
European Challenges for Islamic Banks

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The paper briefly review the growth in Islamic Finance, implications of the Islamic banking in Europe and challenges to be met, in terms of compatibility with local banking markets, product development and strict anti-money laundering rules. The paper analyses also the hawala remittance system and the negative association with the Islamic banks. This type of funds transfer is often related with illegal remittances, money laundering and financial crime. As acting as European banks, newly established in Europe Islamic banks, as new comers, will have to face the critics about their possible link with terrorism support and money laundering.

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Introduction

Every religion, irrespective of time, has played an important or even a critical role in the development of the society and also in the economic activity. The understanding of religion is often distorted by the outsiders' eyes. This is the case of Islam and linked to it is also the understanding of Islamic Financial Services (IFS), which are more and more seen as a particular threat for the Western civilization. Islamic Financial Services came to the attention of the economists, investors and analysts, as the Islamic banks started to open in Europe, targeting Muslim and non-Muslim population.

Islamic banking, and generally Islamic Financial Services are a growing phenomenon, which came into existence to meet the needs of the devout Muslims around the world, who have the main wish to observe the Koran and Sunne.

More than 40 years ago the first Islamic bank Mit-Ghamr was established in Egypt and 15 years ago Iran and Pakistan opted for Islamic banking System. In the last decade, a large number of Islamic banks or Islamic financial institutions were emerged in many countries. As a result of the increased interest in this large transactions, many Western banks started open their branches or subsidiaries in Islamic countries. Following the experience gained in the previous years, there is no doubts that non-interest based financial transactions are viable and feasible, and more and more interesting for western investors.

There is a generally well accepted fact, that Islamic Financial Services Industry (IFSI) is the fastest growing component of the financial services industry, in terms of the availability of the new products and also in the geographical spread. Islamic banking clients are not limited only to Middle East areas, but they are spreading across Europe, Asia and the US.

Currently, the IFSI consists of the following types of institutions:

- a) Islamic banks ,including full-fledged Islamic banks, Islamic subsidiaries and “Islamic windows” of conventional banks
- b) Islamic insurance and reinsurance companies or *takaful* and *re-takaful* operators
- c) Islamic capital markets
- d) Islamic non- bank financial institutions, including Islamic leasing, factoring, finance companies, Islamic microfinance companies, etc.
- e) Islamic financial infrastructure including settlements systems, regulators and supervisors, rating and external assessment

institutions

At least 75 countries have institutions performing Islamic Financial Services on their territory. The world Muslim population is approximately 1.6 billion ¹and Islam is considered to be the fastest growing religion in the world. So, the very high-speed development of the Islamic Financial Services could be explained by the size of the market on the one hand and by the increasing wealth of the regions dominated by Islam, i.e. Middle East.

The current assets in Islamic Banking segment alone are estimated at over \$ 500 billion. The annual market capitalization of the stocks meeting the Dow Jones Islamic Market Index Criteria in Islamic countries is estimated at \$ 300 billion. Corporate and sovereign *Sukuk* bonds amounting to around \$18 billion² have been issued till present day. The growth and development is more spectacular taking into account that in the '90s the IFS were in a nascent stage of its formation.

This rapid growth shows the demand for Islamic financial products in the global financial markets and consequently the demand for such services increased.

The IFS offered previously for retail business, expanded to new areas like private equity, structured products, project finance or mutual funds. For some countries the share of Islamic banking assets in total banking assets is still at very low level, despite the very aggressive development, with a penetration level of 15 up to 22%. The five countries with the largest Muslim population in the world: Pakistan, Indonesia, Egypt, Bangladesh and Turkey are still at very low level of development of the Islamic financial industry. For some countries the ratios of the IFS are improved by the large international players like, Citibank, UBS, HSBC, Deutsche Bank or BNP which entered recently into these markets.

¹ Information downloaded on 6th September 2007 from www.islamicpopulation.com

² Information downloaded on 1st October 2006, from www.lmc Bahrain.com

All have entered the sector within last 10 years and their move coincides with the rise in oil prices, as it happened 3 decades ago. Islamic Financial Institutions bloomed when the oil boom ensured them wealth.

Religious fervor and oil prices are on the rise again and now many western bank or companies are highly interested to do banking business in accordance with Shari'ah and to attract millions of potential clients.

On the other side there are Islamic banks opening branches or subsidiaries in Europe or US, and they are "forcing" the authorities to find some ways to integrate these services into the global financial system.

To the requests for the acceptance of these new types of financial institutions we shall add the more concerns for ethical investments of a large community in the world, which are similar to the Shari'ah concerns of the Islamic finance.

Many financial products were developed and meet the specifications of investments in ethical products or socially responsible services. The optimists consider this like a precursor of the shape and form of global finance in the coming decades. It is true that there are a lot of conventional banks, similar with the Islamic banks, which do not enter in business partnership with companies involved in activities like gambling, prostitution, alcoholic liquor, narcotics, etc. There is no international financial institution which will agree to grant loans to banks which will credit such a/m activities and ethical and socially responsible finance are becoming popular in the Western world (Wilson, 1997).

But, speaking at present about globalization and assimilation of the Islamic banks by the conventional ones, I consider being too early. As more and more we hear about Ethical finance in the western world,

we should consider Islamic investments as a potential opportunity to the conventional financial services.

When analyzing majority of the products, we notice common features for both types of systems and the final result is basically the same. The client receive a credit card in a conventional or Islamic mode, leasing or *ijara* is the final result, the same in case of *sukuks*. Like in the limited case of conventional banks, not extended to Islamic ones, the banking products are almost all “invented” already. It will harder be to develop a new product. But the difference is done by the marketing and targeted clients, as far as all products have the same basic features.

Islamic Finance, Shari’ah Principles and AML

When speaking about Islamic banks, Islamic Fund, *Sukuk* (Bonds), *takaful* (Islamic insurance), the discussions seem to gravitate to one issue, namely the Shari’ah guidelines or Shari’ah principles.

However, the Islamic financial markets do not deal with Divine rules alone and the operational aspects of the Islamic markets can be considered.

Shari’ah principles are applied to all aspects of the Islamic life, including financial services, enabling individuals and companies to adhere to these principles in their investment activities. We can summarize the list with the main requests of Shari’ah:

- No interest (*riba*) will be charged or paid. Avoidance of interest has been abused by those who merely seek to be considered Islamic bankers. Many convert interest into capital gains and find a Koranic justification. The rules were tightened progressively as they have been in tax avoidance.
- Avoidance of risk (*gharar*), means that trading of risk or sale of something not yet obtained, must be avoided

- Trade related business only will be financed .There are western similar instruments, involving commercial papers and bankers' acceptance, which also have to be trade related. We must mention here that many of the developing countries, having strict exchange control regimes, insist that all overseas financing or foreign exchange transactions to be trade- related.
- Part of the income must be given to charity (*zakat*)
- An ethical investment, meaning that investments in certain activities are not permitted (*halal*).These includes production of alcohol, tobacco, pork, gambling and weapons.
- The concept of profit sharing business is the base of each credit contract.
- The principles are religious and generally are concerned how the income is generated, wealth's distribution in society or how the profit and loss are shared.

The Islamic principles of sharing risks and rewards, joint partnership in the wealth creation by lender and borrower, through substituting equity for debt, is a possible positive solution that promotes entrepreneurship and creativity. Usually this model is transformed into a partnership through risk sharing and sharing of the profit and loss.

It doesn't mean that investments with financial institutions are necessarily speculative. More than that, Islamic banks are structured to retain a different status between shareholders' capital and clients' deposits, in order to ensure correct profit sharing according to Islamic principles. Islamic investors are motivated in their choice of investments by almost the same criteria as their western counterparts. The search for acceptable investments is balanced by natural risk-aversion. In the same way, Islamic borrowers also have a reluctance to give away a share in the profits of their enterprise. The most Islamic banks take the form of one type mark-up or other, rather than profit sharing.

Investing according to Shari'ah principles requires trained scholars, with a good understanding of Islamic Law and very good knowledge of the financial markets.

Another requirement is standardization of the accounting and auditing principles. The Accounting and Auditing Organization for Islamic Financial Institution (AAOFI) has about 140 members from 30 countries and developed 68 standards, including 30 Shari'ah standards. However, as it is explained in the recent documents of Islamic Research and Training Institute¹, there is still more to be settled, as far as Shari'ah is an interpretative law that has variance among countries and people. At present, there is no Islam-wide authority that says what is *haram* (prohibited) and what is *halal* (accepted) and like in the Western banking moving from one tax jurisdiction to another, the Islamic product developers can go from one scholar to another to get the approval of their product, as it is compliant to Shari'ah.

In addition to normal audits, Islamic banks have to conduct Shari'ah review of their transactions and to check the compliance. It is supposed they will see any funds used for prohibited activities. Unfortunately this beneficial feature was not yet widely disseminated and used as a tool for the prevention of the money laundering.

As the Islamic banks are engaged in partnerships with their clients, within the profit-loss sharing framework, they have to know their clients, their sources of funds and their business. Thus, the Islamic banks are in a better position to identify and prevent the suspicious transactions of their clients.

In the last few years were many articles, opinions, etc related to the *Hawala*. I would like to describe it with more details for a better understanding of the link of *hawala* with the anti money laundering guidelines and also with the Islamic banks, if any links with the last ones exist.

¹ Ten-year Framework and Strategies ,Islamic Financial Services Industry Development, A Joint initiative of IRTI and ISDB, 2007, downloaded from www.irti.org on July 2007

Hawala was originating in the Middle East and means in Arabic “transfer”. We may say that hawala was practically the first banking system established by the Phoenicians and then used by the Jewish immigrants in Europe. Hundreds of years ago, merchants were forced to hide and to transfer their wealth in more secure regions and they started to establish a trust-based network. Many experts believe that *hawala* was established in the modern era by the immigrants, sending money from Europe or from Dubai and Bahrain in their countries in Asia and Africa. The system was also used to avoid bans on gold imports into South-East Asia. This system was developed and improved and now we can say *hawala* is an informal, parallel, illegal remittance system based on honor and performance among a large network of dealers, which are primarily located in Middle East, Asia and Africa. In many countries, like India, Sri Lanka, Philippines and Bangladesh, the system was eradicated.

When comparing a bank transfer with *hawala*, anybody from the Muslim users can say the system is trustful, timesaving and costless.

In this system, a client gives an amount of money to a dealer and also the details referring to the recipient. The *hawala* dealer contacts another dealer in the city and country, where recipient is located and gives deposit instructions for the funds. He also retains a small commission and promise to effect the payment at a later date.

There is no written document in the transaction, which is merely done based on honor than on documents. For most people, despite the existence of a multitude of banks, either conventional or Islamic, *hawala* is a convenient, fast, cheaper and safe remittance system.

Today, most of the *hawala* transactions are taking place in the rich Middle East countries, by sending money to the Asian countries, origin countries for most of the immigrants. The reason for domiciling most of the *hawala* transactions here is that there is a large population of expatriates workers and because especially Dubai is the large gold market for India and Pakistan.

Irrespective how efficient or trustful would be *hawala* put a shadow from the AML point of the credibility of the banks operating in these countries. Quite often we've read opinions (Ramachandran, R., 2007) related to the close link of the Islamic banks with *hawala*, which logically it does not make any sense as far as the banks and *hawala* are "competitors" on the transfer funds market.

There are of course operations, which can indicate the existence of a *hawala* transaction. This bank operation can be done not only using Islamic banks, but conventional banks for some certain transactions. In the paper¹ published by Interpol General Secretariat on January 2000, there are detailed explanations of the routes, mode and even registrations of the *hawala* operations.

After carefully analyzing all these procedures, I couldn't prove any link with the Islamic banks, except the case when the initial transfers to the first *hawala* dealer are routed through a bank, which we must say could be a conventional or an Islamic one. The first transfer should be identified as a money laundering operation as the amount is unusual for the previous activity on the account, if it is not a document based payment, if the account shows a significant deposit activity previous to the transfer, mainly in the form of cash or checks. All these indicators can appear in a conventional or Islamic account and there is no difference in the obligations of the compliance officers to report the suspect transaction.

So, anti- money laundering in the sense of the fight against any activity which refers to "cleaning" of the profits generated by illegal activities has to be regulated in any country.

Know your customer (KYC) is a term used for the customer identification process which helps banks or any financial institutions to identify and prevent suspicious transactions.

¹ Jost, P, Sandhu, H.S., "The hawala alternative remittance and its role in money laundering", published by Interpol General Secretariat ,Lyon, 2000

Banks are aware about AML and KYC policy and they implemented strict controls for money laundering.

As it results from the detailed analysis of the Islamic banking products, due to the specific requirements for considering “*halal*” transactions, we may say that Islamic banks should have more abilities to know their clients than conventional banks.

When Islamic banks start to establish in Europe, they have to know that they have to obey the AML rules, already established by the international banking community. As Michael Foot, Managing Director of the UK Financial Services Authority mentioned¹ “There will also need to be the usual guards against misuse of a bank for purposes of financial crime and terrorism. But I see no reason why the conditions they will need to be met for shari’ah compliance need to be more difficult than for a conventional bank the key task of ”knowing your customer” which is at the heart of most good safeguards for banks against financial crime.”

European Challenges of the Islamic Financial Services

Growing Muslim communities internationally has led to the request for more Islamic banking services. Much progress was made in UK for launching Islamic products from an UK authorized and established Islamic bank. This is expected to be followed by similar initiatives among 20 million Muslims in Europe, US and Canada. UK made important steps in making allowances such as abolishing the double stamp duty on Islamic mortgages. In Europe the main challenge will be to make the Islamic mode of financing widely accepted among a constituency which transcends Muslim communities. Still the main concern is the European countries like Germany or France is either

¹ Michael Foot, Managing Director of the UK FSA, Second International Islamic Finance Conference Dubai, Sept.2003,downloaded from www.fsa.gov.uk on 23rd July,2007

not interested or even reluctant to agree with the establishment of the Islamic financial institutions despite the fact that as Khan (1986) noted, the appearance of interest-free based transactions are not an alien subject for western economies.

The global Islamic finance sector is growing year by year. Islamic banks are able to offer new and innovative products, but there are challenges to be met, especially when they have to compete in Europe with international sophisticated and experienced banks. Definitely, the Islamic banks had a fierce competition in their own countries, as many international banks open “Islamic windows” there, but the challenges they have to face are mostly the same in their origin countries or in Europe (I would say even more in Europe, and I’ll explain later on):

- Shortage of experts in Islamic banking, I refer here to executive specialists not to scholars
- Tax regimes not meeting the needs of Islamic products
- Lack of uniform rules in credit analysis
- Lack of relevant of accounting and auditing standards for Islamic banks. Basel II and IFRS changes will act as catalysts to improve the quality and consistency of disclosure of the Islamic financial institutions.
- Enhancement of product development, according to the market needs, taking into account the offers of conventional banks. I insist on the fact that Muslim population in Europe, having at least a medium living standard level, applied already to conventional banking products. They opened accounts in European banks, because they needed it and they did not wait for a potential establishment of an Islamic bank. We do not have to forget the 2 generations families living in Europe, who were using the conventional banking services for many years. It is quite difficult now, irrespective of their religiosity, to shift to another bank without comparing the cost, the quality and diversity of

services of the two banks. Management of the Islamic banks in Europe and not only have to be more creative, developing product variations and enabling their banks to compete with their conventional peers.

- Improvement of corporate governance and risk management. Worth to be mentioned here that definitely Shari'ah board should be totally separated by the Risk Committee.
- Shortage of Shariah scholars. Shari'ah principles are set forth by qualified religious scholars. There are estimations of the existence of about 250 clerics, and they have to provide to all Islamic financial institutions support to product development according to Shari'ah rules. General practice states at a Shari'ah committee consists of three or more scholars, but in fact these scholars, due to their limited number serve more committees. Therefore, Shari'ah clerics need more trained scholars that combine an understanding of Islamic law, Islamic economics and global financial markets
- Strict Anti-Money Laundering rules, which have to be observed

In his paper¹, Sayyid Tahir noted as a challenge innovation to create “financial instruments yielding stable income flows for orphans, widows, pensioners and other weaker segments of the society.” Like in other papers or articles, there are mixes among the challenges for the Islamic banking and those of Islamic religious institution. In my opinion there is clearly a need for separating the social life's requests from those of banking or, generally Islamic financial services. For the above mentioned issue, the Muslims and not particularly those dealing with the banking sector, have a specific instrument “zakat”, which is used and must be used by every religious Muslim. Including this issue on a

¹ Sayyid Tahir is professor of Economics in Islamabad .His paper “Future of Islamic Banking” was prepared for the course on Islamic Banking in Tehran, on 2-6 March 2003

list with possible challenges will complicate more the Islamic banking system, adding to it components which belong to social assistance activity and not banking.

Conclusion

There is a certain need for designing the new financial architecture of Europe, which should promote the strong infrastructure for better global integration of both conventional and Islamic finance. Both types of institutions will have to work together with the supervision and regulatory bodies, national or European, for ensuring a free, fair and transparent market. Providing banking services in conformity with Shari'ah rules will enhance the accessibility of a significant part of population to financial services and should have positive implications for social justice and economic development.

Due to their specificity, Islamic banks need to invest more in their research for new products in order to ensure a proper financial risk management, resource mobilization at a competitive price and a proper balance sheet management through securitization.

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