the risk weighting of such mortgages. So far, these products require—in the UK—a higher capital weighting than conventional mortgages.¹⁷⁶

¹⁷¹ Cf. U.A. (2002a), pp. 363-364; cf. ODRICH (2003a), p. 41.

¹⁷² LEWIS (1994), p. 17.

¹⁷³ Cf. U.A. (2002a), p. 368.

¹⁷⁴ Cf. SCHÖNAUER (2003), pp. 21ff.

¹⁷⁵ Cf. ODRICH (2003b), p. 45.

¹⁷⁶ Cf. U.A. (2003d).

5 Challenges and opportunities of Islamic Banking

5.1 Standardisation of accounting

Accounting in Islamic Banking is still characterised by a high degree of uncertainty and a lack of standardisation. However, due to the fact that Islamic economies are based on different considerations than Western economies, Western accounting standards cannot be accepted for the purpose of Islamic Banking.¹⁷⁷ According to TRIYUWONO/GAFFIKIN (1996), “accounting may be viewed as a means of reflecting reality. When reality is constructed in relation to ethical values, accounting should also be based upon the ethics. If not, the reality will be reflected in other presentations and in turn will mislead those, who are interested in it”¹⁷⁸. Therefore, a major reason for the refusal of Western accounting is the strong emphasis of ethics and social justice along with the avoidance of materialism in Islam. CRANE (1981) writes that “Western economists generally cannot conceive of any measure that extends beyond the material world, whereas Muslims generally cannot conceive of any measure that does not”¹⁷⁹.

Two Western accounting concepts, that are unacceptable for Islamic Banking, are described as examples in the following, in order to reveal the different train of thought in Islam: first, the German recognition-of-loss principle, including the lower of cost or market principle for asset valuation.¹⁸⁰ Whereas assets and revenues are not to be overstated, liabilities and expenses are not to be understated. In Islamic Banking, this rule would break with Shariah principles due to one of the most important religious duties of paying “Zakat”. Zakat is one of the five pillars of Islam and is to a certain extent comparable to Western tax. It is defined as “a means, where the well-off pay a set amount of their wealth. Zakat means to purify oneself. It is obligatory on Muslims to pay a small percentage [2.5 percent on accumulated wealth exceeding wealth necessary for personal use or consumption]¹⁸¹ of their accumulated wealth towards Zakat, which is used for the benefit of the needy and the poor.”¹⁸² An Islamic accountant is therefore prohibited to apply the rule of strict lower of cost or market principle, because understating assets would mean to reduce the amount of Zakat to be paid, which is regarded as acting socially irresponsible.

A second example of the non-applicability of Western accounting standards to Islamic Banking is the going-concern principle of Anglo-American accounting¹⁸³, which assumes that the audited business has a perpetual life. This is in general not applicable to Islamic Banking and

¹⁷⁷ Cf. RAHMAN (1997).

¹⁷⁸ TRIYUWONO/GAFFIKIN (1996).

¹⁷⁹ CRANE (1981).

¹⁸⁰ Cf. § 253 HGB.

¹⁸¹ Cf. HAQIQI/POMERANZ (1987); cf. CLARKE ET AL. (1996).

¹⁸² U.A. (2004n).

¹⁸³ Cf. IAS 1.24: an entity is a going concern, if it has neither the intention nor the need to liquidate or to cease its operations within at least 12 months from the balance sheet date.

in particular not to Mudarabah transactions, where contracts between the bank and the client are of a limited life and can be terminated from the client's side at any point in time.¹⁸⁴

As an approach to harmonise accounting standards for Islamic banks and to create international credibility in the industry, the "Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)" was established in Bahrain on March 27, 1991, when the Islamic Banking industry had officially decided that internationally accepted accounting and auditing principles could not be applied to Islamic Banking. Today, the AAOIFI is recognised as the main self-regulatory standard-setting organisation in this field and in the meanwhile, 50 standards published by the AAOIFI are in existence, dealing with issues of accounting, auditing, governance, ethics and Shariah-compliance. According to the AAOIFI's homepage, 23 countries with an overall 93 member institutions are represented, including Switzerland, which in return is represented by the Shamil Bank of Bahrain, as the only Western country. The AAOIFI itself has a Shariah board composed of 15 members, who consult different banks' Shariah boards on the interpretation of law, so as to achieve a higher degree of harmonisation, and who develop advanced Shariah-compliant financial instruments. Currently, the AAOIFI is planning to introduce the Certified Islamic Public Accountant programme, to take the industry further with well-trained personnel.¹⁸⁵

In summary, it can be said that the harmonisation and transparency of accounting principles is very important, in order for Islamic Banking to become an internationally respected and credible alternative mode of financing. It can help the Islamic finance industry to attract investors, who have been put off due to the fear of arbitrariness of accounting and a lack of transparency by financial institutions. It was shown that the adoption of accounting standards like the "International Financial Reporting Standards (IFRS)" does not fully fit the needs of Islamic Banking, because of the latter's strong focus on ethics derived from the Qur'an. However, the development of a proper accounting framework risks the isolation of the industry to its home countries. Rather, international standards should be applied as much as justifiable and smaller modifications should be made wherever necessary. This clearly promises a larger market potential for Islamic Banking worldwide while safeguarding Shariah-conformity.

5.2 Centralisation of Shariah boards

In order for Islamic Banking to keep up its expansion, the establishment of industry-wide accepted standards is indispensable.¹⁸⁶ A first such step was undertaken on November 3, 2002, with the foundation of the "Islamic Financial Services Board (IFSB)", headquartered in Kuala Lumpur.¹⁸⁷ The initiative for this foundation was taken by a group of governors, senior officials of central banks and monetary authorities of several Islamic countries, supported by the

¹⁸⁴ Cf. RAHMAN (1997).

¹⁸⁵ Cf. U.A. (2004o).

¹⁸⁶ Cf. DUDLEY (2003).

¹⁸⁷ Cf. U.A. (2004p).

IDB, the AAOIFI and the IMF.¹⁸⁸ The general objective of the IFSB is “promoting, disseminating and harmonising best practices in the regulation and supervision of the Islamic financial services industry”¹⁸⁹. Practices always have to be Shariah-conform with the standardisation of Shariah committee rulings being a major aim. So far, several Shariah boards sometimes ruled differently on the same issue.¹⁹⁰ To increase credibility, such divergence is to be avoided in future. At the same time, some banks do not have Shariah boards after all and consequently cannot guarantee that their Islamic products are Shariah-compliant. Therefore, a unified authority as represented by the IFSB to ensure Islamic product correctness in accordance with the Qur’an, the Shariah and the Sunna seems beneficial. However, such a centralisation of authority may not interfere with the independent status Shariah boards nowadays have. Three council meetings have been held since the foundation of the IFSB and the board is currently preparing two prudential standards on risk management and capital adequacy. Additionally, work on a new corporate governance standard is likely to start soon.¹⁹¹ The support of the IMF for the foundation of the IFSB underlines the importance of such a board. The IFSB can help to pave the way for the institutionalisation of Islamic Banking through the establishment of transparent structures.

5.3 The Basel Capital Accord

Since Islamic banks distinguish themselves from conventional banks in their ideally depositor-free capital structure, Islamic banks theoretically are not subject to capital adequacy regulation. However, because of investors’ risk aversion, Islamic banks today have savings and current accounts on their balance sheet’s liability side, amounting to approximately 20 to 40 percent of total liabilities.¹⁹² Depositors are consequently repaid the principle amount and a moderate return, leading to the conclusion that Islamic banks are concerned with minimum capital standards. However, the slightly different risk structure due to the existence of investment accounts needs to be considered.

The first uniform capital ratio standards were introduced by the Basel Committee of the Bank for International Settlements (BIS) in 1992 with the Basel Capital Accord, requiring a minimum capital standard of 8 percent.¹⁹³ Despite the abovementioned different conditions, under which Islamic banks operate, the Basel Committee did not specifically deal with the needs of Islamic institutions, which might have been caused by the fact that none of the Committee

¹⁸⁸ Note: current IFSB member institutions are Bahrain Monetary Agency, Brunei Currency Board, Central Bank of Egypt, Bank Indonesia, Central Bank of Jordan, Bank Markazi Jomhouri Islami Iran, Central Bank of Kuwait, Bank of Lebanon, Bank Negara Malaysia, State Bank of Pakistan, Qatar Central Bank, Saudi Arabian Monetary Agency, Bank of Sudan, Islamic Development Bank; cf. U.A. (2004w).

¹⁸⁹ U.A. (2004p).

¹⁹⁰ Cf. section 2.3.1.

¹⁹¹ Cf. HAUGSETH (2003).

¹⁹² Cf. HARON (U.Y.).

¹⁹³ Cf. HASSAN/BASHIR (2002), p. 12.

members is originally coming from an Islamic country.¹⁹⁴ In response, the AAOIFI, as introduced in section 5.1, has taken up the cause of Islamic capital standards beyond its original function to establish auditing principles. The AAOIFI published the “Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks” in March 1999, whose basic issue is the inclusion of assets, that are financed on a profit-and-loss sharing basis. The rationale behind this inclusion is to cover possible losses arising from misconduct or negligence in investment activities and thereby referring to typical principal-agent problems. Following the basic ideas of the Basel Capital Accord, the AAOIFI suggested the following formula for the capital adequacy ratio of Islamic banks:

$$CAR = \frac{OC}{W_{OC+L} * (OC + L) + W_{PSIA} * (0.5 * PSIA)}$$

where:	CAR	= capital adequacy ratio
	OC	= own capital (tier 1 and tier 2)
	L	= non profit-and-loss sharing deposits
	PSIA	= profit-sharing investment accounts
	W_{OC+L}	= average risk weight for assets financed by OC and L
	W_{PSIA}	= average risk weight for assets financed by PSIA

As in the Basel Capital Accord, the AAOIFI requires the capital adequacy ratio to be at least 8 percent. Assets financed from profit-and-loss sharing are weighted with 50 percent in the denominator.¹⁹⁵ In order to give an idea about the average risk weight for financed assets from the Council of Mortgage Lenders in the UK, Murabaha mortgage structures currently have a 50 percent risk weighting, which is said to decrease with the New Basel Capital Adequacy framework. Ijara is at a disadvantage with a current 100 percent risk weighting, but should be treated the same as Murabaha financing in the long run.¹⁹⁶ The criticism of the capital adequacy ratio remains that, while dealing with aspects of solvency, it ignores principal-agent conflicts, which are of particular importance for Islamic banks, whose investment account holders share losses arising out of such investment partnerships.

Overall, the Basel Capital Accord lacks to make propositions for the differing capital and risk structure in Islamic Banking. The adjusted capital adequacy ratio of the AAOIFI is apparently a sensible approach to consider these differences as long as the average risk weight for assets can be determined. However, principal-agent problems are not specifically dealt with. It is rather assumed that holders of investment accounts, who are aware of a higher inherent risk, are rewarded with higher returns on capital in the case of profitable projects.

¹⁹⁴ Note: Committee members are coming from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the US; cf. U.A. (2004q).

¹⁹⁵ Cf. MULJAWAN ET AL. (2002), pp. 8-10.

¹⁹⁶ Cf. U.A. (2003e), p. 2.

5.4 Financial engineering

Islamic finance, just like conventional finance, is obliged to develop new products, so as to provide clients with attractive investment choices and to keep up its expansion. Currently, investors do not have many possibilities of diversifying their Islamic portfolios and chapters 3 and 4 have shown that products have—particularly on a retail level—rather plain structures. To recall, simple Murabaha transactions still account for nearly 90 percent of Islamic banks' total business.¹⁹⁷ Therefore, the demand for financial engineering in the industry becomes more and more apparent, and some action was already taken in this field over the past years.

By definition, financial engineering refers to “either building complex instruments utilising basic building blocks or unbundling and repackaging different components of existing financial instruments with respect to return, price risk, credit risk, country risk, etc.”¹⁹⁸. In this definition, IQBAL (1999) distinguishes between product innovation and product re-engineering, so-called reverse engineering. Both innovation and reverse engineering bear certain advantages and disadvantages. As for innovation, new products represent an alternative, that has been derived independently of conventional finance techniques. Products are developed by Islamic economists or financial experts, for example from the AAOIFI, who guarantee the Shariah-conformity of products. However, innovation is more time-consuming, it binds research resources and requires the consistent commitment by experts. Examples of innovation in Islamic Banking are the modern versions of such classical Islamic products as Murabaha, Mudaraba and Ijara. Reverse engineering deals with the restructuring of “time-tested, well-established and standardised financial instruments”¹⁹⁹ and might thus win investors' confidence more easily by ways of recognition, triggering a faster integration of new products. But reverse engineering, in return, can also be interpreted as a lack of own creativity along with a shortage of theoretic foundations, whereof new products can be developed. Examples of reverse engineering include the derivation of Sukuks from conventional bonds and the introduction of the securitisation business to Islamic finance. In these cases, conventional financial products have been restructured, in order to derive an Islamic substitute, for example by eliminating their typical interest component.

When analysing Islamic Banking, it is obvious from the beginning that its concepts are largely based on its religious principles. A thoroughly grounded theoretical background, which would probably facilitate product innovation, cannot be detected, but should be approached for the purpose of general acceptance and understanding. KAHN (2003), CEO of HSBC Amanah Finance, remarks that “[...] research [is needed] to be carried out into developing an Islamic version of the M&M model, and in many other areas of Islamic finance such as risk management and securitisation, so that we can build the Islamic Banking industry on

¹⁹⁷ Cf. section 2.2.3.

¹⁹⁸ IQBAL (1999), p. 544.

¹⁹⁹ IQBAL (1999), p. 547.

sound theoretical foundations.’²⁰⁰ As for the standard version of the Modigliani-Miller (M&M) theorem, generally stating that a firm’s capital structure is irrelevant for the value of the firm²⁰¹, its basic assumption to distinguish between depositors and shareholders must be reviewed for Islamic Banking, as depositors referred to in the M&M theorem do not exist as such in Islamic Banking. Rather, they are—for the majority—substituted by investment account holders sharing in profits and losses.²⁰² Ideally, typical depositors cannot exist in Islamic Banking due to the prohibition of Riba and fixed returns on capital.

IQBAL (1999) believes that a mixture of innovation and reverse engineering is the most feasible solution in the short-run.²⁰³ An example of such a successful mixture of innovation and reverse engineering is the introduction of “Istijrar” at the end of the nineties, a product developed in Pakistan, which combines options and Murabaha. Like in a typical Murabaha contract, the bank buys raw materials or equipment for its client at a certain price. Additionally, both parties agree, when the contract is signed, on a predetermined Murabaha price as well as on an upper and lower bound around the bank’s purchase price with the upper bound being larger than the Murabaha price. At contract maturity, the price, that the client has to pay to the bank, depends on the current value of the underlying asset of the contract. If the asset’s market value is within the boundaries, the client pays the average price of the asset over the contract life. If market value falls below the lower bound, the bank exercises the option and the client pays the pre-determined Murabaha price, just like in the case, when the market value exceeds the upper bound.²⁰⁴

Therefore, Istijrar is innovative in the way that it takes price changes of the underlying asset into consideration, but limits losses and gains on both sides. Such a contract avoids any fixed return in the form of Riba and it avoids Gharar, because both parties involved know the Murabaha price and the boundaries of price movements up-front. Also, both parties are being offered an option.²⁰⁵

The Islamic finance industry has recognised the need for financial engineering, which is shown by the product range extension of the past years.²⁰⁶ However, a majority of products are reverse engineered from conventional finance, raising criticism of unoriginality in Islamic finance. In the long-run, Islamic Banking is challenged to create truly innovative products in order to solidify its competitiveness and to leave the slipstream of conventional finance.

²⁰⁰ KAHN (2003) in U.A. (2003e).

²⁰¹ Cf. ROSS ET AL. (2002), p. 406.

²⁰² Cf. U.A. (2003d).

²⁰³ Cf. IQBAL (1999), p. 548.

²⁰⁴ Cf. ISMATH BACHA (1999), pp. 10-12.

²⁰⁵ Cf. OBAIDULLAH (U.Y.).

²⁰⁶ Cf. KAMALI (1999), pp. 524-528.

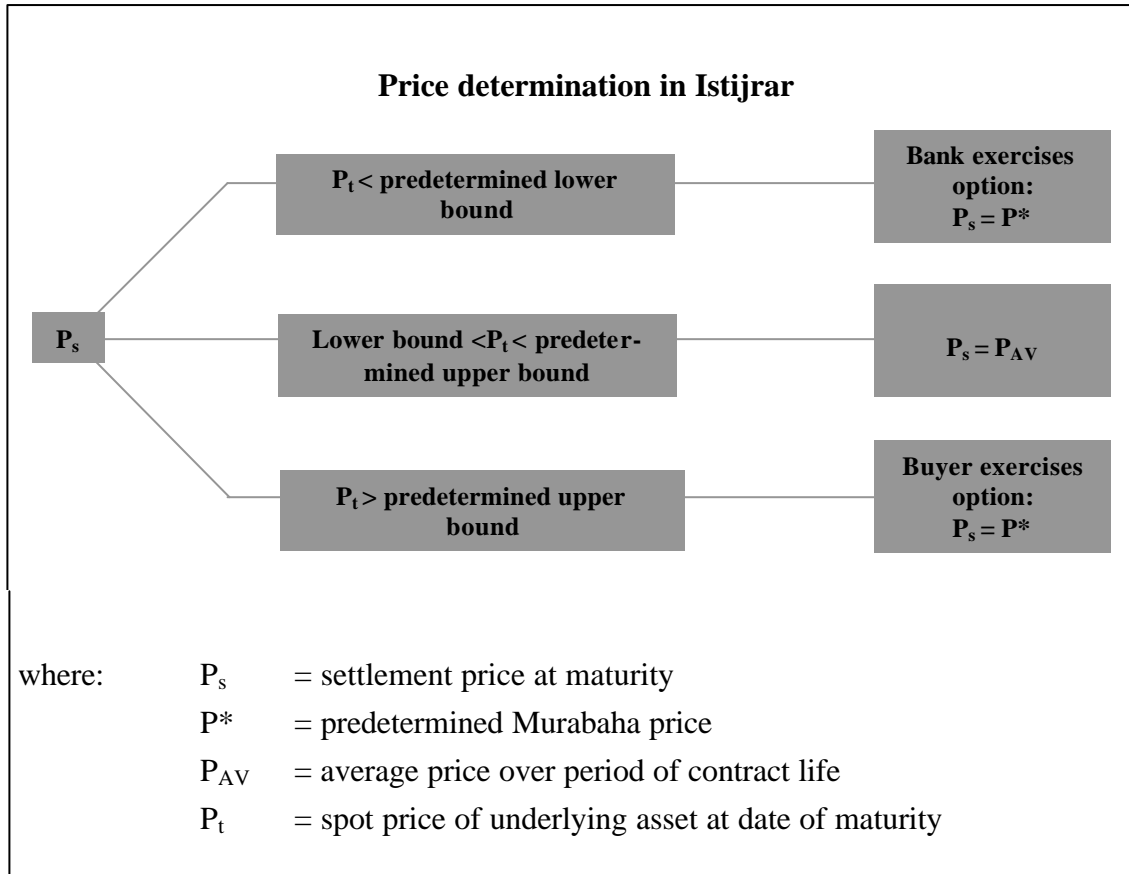


Figure 2: Price determination in Istijrar

Source: Ismath Bacha (1999), p. 11.

6 Conclusion and outlook

“The Islamic financial industry is already one of the fastest-growing industries and has great potential”²⁰⁷. The discussion in this paper has demonstrated that Islamic Banking is indeed in some countries, such as the UK, a powerfully developing market. However, our empirical research has also revealed that in Germany, Islamic Banking is still far from reaching its full market potential.

In 2001, the industry feared that its steady development could be threatened because of the terrorist attacks in the US on September 11. Experts forecast that Islamic Banking could erroneously be brought into disrepute.²⁰⁸ In fact, the opposite was the case, although Islamic Banking indeed was more in the public eye than ever before²⁰⁹. Capital invested by Muslims in the US did flow back to Arab countries due to the unproven accusations of money laundering for the purpose of terrorism financing. Arab businessmen instead feared that their æ-

²⁰⁷ IQBAL/LLEWELLYN (2002), p. 1.

²⁰⁸ Cf. KOPROWSKI (2001), pp. 9ff.

²⁰⁹ Cf. SCHÖNAUER (2003), pp. 21ff.

counts would be frozen in the US. This flow back of capital triggered an even faster development of Islamic Banking by both Islamic banks and Islamic windows of conventional banks in Muslim countries.²¹⁰

However, this paper also showed that—although Islamic Banking credit products account for the majority of transactions in Muslim countries—the industry is still a niche market outside of these countries with only a small, yet dominant, community of experts and providers. So far, the notion of “Islamic Banking” is still largely unknown in Europe. Although the Islamic mortgage market is prosperous in the UK, Islamic Banking credit products are by far not a field of business applicable in any country. As section 4.1 has shown, the German market does not seem to display a sufficient demand for a large-scale integration of Islamic Banking credit products. Rather, countries where such products are offered, like the UK, should have an active Muslim community, that is not only keen to keep up its religion and traditions, but that also wants to let its religious convictions influence its financial decisions and transactions. In this context, particularly Riba must be regarded as unacceptable.

As chapter 5 revealed, Islamic Banking still faces a number of challenges, that need to be overcome. The efforts of various organisations like the AAOIFI and the IFSB help Islamic Banking to foster through ways of the standardisation of principles applied and through the centralisation of institutions like the Shariah boards, in order to become a sophisticated and internationally recognised alternative to conventional finance. So far, Islamic Banking displays a high degree of fragmentation and undefined rules, that make investors feel uncertain. If some rules are not even clarified in Muslim countries, where people grew up with the corresponding religious background, then it is obviously very difficult to apply Islamic principles in countries, where there is little understanding of such principles. Also, one of the most important challenges of Islamic Banking is its need for financial engineering, as particularly in the credit business product offerings are limited.²¹¹ This is underlined by a statement from SHABSIGH (2002), senior economist at the IMF, saying that “growth [in Islamic Banking] will not succeed without a better innovation push”²¹². These innovations should be based on a researched theoretical background.²¹³

In the long-run, Islamic Banking should complement its product offerings, particularly in Western countries, where current offerings of Islamic Banking credit products are relatively low, with increased business in profit-and-loss sharing financing techniques. This is likely to raise the attention of corporate and institutional investors and to stimulate competition.²¹⁴

Altogether, Islamic Banking is still in its infancy but displays, if consistently and thoughtfully applied, a large potential for future growth. This growth potential is likely to be particularly

²¹⁰ Cf. U.A. (2002b). As for Islamic windows of conventional banks, money increasingly flows into Malaysia, Singapore, China and Hong Kong; cf. RICHARDSON (2002).

²¹¹ Cf. KASSEM (2002), pp. 10ff.

²¹² SHABSIGH in KASSEM (2002), pp. 10ff.

²¹³ Cf. IQBAL/LLEWELLYN (2002), p. 14.

²¹⁴ Cf. u.A. (2002b).

achieved in Muslim countries and in some major Western financial centres, like in London. It remains interesting to follow the developments of Islamic Banking and to observe, how innovation and theoretical research will be handled.

Bibliography

- AINLEY, M. (1997): Under a veil of regulation, in: *The Banker*, vol. 147, iss. 880/1997, pp. 73-74.
- AL-DARIR, S. (1997): Al-gharar in contracts and its effects on contemporary transactions. Islamic Development Bank Eminent Scholars' Lecture Series, no. 16. Jeddah 1997.
- AL-SUWEILEM, S. (2000): Towards an objective measure of Gharar in exchange, in: *Islamic Economic Studies*, vol. 7, nos. 1 & 2, October 1999/April 2000, pp. 61-101.
- AMERELLER, F. (1995): Hintergründe des „Islamic Banking“ – Rechtliche Problematik des riba-Verbotes in der Shari'a und seine Auswirkungen auf einzelne Rechtsordnungen arabischer Staaten. Diss., Berlin 1995.
- ARIFF, M. (1988): Islamic Banking, in: *Asian-Pacific Economic Literature*, vol. 2, no. 2/1988, pp. 46-62.
- AYUB, M. (2002): *Islamic Banking and Finance – Theory and Practice*. Karachi 2002.
- BHAT, V. P. (1999): Banking by partnership, in: *Financial Times*, July 22, 1999, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- BÄLZ, K. (2001): Islamic Banking, in: SIEBEL, U. (ed.): *Projekte und Projektfinanzierung*. München 2001, pp. 241-250.
- BÄLZ, K. (2003): Islamische Bankgeschäfte vor europäischen Gerichten, in: *Wirtschaftsforum Nah- und Mittelost*, vol. 6, iss. 1/2003, pp. 22-23.
- BANSMER, J./PFEIL, M. (2003): Zinsen verboten – Profit erlaubt, in: *Handelsblatt*, no. 184/2003, p. 22.
- BARTSCH, M. (2004): Zinsen für Ostdeutschland mit Allahs Segen, in: *die Tageszeitung*, no. 7263/2004, p. 8.
- BIELLENSTEIN, W. (2003): Sachsen-Anhalt plans 100m euro Islamic bond, in: *AME Info*, November 19, <<http://www.ameinfo.com/cgi-bin/cms/page.cgi?page=print&link=31341>>, date of retrieval: January 29, 2004.
- BUCKMASTER, D. (1996): *Islamic Banking – An Overview*. London 1996.
- CHAND, I. (2000): Sudan: Reforms aim to keep pace, in: *The Banker*, vol. 150 no. 894/2000, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- CLARKE, F./CRAIG, R./HAMID, S. (1996): Physical asset valuation and zakat – Insights and implications, in: *Advances in International Accounting*, vol. 9, pp. 195-208.
- CRANE, R. (1981): *Islamic commercial law in contemporary economics*. Embassy handbook, Washington 1981.

- DAR, H.A./PRESLEY, J.R. (2000): Lack of Profit Loss Sharing in Islamic Banking – Management and Control Imbalances. Economic Research Paper no. 00/24, Loughborough University 2000.
- DIEM MEIER, M. (2002): UBS will Allahs Dollars, in: FACTS, September 19, 2002, p. 80.
- DRUMMOND, J. (2000): Islamic banking – Interest is the deciding factor for Muslims, in: Financial Times London, October 26, 2000, p. 4.
- DRUMMOND, J. (2001): Financial reporting Islamic financial institutions – A risk-free return? – It's forbidden, in: Accountancy, April 30, 2001, p. 98.
- DUDLEY, N. (2003): Middle East & Africa: Islamic Banking – Structure is a necessary target – A new institution aims to set industry-wide standards for Islamic banking, in: The Banker, 2003, <http://www.findarticles.com/cf_dls/m3259/2003_May_1/102327273/p1/article.jhtml>, date of retrieval: February 2, 2004.
- EL-ASHAKAR, A. (1995): Towards an Islamic stock exchange in a transition stage, in: Islamic Economic Studies, vol. 3, pp. 79-114.
- FRANCK, K./PETZOLD, R./HENNIG-THURAU, T. (2002): Der Markt für nachhaltiges und ethisches Investment in Deutschland und Europa, in: HEHN, E. (ed.): Asset Management in Kapitalanlage- und Versicherungsgesellschaften: Altersvorsorge/Nachhaltige Investments/Rating. Wiesbaden 2002, pp. 33-48.
- GAFOOR, A.L.M.A. (1995): Interest-free Commercial Banking. Groningen 1995.
- GASSNER, M. (2003): Islamic Banking – Wachstumsmarkt für deutsche Banken, in: Die Bank, 11/2003, pp. 732-736.
- HABIB, H. (1989): Islamic banking – The basis of Islamic banking is to develop a system which excludes interest-based transactions and develop new financial instruments, in: The Banker, vol. 139 no. 759/1989, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- HALLIDAY, F. (1992): Arabs in Exile, Yemeni Migrants in Urban Britain. London 1992.
- HAMWI, B./AYLWARD, A. (1999): Islamic Finance – A Growing International Market, in: Thunderbird International Business Review, vol. 41, nos. 4 and 5, 7-10/1999, pp. 407-419.
- HAQIQI, A.W./POMERANZ, F. (1987): Accounting needs of Islamic Banking, in: Advances in International Accounting, vol. 1, pp. 153-168.
- HARON, S. (U.Y.): A comparative study of Islamic Banking practices, <<http://www.kaau.edu.sa/CENTERS/SPC/page-092.htm>>, date of retrieval: February 2, 2004.
- HARTMANN-WENDELS, T./PFINGSTEN, A./WEBER, M. (2000): Bankbetriebslehre, 2nd revised edition, Berlin/Heidelberg 2000.

- HASSAN, M.K./BASHIR, A.-H.M. (2002): Determinants of Islamic Banking profitability, <http://www.erf.org.eg/tenthconf/Financial_Markets_Presented/Kabir_Bashir.pdf>, date of retrieval: February 2, 2004.
- HASSOUNE, A. (2003): Key rating factors for Islamic banks, in: *The Banker*, 2003, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- HAUGSETH, C. (2003): Bahrain to host leading central bank governors for IFSB Council meeting, in: *AME Info*, 2003, <<http://www.ameinfo.com/news/Detailed/31701.html>>, date of retrieval: February 2, 2004.
- HENRY, C.M. (1999): Guest Editor's Introduction, in: *Thunderbird International Business Review*, vol. 41, nos. 4 and 5, 7-10/1999, pp. 357-368.
- IBRAHIM, B.-E.-D.A. (2003): Poverty Alleviation via Islamic Banking – Finance to Micro-Enterprises (MEs) in Sudan – Some lessons for poor countries. Discussion paper no. 35, Sudan Economy Research Group. Bremen 2003.
- INGSRISAWANG, C. (2002): Islamic branches get set for may opening, in: *Bangkok Post*, March 18, 2002, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- IQBAL, Z. (1999): Financial Engineering in Islamic Finance, in: *Thunderbird International Business Review*, vol. 41, nos. 4 and 5, 7-10/1999, pp. 541-559.
- IQBAL, Z./MIRAKHOR, A. (1999): Progress and Challenges of Islamic Banking, in: *Thunderbird International Business Review*, vol. 41, nos. 4 and 5, 7-10/1999, pp. 381-405.
- IQBAL, M./LLEWELLYN, D.T. (2002): Introduction, in: IQBAL, M./LLEWELLYN, D.T. (eds.): *Islamic Banking and Finance – New perspectives on profit-sharing and risk*. Cheltenham/Northampton 2002, pp. 1-14.
- ISMATH BACHA, O. (1999): Derivative instruments and Islamic finance: some thoughts for a reconsideration, in: *International Journal of Islamic Financial Services*, <islamic-finance.net/journals/journal1/art2.pdf>, date of retrieval: February 1, 2004.
- KAHF, M. (1999): Islamic Banks at the Threshold of the Third Millennium, in: *Thunderbird International Business Review*, vol. 41, nos. 4 and 5, 7-10/1999, pp. 445-460.
- KAMALI, M.H. (1999): Prospects for an Islamic Derivatives Market in Malaysia, in: *Thunderbird International Business Review*, vol. 41, nos. 4 and 5, 7-10/1999, pp. 523-539.
- KASSEM, M./GREIL, A. (2001): Islamic banking suffering fallout – Terrorist search hazards system already on rocks, in: *The Houston Chronicle*, November 11, 2001, p 5.
- KASSEM, M. (2002): Islamic banks face new challenges – Institutions must find ways to attract repatriated capital, in: *The Wall Street Journal Europe*, January 4, 2002, p. 10.

- KOPROWSKI, G.J. (2001): Islamic Banking is not the enemy – In fishing for Osama’s elusive millions, innocent banks may be caught in the dragnet, in: *The Wall Street Journal Europe*, October 1, 2001, p. 9.
- LERCH, W.G. (1994): Hort des Wuchers, in: *Frankfurter Allgemeine Zeitung*, February 25, 1994, p. 12.
- LEWIS, P. (1994): *Islamic Britain – Religion, Politics and Identity among British Muslims*. London 1994.
- MOORE, P. (1997): *Islamic Finance – A Partnership for Growth*. London 1997.
- MORITZ, F. (2001): Gottloses Geld – Für Moslems ist es schwer, sich an das Zinsverbot zu halten, <<http://www.zdf.de/druckansicht/0,1986,2000682,00.html>>, date of retrieval: January 29, 2004.
- MUKHTAR, A. (2001): Bai Murabaha (deferred payment sale) most commonly used financial instrument in Islamic banking, in: *Business Recorder*, January 5, 2001, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- MULJAWAN, D./DAR, H.A./HALL, M.J.B. (2002): A capital adequacy framework for Islamic banks – The need to reconcile depositors’ risk aversion with managers’ risk taking, <<http://www.lboro.ac.uk/departments/ec/Dept%20Research%20papers/Papers2002/13-02/HarvardPacificFinal4.pdf>>, date of retrieval: February 2, 2004.
- NIVATPUMIN, D.C.C. (2003): Islamic Bank takes investors’ interest, in: *Bangkok Post*, August 18, 2003, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.
- OBAIDULLAH, M. (U.Y.): Financial options in Islamic contracts – Potential tools for risk management, <<http://islamic-finance.net/netversity/articles/obaid2.html>>, date of retrieval: February 3, 2004.
- ODRICH, P. (2003a): Britische Banken entdecken die Muslime – Schariakonforme Hypotheken- und Finanzgeschäfte, in: *Frankfurter Allgemeine Zeitung*, September 5, 2003, p. 41.
- ODRICH, P. (2003b): Durchbruch für zinslose Hypotheken an Muslime – Als erstes westliches Land schafft Großbritannien Voraussetzungen für Islamic Banking, in: *Frankfurter Allgemeine Zeitung*, April 11, 2003, p. 45.
- OLFERT, K. (2001): *Finanzierung*, 11th edition. Ludwigshafen 2001.
- PREMCHAND, S. (1999): *Islamic Banking – An Introduction*. Zürich 1999.
- RAHMAN, S. (1997): *Islamic Accounting Standards*, <<http://islamic-finance.net/islamic-accounting/acctg5.html>>, date of retrieval: January 30, 2004.

- RICHARDSON, K. (2002): Muslims get an offshore fund – Islamic reinsurer offers insurance product in line with religious principles, in: *The Wall Street Journal Europe*, August 29, 2002.
- RICHTER, N. (2000): Ein Allah wohlgefälliger Fonds – “Lasset den Rest des Wuchers fahren”, in: *Süddeutsche Zeitung*, January 28, 2000, p. 12.
- RITTERSHOFER, W. (2002): *Wirtschaftslexikon*, 2nd revised edition. München 2002.
- ROSS, S.A./WESTERFIELD, R.W./JAFJE, J. (2002): *Corporate Finance*, 6th edition, New York 2002.
- RÖTTGER, J. (2003): Gottgefälliger Gewinn – Islam-Fonds verwalten weltweit über 200 Milliarden Euro, in: *die Tageszeitung*, March 31, 2003, p. 11.
- SAEED, A. (1996): *Islamic Banking and Interest – A Study of Prohibition of Riba and its Contemporary Interpretation*. Leiden et al. 1996.
- SAIFUDDIN, N.S. (2002): More local banks now offer Islamic products, in: *Business Times Malaysia*, 2002, p. 2.
- SCHÖNAUER, F. (2003): Experten rechnen mit zweistelligen Wachstumsraten in Europa – Islamische Banken auf dem Vormarsch, in: *Handelsblatt*, no. 19/2003, p. 21.
- SCHRADER, H. (1998): *Modernisation between economic requirements and religious law – Islamic Banking in Malaysia*. Working paper no. 306, University of Bielefeld/Faculty of Sociology. Bielefeld 1998.
- SPROTHERN, V. (2003): Kapitalanlage im Sinne des Propheten – Strenge moralische und ökonomische Regeln setzen Investoren enge Grenzen – Investmentfonds für gläubige Muslime, in: *Süddeutsche Zeitung*, April 16, 2003, p. 24.
- TRIYUWONO, I./GAFFIKIN, M. (1996): *Shari’ate accounting – An ethical construction of accounting knowledge*, <<http://islamic-finance.net/islamic-accounting/acctg4.html>>, date of retrieval: January 30, 2004.
- U.A. (1995): *Principles of Islamic Banking*, in: *Nida’ul Islam magazine*, vol. 10/1995, <<http://www.usc.edu/dept/MSA/economics/nbank1.html>>, date of retrieval: January 2, 2004.
- U.A. (2002a): *The situation of Muslims in the UK – Monitoring the EU accession process – Minority protection*. Open Society Institute 2002.
- U.A. (2002b): *Theoretische Betrachtungen im islamischen Finanzwesen*, in: *Neue Zürcher Zeitung*, September 14, 2002.
- U.A. (2003a): *Glossary: Islamic Banking 5*, in: *The Times London*, October 8, 2003, <<http://web.lexis-nexis.com/professional/>>, date of retrieval: January 12, 2004.

- U.A. (2003b): HSBC – Islamic mortgages attract interest, in: Datamonitor, July 2, <<http://www.datamonitor.com/~e38f79583f834cbfa981138a88aaf6e2~/all/news/product.asp?pid=8144CD76-BB7C-4D66-87B4-9AC203A0B457>>, date of retrieval: January 29, 2004.
- U.A. (2003c): Ahli United Bank B.S.C. Investment Update, <http://www.menafn.com/updates/research_center/Bahrain/Equity_val/global1203.pdf>, date of retrieval: February 1, 2004.
- U.A. (2003d): Drawing the roadmap for Islamic banking, in: The Banker Middle East, iss. 42, 12/2003, <http://www.bankerme.com/bme/2003/dec/islamic_banking.asp>, date of retrieval: February 1, 2004.
- U.A. (2003e): Basel Committee on Banking Supervision – Response by the Council of Mortgage Lenders to the new Basel Capital Accord – Third consultative document, <<http://www.bis.org/bcbs/cp3/coofmole.pdf>>, date of retrieval: February 1, 2004.
- U.A. (2004a): Shariah Rulings in Islamic banking and insurance – Glossary, <<http://www.islamic-banking.com/shariah/glossary.php>>, date of retrieval: January 2, 2004.
- U.A. (2004b): HSBC Amanah Finance, <<http://www.amanahfinance.hsbc.com>>, date of retrieval: January 2, 2004.
- U.A. (2004c): Leasing (Ijara), <<http://www.oicexchange.com/docs/leasing.pdf>>, date of retrieval: January 16, 2004.
- U.A. (2004d): Council of Mortgage Lenders welcomes encouragement for Islamic mortgage finance, <http://www.cml.org.uk/servlet/dycon/zt-cml/cml/live/en/cml/press_releases_2003_0409>, date of retrieval: January 29, 2004.
- U.A. (2004e): Islamic Banking, <<http://http://www.islamicity.com>>, date of retrieval: January 5, 2004.
- U.A. (2004f): Istisna'a mode of financing, <http://www.isdb.org/english_docs/idb_home/MFIstMod_Home.htm>, date of retrieval: January 16, 2004.
- U.A. (2004g): Akbank Niederlassung Deutschland, <<http://www.akbank.de>>, date of retrieval: January 27, 2004.
- U.A. (2004h): Isbank annual report 1999, <http://www.isbank.com.tr/english/report99_25_e.html>, date of retrieval: January 27, 2004.
- U.A. (2004i): AlSukoor European Equity Fund, <<http://www.alsukoor.de>>, date of retrieval: January 22, 2004.
- U.A. (2004j): Albaraka Türk, <<http://www.albaraka.com.tr>>, date of retrieval: January 23, 2004.

- U.A. (2004k): Asya Finans, <<http://www.asyafinans.com.tr>>, date of retrieval: January 23, 2004.
- U.A. (2004l): Kuveyt Türk, <<http://www.kuveytturk.com.tr>>, date of retrieval: January 23, 2004.
- U.A. (2004m): Helping you to buy your home in accordance with Islam, <<http://www.iibu.com>>, date of retrieval: January 25, 2004.
- U.A. (2004n): Zakat, <<http://islamingeneral.8m.com/pages/zakat.htm>>, date of retrieval: January 30, 2004.
- U.A. (2004o): The Accounting and Auditing Organisation for Islamic Financial Institutions, <<http://www.aaofi.com>>, date of retrieval: January 30, 2004.
- U.A. (2004p): Islamic Financial Services Board, <<http://www.ifsb.org/index.php>>, date of retrieval: February 2, 2004.
- U.A. (2004q): The Bank for International Settlements, <<http://www.bis.org>>, date of retrieval: February 3, 2004.
- UPPAL, J.Y. (1999): Risk and Return of Mudarabas – Empirical Evidence from Pakistan, in: Thunderbird International Business Review, vol. 41, nos. 4 and 5, 7-10/1999, pp. 561-582.
- USMANI, M.T. (U.Y.): Forward Sales and Manufacturing Contracts: Salam and Istisna, <http://www.albalagh.net/Islamic_economics/salam_istisna.shtml>, date of retrieval: January 16, 2004.
- WIENEN, I. (1999): Impact of Religion on Business Ethics in Europe and the Muslim World – Islamic versus Christian Tradition. 2nd revised edition Frankfurt et al. 1999.
- WILSON, R. (2002): The interface between Islamic and conventional banking, in: IQBAL, M./LLEWELLYN, D.T. (eds.): Islamic Banking and Finance – New perspectives on profit-sharing and risk. Cheltenham/Northampton 2002, pp. 196-212.