

# How serious is the Erudite Shariah-compliant Business in Europe? Evolution, Pivotal Challenges and the way forward

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## Abstract

Traces the historical milestones of Islamic banking and finance into Europe. Showcases the evolution of the erudite way of Islamic banking over the years while concentrating on active European Islamic finance markets i.e. France, Germany and United Kingdom. Also, critically analysis the current practices of Islamic financial institutions in the said markets. Lastly, identifies some of the pivotal challenges facing Islamic banking industry and its future prospects in the region.

**Keywords:** Shariah-compliant, Europe, Well-versed Advisors, Comprehensive Shariah Framework

## 1. Bank and Banking

A healthy and vibrant economy requires a financial system that swiftly moves funds from people who save to people who have productive investment opportunities. Financial sector is considered to be the backbone of any country economy. Though the financial system has a complex structure yet, it channels funds from savers to productive investors through a range of diversified institutions comprising banks, finance and insurance companies, mutual funds, bond and stock markets etc. Therefore financial intermediaries and financial markets play a significant role in the economic development of any country (Casu et al., 2006).

Financial markets perform the essential economic function and offer direct finance alternative opportunities for lenders and borrowers to transact openly (Mishkin, 2007). Financial claims (such as bank deposit accounts, bonds, loans, life insurance policies, money, shares, etc.) are generated on such markets where the lender holds the borrower's financial claim and said to hold a financial asset while, the issuer of the financial claim is said to have financial liability (Casu et al., 2006; Mishkin, 2007). Majority of the investors prefer short-term lending with higher returns whereas, borrowers demand long-term cheap liabilities. This leaves the gap, which can be bridged by a bank as they said to be borrowing short – typically, deposits are low-risk, small-size and highly liquid and lending long – loans are high-risk, large-size and illiquid (Casu et al., 2006; Mishkin, 2007).

### 1.2. Origin of Banking

Financial intermediaries such as banks are the lubricants which make a financial market run better. According to Mishkin (2007) financial markets will not be able to move their funds across the economy without banking system. The historical roots of banking run deep. Banking is considered as old as human society. Forever since man came to realize the significance of money as medium of exchange, the obligation of a controlling or regulating agency or institution was naturally felt (Gomez, 2011).

Gomez (2011) claims that the religious temples in ancient Babylon were in banking business as early as 2000 B.C. The temples were used to store gold and other precious assets since they were well-built and considered to be safe. Furthermore, there are extant records of loans from 18<sup>th</sup> century B.C. in Babylon that were made by the temple priests to merchants at high rates of interests.

There is no one agreed upon definition of bank as banks perform different functions across the world. In general, a bank<sup>1</sup> is said to be a full service intermediary financial institution whose core business is to increase economic efficiency by endorsing a better allocation of available financial resources (Casu et al., 2006). The bank performs such an intermediation function by accepting deposits (surplus capital) from savers and allocating the same to both individuals and corporates with deficit of funds (Casu et al., 2006; Mishkin, 2007). Hence bank is a collecting and paying agent, which deals with money. Nonetheless, contrary to the aforementioned banking mechanism, there exists yet another way of banking.

## 2. Islamic Finance

Islamic financial system that has emerged in the last four decades or so offers a different standpoint on the said relationship. Nawaz (2013, p. 226) have opined that Islamic finance can no longer be dismissed as a passing fad or as an epiphenomenon of Islamic revivalism. Islamic banking is one of the most blossoming doctrines in the global economic system as a result of globalization, dramatic changes in political-economic environment and Islamic resurgence – a new generation of Islamic finance which is more innovative and diverse is emerging as the doctrine is undergoing a new aggiornamento. The fast growing awareness about Islamic financial system (Interest-free) has brought strong feelings to the Islamic financial experts to confront the conventional (Interest-based) economic cycle. The Islamic economic system is rising as a reliable substitute to the current interest based system. Where an Islamic bank is defined as:

*a full service intermediary financial institution that abides by the Islamic law which is derived from Qur'an – the holy book of Muslims and Sunnah (the sayings and actions of the Holy Prophet Muhammad PBUH). The most prominent features of Islamic finance are interest-free banking – collection or payment of interest is not permissible and profit/loss sharing based financing. Additionally, Islamic banks are co-governed by the Islamic-religious leaders (advisers) who identify the religiously permissible transactions – for instance it does not invest in; gambling, alcohol, armaments, tobacco, and pornography and so on and so forth (Nawaz and Goj, 2013, p. 311).*

### 2.1. An Islamic Standpoint on Banking

The Islamic stance on banking is somewhat different. Islam and money have been rubbed together for more than 14 centuries (Plews, 2005), this led Islam to lay down certain rules in connection to the nature of money and its use – prohibition of *riba*<sup>ii</sup> (known as interest in the conventional financial system) is one prominent example. However, Muslims are allowed to bank with conventional (interest-based) financial institutions subject to the unavailability of a better (religiously permissible) option. Shariah<sup>iii</sup> law – the legal code of Islamic jurisdiction provides guidance to determine and apply Islamic principles of finance. All those financial intermediaries seeking to be perceived as an Islamic financial institution or conventional banks offering Islamic banking facilities through “*Islamic-window*” are obligated to abide by the Shariah law in terms of their financial activities (Plews, 2005).

## 3. Europe and the Erudite way of Islamic Banking

*Islam all too often resonates negatively in Europe, with a great part of non-Muslim public opinion uncomfortable with Islamic culture and values. Secular and Christian opinion is at best suspicious of Shariah – the Islamic law, and indeed often antagonistic. The notion of wanting to apply Islamic principles to banking and finance is treated with skepticism if not outright hostility, especially as there is no concept of Christian or Jewish banking, even if there are some parallels between Shariah financial principles and the teaching of the Old Testament. Yet Islamic finance is thriving in Europe, and many major European banks perceive it as a profitable opportunity to generate new business rather than as a threat to existing business (Wilson, 2007, p. 1).*

During the nineteenth century, most of the Muslim world was controlled by the colonial powers from the West. These powers brought the Muslim world into a Western-imposed economic order for which it was ill-prepared (Warde, 2000). In the last decade of nineteenth century, European commercial banks decided to cater these occupied Muslim territories. In an attempt to process the financial transactions related to the Suez Canal construction, Barclay Bank opened a branch in Cairo back in 1890s. It is considered to be to be the first commercial bank established in the Muslim world (Islamic Development Bank, 2007).

On the other hand, Wilson (2007) maintains that the European banks first engaged with the Gulf region about a century ago. In the 1920s, the Eastern Bank – predecessor of Standard Chartered Bank proposed a branch on the Island of Bahrain. The permission was subject to the elimination of all interest based transactions. That is when the European banks had to encounter demands for Islamic finance. Simultaneously, under the same condition – avoidance of all interest based transactions, the National Handelsbank of the Netherlands – predecessor of ABN-Amro received approval in Saudi Arabia. The bank established itself in Jeddah, to provide money exchange facilities to the Dutch-Indonesian pilgrims. Ever since, the Western financial system has kept Islamic financial system as dormant (Malik *et al.*, 2011). Most of the European and local banks based in the Muslims countries

were adopted to conventional (interest-based) banking system until, the fourth quarter of the twentieth century. All the business transactions took place during that period were interest-based, backed by the local authorities, as religion believed to be had no role to play within the financial system (Wilson, 2007). Nonetheless, there have been a revival of interest of late (Malik *et al.*, 2011). The perceptions of European bankers started to change in the early 1970s, mainly as a result of the emergence of Islamic banks in the Muslim world. Dubai Islamic Bank became the first fully-fledged Islamic bank to be established in United Arab Emirates in 1974, followed by the Kuwait Finance House in 1977 and the Bahrain Islamic Bank in 1978 (Nawaz, 2013).

In a metaphorical way, due to the emergence of Islamic banking, traffic of financial knowledge transfer between East and West have become two-way rather than simply a one sided affair (Wilson, 2007). Banks operating in the Gulf region have been importing most of the conventional financial products from their European counterparts in the past, now the situation has turned the other way around. European banks are importing Shariah compliant products and services from the Muslim world, to cater their overseas Muslim clients, as well as for the growing Muslim population of Europe. Wilson (2007) observes that banks operating in Europe have as much to learn from the Muslim counterparts as the latter have from Europe as interdependence replaces dependence.

### **3.1 Muslim Population in Europe**

According to the Pew Research Centers' Forum on Religion & Public Life (2011) Muslim population in Europe has increased from 29.6 million in 1990 to 44.1million in 2010 – about 6 per cent of Europe's total population. The projected estimate for Muslim population in Europe by 2030 is 58 million and it will account for about 8 per cent of the total population of Europe. According to the report, top three European countries with highest number of Muslims are France (4.7 million, 7.5 per cent of the overall population), Germany (4.1 million, 5 per cent of the overall population) and the United Kingdom (2.9 million, 4.6 per cent of the overall population) respectively.

## **4. Shariah in Action: Reflections from European Financial Markets**

The following section analysis the evolution of Islamic banking and finance industry in Europe over the years. Historical developments, present market situation and future trends in Islamic banking and finance in the region are highlighted. Islamic banking and finance activities in the leading countries (e.g. France, Germany and UK) are discussed in the following section. Additionally some of the niche markets for Islamic finance business are also identified.

### **4.1 United Kingdom**

#### *London: Western Hub of Shariah-compliant Business*

The United Kingdom has been the gateway for Islamic banking to enter Europe (Wilson, 2007). London has earned itself a status as the leading international Islamic financial centre in the West (Baba, 2007; Wilson, 2000). It has attracted major Islamic banks, partly due to the breadth of specialist financial services offer, but also as a consequence of the exposure of leading British banks to the Arab and wider Islamic World. Good reputation of British banks and their depth knowledge of these markets are amongst those additional factors. Geographically being near to the Middle East with a convenient time zone is yet another advantage for London over New York (Baba, 2007). In addition to that, there exists no language barrier either, thanks to the long historical connections with the UK, majority of the bankers and businessmen speak English as their second language (Wilson, 2000).

#### *4.1.1. Development of Islamic Banking in the UK*

The success of pioneer Islamic banks in the Gulf region grabbed the attention of many in the West. These Islamic banks were extensively involved in Shariah-compliant trade finance and their success was mainly, driven by the sky-high oil prices during the same period (Warde, 2000; Nawaz, 2013). However, it laid the cornerstones for Gulf's expertise in Islamic banking and finance business.

The United Kingdom is the only European country that has fully Shariah-compliant Islamic banks. There are five fully-fledged Islamic banks operating in the UK, comprising, one retail Islamic bank and four Islamic Investment banks.

The UK regulator – the Financial Services Authority (FSA) granted first banking license for the Islamic Bank of Britain (IBB) in August 2004 (Islamic Bank of Britain, 2013; Kay, 2004; Wislon, 2005). Second bank approved

by the FSA is the European Islamic Investment Bank (EIIB) on January 2005 (European Islamic Investment Bank, 2013). In July 2007, FSA approved the third Islamic bank named the Bank of London and The Middle East (BLME). Additionally, BLME is also the first Islamic bank authorized by the FSA, to offer its products and service across the European Union state members without being physically present in the host country through – the EU Passporting. In other words, the EU Passporting, allows an Islamic bank to “*passport*” its products and services to an estimated 15 million potential customers across the EU (FSA, 2007). Fourth approved Islamic bank is The QIB (UK), which got approval in January 2008. The last approved Islamic investment bank is the Gatehouse Bank (GB), which opened its gates on 21<sup>st</sup> April 2008. All of the aforementioned banks are fully-fledged Islamic banks offering a range of retail and investment banking products and services based on Shariah principles.

Additionally, several conventional banks offer an extensive range of Islamic financing services, ranging from private banking, mortgages, house and car financing to Islamic project and trade finance, and investment banking (Baba, 2007). The abolition of double-stamp-duty in 2003, encouraged many conventional banks to offer Islamic finance facilities i.e. HSBC Amanah (2004) and Lloyds TSB (2005) are the pioneering conventional banks to offer Shariah-compliant products and services in the UK (Malik *et al.*, 2011; Khan and Bhatti, 2008; Wilson, 2007). Referring to the inception of pure Islamic banking in the UK, Wilson (2007, p. 4) have opined that “It is a challenge for a new entrant such as the Islamic Bank of Britain to compete in a mature market for banking services with the major conventional banks offering Islamic products, notably HSBC, through its dedicated – Amanah Islamic finance division and Lloyds TSB”. Yet over the years IFIs have been handling these market pressures quite well and thriving in the market.

#### 4.1.2. Future Outlook of the Britain Islamic Finance Market

Wilson (2007) is of the view that Islamic banking has always been backed up by the ordinary Muslims and that development of Islamic finance industry can be regarded as a populist movement rather than an initiative from governments – it is with no doubt that retail banking dominated the Islamic financial activities (Wilson, 2005). For instance, leading Islamic banks around the world (e.g. Dubai Islamic bank of UAE, Al Rajhi Bank of Saudi Arabia, Kuwait Finance House, and Bank Islam Malaysia) primarily offered retail, private and personal banking solutions (Wilson, 2005). In Europe, Islamic finance has adopted the same – a bottom up rather than a top down movement (Wilson, 2007).

After the end of colonialism in 1947, many Muslims migrated or continued residing in Britain. The estimated Muslim population in Britain in 1971 accounted for 1 million. The figure speaks for itself. It is evident that there has always existed a large potential market size in the UK for Islamic financial services (Malik *et al.*, 2011). There are about 3 million Muslim residents in Britain (Pew Research Center, 2011) most of whom are British national and have been born in the country. In general, the typical Muslim family is twice a size of an average UK family (Wilson, 2000).

Great Britain stands alone in Europe, with five fully-ledged Islamic banks. Much of the financial activities of these banks are subject to corporate finance and investment banking rather than personal or retail banking as one (Islamic Bank of Britain) out of five is a retail Islamic bank.

Islamic retail banking is primarily focused to cater the high net worth individuals – the alternate target of the bank is to generate large amounts of capital from these individual investors to improve their liquidity ratios. It is evident from the fact that in an attempt to attract the petro-dollars of Middle Eastern sheikhs, the Islamic Bank of Britain established its office in Mayfair – the most expensive area of London, inhabited by multi-billionaires Muslims who usually, spend their summer in London (Malik *et al.*, 2011).

Despite the fact that United Kingdom has an active and well-established financial sector in the whole Europe nevertheless, most of the financial activities until recently, have been subject to the role London as global financial hub, rather than catering the retail banking needs of the local Muslim community (Wilson, 2007). Baba (2007) have opined that London has earned itself the status of a global ancillary center for Shariah-compliant business booked in London, mainly by those residing in the Muslim countries, especially, the Middle Eastern region. London is the third-largest market for Islamic finance, following the Muslim powerhouses, the Middle East and Malaysia. The first secondary market, outside the Islamic world in Sukuk (the Islamic bond) has been established in London. Muslims from across the world are investing in the UK real estate and in other assets through this market (Oakley, 2009). All such hard-edged facts allow the prediction that the City of London will maintain its position as a European hub for IBF in the years to come for two basic reasons. First, because

London is not yet, threatened by any other European competitor and second, the UK government and the financial regulators are in full support of Islamic finance.

#### *4.1.3. UK-Government Initiatives to Promote Islamic Finance*

The effect of the UK Banking Act 1987 brought some swift changes at retail banking level. It brought an end to the dominance of the big four – Barclays, Lloyds, Midland Bank and NatWest and a consequence external retail organizations such as Marks and Spencer, Sainsbury and Standard Life insurance entered into the banking business (Wilson, 2000).

In principle, there has been absolutely no objection to the notion of an Islamic financial institution by the UK regulators on its patch – as stated by the Chairman of FSA (Davies, 2002). Those living in Britain have full freedom to choose the way they conduct their commercial activities providing, no conflict with the law. The government has a crucial role to play in the sustainability and further development of Islamic banking and finance (IBF) within the United Kingdom. Abolishment of double stamp duty and the Finance Acts of 2003, 2005 and 2006 are amongst those serious steps taken by the UK government to show its commitment towards IBF (Malik *et al.*, 2011). The EU Passporting is yet another milestone. As mentioned earlier, the FSA (FSA, 2007) authorized Bank of London and The Middle East (BLME) to cater about 15 million Muslims residing in the European Union (EU) without being physically present in the respective countries.

#### **4.2. France**

According to some of the commentators France has the largest Muslim population in Europe, between 6 to 7 million, at present (Paris EUROPLACE, 2011). However, the recent census conducted by the Pew Research Center (2011) counts that Muslims in France are over 4.7 million. Majority of the French Muslims are immigrants primarily, from the former French colonies in North Africa particularly, from the countries across the ocean – Morocco, Algeria and Tunisia.

Despite the largest Muslim community with an increasing demand of Shariah compliant services – the French financial sector has little to offer. Although French banks operating in the gulf region are quite active in Islamic banking and finance industry and have strong roots in the region, yet, they seem to have no plans on catering the local French Muslims. One possible reason is the French apprehensiveness about introducing Shariah law in their social framework – as religion is not involved in everyday life (Paris EUROPLACE, 2011; Rauf, 2011). Thus far, there exists no fully Shariah-compliant financial institution in France though; some conventional banks are active in Islamic finance on a limited scale. Additionally, few Middle-eastern based banks such as Al Baraka Banking Group, Kuwait Finance House and Qatar Islamic Bank are offering Islamic finance products through their French subsidiaries. However, none of these banks is yet, active in Islamic retail banking.

##### *4.2.1. Recent Developments and Future Prospects of Islamic Finance in France*

Nonetheless, the French authorities are taking some serious measures as they realize the obvious benefits of Islamic financial services for the French banks and businesses alike (Hassoune and Haladjian, 2008). In an initial attempt to establish a conducive environment for Shariah complaint business, the French authorities – Autorité des marchés financiers (AMF) and Paris Europlace has approached the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) based in the Kingdom of Bahrain. Paris EUROPLACE was authorized by the Ministry of Economy, Finance and Industry to coordinate the Islamic banking and finance development in France. In 2009, it signed a contract with AAOIFI, which enacts legal, accounting and finance standards for IBF in France (Paris EUROPLACE, 2011). The AAOIFI is currently working with the French regulators to translate certain Shariah laws and standards into French language (Schönenbach, 2011).

Additionally, Paris is determined to be the hub for Islamic banking and finance outside the Muslim world and to topple London in Shariah-compliant business (FIIF, 2012). Furthermore, the French legislation poses no obstacles specifically, tax implementation on IBF products (Schönenbach, 2011). Hassoune and Haladjian (2008) are of the view that the nature of French law is sufficiently open and flexible. A few give or take adjustments are required to accommodate Islamic finance principles.

The French economy has already gone under recession since the beginning of this year. In such tight economic conditions, France sees Islamic finance as a rescuer with more than US\$1.5 trillion of assets. Therefore, France's



prime interest in Islamic finance is to benefit from this market segment in such a way which could result in improved economic conditions in the country. To fill in this purpose, it has to extend and deepen its relationship with the Muslim world through improved cooperation and friendship. Since business is a powerful vector, therefore, one needs to learn the language of her/his partner to communicate freely, as not always expect them to speak one's own (Moody's Investors Service, 2009).

#### **4.3. Germany**

Germany represents the second highest Muslim population in Europe. According to the Pew Research Center Report (2011) 5 per cent of the overall German population consists of Muslims. A population of 4.2 million young Muslims three-quarters of whom are under the age of 49, majority (74%) considering themselves to be spiritual, along with a significant rate of savings which accounts almost the double of the national average (18% against 10%) and 35 billion Euro (US\$ 50 billion) of wealth makes Germany a potential market for Islamic Banking & Finance (Booz & Co., 2008; Kern, 2011). Especially this group of the Muslim society stands as a potential target for Islamic financial products and services in Germany.

A keen interest (74%) in Islamic financial products has been shown by the German-Muslims in a recent survey, while even a higher (94%) interest was shown if these services are provided by a fully-fledged Islamic bank (Booz & Co., 2008). According to the estimations, the potential for Islamic finance products stands at 1.2 billion Euros; however, so far less than 5 per cent of the German-Muslim community uses Islamic banking products (Booz & Co., 2008).

Despite the largest and strongest economy in Europe with a higher Muslim population in absolute numbers Germany, like France lacks way behind than the United Kingdom in Islamic finance business. There is not a single fully-fledged Islamic retail bank active in the German financial market, till to date. Caused by least interest of the German authorities and tax and, regulatory issues, a few structured Shariah-compliant products are available at some of the conventional banks or through the branches of some International Islamic banks.

In July 2004, German Federal State of Saxony-Anhalt raised a 100 million Euros through an issuance of five years Sukuk (Askari, Iqbal and Mirakhor, 2009; Stimpfle, 2011; Wilson, 2007). It was the first Western government issued bond and was heavily marketed in the Middle East (Ahmad, 2010). Additionally, Deutsche Bank is actively present in Islamic finance business since last three decades with its dedicated offices around the Middle Eastern region including, Bahrain, Egypt, Saudi Arabia and United Arab Emirates. However, the bank is not catering the local German Muslims and it is not active on the Islamic finance side within the country.

In the most recent event, the German Federal Financial Services Authority (BaFin) authorized Kuveyt Turk Participation Bank in 2010 and issued a limited banking license to operate in the country. The license is subject to the money transfer only – not a full banking license. The prime target is the Turk Muslim population. The bank has established a representative office in Mannheim, Germany since early 2011. Under this license, the bank is authorized to collect investment funds and deposits in Germany. Further these funds are transferred into profit-and-loss-sharing accounts established in the name of the respective investors and depositors in Turkey.

##### **4.3.1. Challenges facing Islamic Finance in Germany**

Despite the 4.2 million Muslim population, there exists not a single Islamic bank in Germany. All those involved somehow in Shariah-compliant business are merely concentrated on their overseas clients and are least concerned with local Muslim community needs. Consequently, Islamic finance has failed to make its mark in the German financial market so far. Most of the commentators hold the regulatory authorities responsible as they are not showing any flexibility particularly, with regards to the tax relaxation – double stamp duty on some specific modes of Islamic finance. As a result the Islamic financial products appear to be expensive as compare to their conventional counterparts. The German government has so far not announced any tax relieves to accommodate Islamic finance unlike the French and the Britain authorities.

#### **4.4. Niche Markets within Europe**

Other than these major players discussed above, there are some niche markets as well for Islamic finance in Europe, where Islamic banking does exist in some form. i.e. Albania (e.g. Arab Albanian Islamic Bank; ICB Banking Group), Belgium (Moroccan Chaabi Bank) and Switzerland (Faisal Private Bank). Some additional

potential markets are Italy, Scandinavian and Eastern European countries, which are hosting a handsome amount of Muslim communities. However, in synthesizing the above discussion, the prime focus of all those financial institutions be fully-fledged Islamic banks or conventional banks with *Shariah-window* is to target the wealthy investors to fulfill their liquidity needs not to focus on the layman. On the other hand, the European authorities are also not that serious about Islamic way of banking as they are too busy in tackling the Euro-zone-crisis. The effects of the recent financial crisis are still lively in Europe as many European economies are still on stake i.e. Greece, Spain, Portugal, Italy and France. Hence, European financial markets including major banks are busy in building China-wall against them in order to protect themselves in case of worst case scenario and are not able to afford the luxuries such as Islamic banking, at the moment with UK an exception, which is relatively performing better due the pound as separate currency.

## 5. Pivotal Challenges Facing Shariah-compliant Business in Europe

A closer look at the Shariah supervisory boards of all those Islamic financial institutions operating in Europe stem the fact that same Shariah scholar is advising various banks, which are competing in the same market. This evidence that there is an acute shortage or well-versed Shariah interpreters or scholars, which is one of the most prominent challenge facing Islamic finance industry in general and European Islamic finance industry in particular. Before walking the argument further, it is imperative to define the role of Shariah Supervisory Board within the settings of an Islamic financial institution.

In general, all those financial institutions – fully-fledged Islamic banks, Conventional banks or Insurance companies offering Shariah-compliant products are obligated to have their own independent SSB – which usually, consists of three or more members permanent board members (Schönenbach, 2012; Nawaz and Goj, 2013). The role and responsibilities of these intellectuals is discussed in the following section.

### 5.1. Board of Islamic Intellectuals: Duties and Responsibilities

The prime obligations of SSB includes of but not limited to; advising on some specific issues with reference to Shariah. Such advice is needed when the bank is in a process to engineer a newly financial instrument or financial product. Once the initial structure of the product is finalized, the proposal is sent to the SSB for their approval before launching the same into the market (Kettell, 2011; Nawaz and Goj, 2013). The approval process consists of several stages and varies from one institution to another. The duties of SSB is not limited to the approval of the product or financial instrument alone, once the bank is in business through an approved Shariah-compliant tool, it is the duty of the SSB to closely monitor the whole process till end. Shariah audit is yet another obligation of SSB to satisfy the stakeholders – as it does not operate as *ex-post* compliance medium (Schoon, 2010; Kettell, 2011; Nawaz and Goj, 2013).

Islamic financial institutions have their own independent Shariah Supervisory Board (SSB), which usually consists of three or more permanent members (Kettell, 2011). However, most of the conventional banks with Shariah-window especially, those operating outside the Islamic world does not have a permanent SSB. Such banks hire independent Shariah consultants instead when it is required.

As stated earlier, although the Islamic banking and finance is experiencing an unprecedented rate of growth at present yet, one of the challenges facing IBF industry is the shortage of Shariah scholars well versed in Shariah matters as well as in modern banking (Iqbal and Mirakhor, 2007). Consequently, it is not surprising to identify the same person sitting on different Shariah boards. Schoon (2010) justifies this issue as so that each institution may claim strong endorsement to enhance the credibility of the institution's practices. Especially in the case of those Islamic financial institutions operating in Europe. However, the hazard or threat posing such board composition is that it creates asymmetric of information. As such board members have inside information which is not made available to both sides of the transaction.

Such board composition provokes yet another structural challenge that is adoption of a comprehensive Shariah standards. For instance, in Europe, France opted for the AAOIFI standards while Luxembourg is inclined towards the IFSBI standards (Islamic Financial Service Board based in Kuala Lumpur). The systems of the GCC and Malaysia are different in method and judgments. In Malaysia, the government assigned a Shariah-high court whose judgments are binding for all Malaysian Islamic financial institutions. This system avoids diverging standards for same products and therefore avoids discussions on whether or not specific products are Shariah-

compliant or not. While in the GCC, each financial institution chooses its own Shariah-board. As there is no higher authority, judgments can differ depending on the scholars sitting on the board.

The Malaysian system is very efficient and easier to handle for companies, the GCC system allows for the diversity of opinions to coexist and the possibility of each company to choose the Shariah-scholars that their clients trust to be authorities in their field. Sheik Nizam Yaqubi, one of the top ten Shariah-scholars world-wide, stated at the *World Islamic Finance Conference* that 90 per cent of all Shariah-judgments are coming to the same conclusion and that diversity of the rest is in no way a significant problem (Schönenbach, 2012).

Hence, Islamic financial institutions are in need of a standardized Shariah framework. An agreed upon comprehensive Shariah framework will not only help Islamic bankers to work well in an efficient manner but it will also provide a base upon which new standards for Islamic finance industry as a whole can be developed.

Nonexistence of a comprehensive Shariah framework further exposes Islamic financial institutions (IFIs) to Shariah non-compliance risk, which is fatal and unique to Islamic banks alone and reputational risk, which is more important for Islamic banks as it is tied to the reputation of Islam as well. Therefore, even the name used for Shariah-compliant business – the "*Islamic-banking*" is jeopardizing Islam as a whole, intentionally or unintentionally. A single misconduct by a bank will ruin the reputation of Islam at large and give bad name to this religion. Thus, a name switch is suggested. Ethical-banking is one of the most suitable substitute names for Islamic-banking. Other possible alternatives include but not limited to Welfare-banking, Societal-banking, and Community-banking etc. In addition, the language or terms used to describe various products and modes of Islamic finance are pure Arabic. This creates yet another problem for those with non-Arabic backgrounds to understand the tools of Islamic finance. Even if such names may appear and sound fascinating, yet, investors demand a language, which is clear and easy to understand. Also, it gives the impression that such type of banking is subject to Muslims alone that makes Islam a conservative religion that is contrary to the basic teachings of Islam.

The next issues in line is that most of the IFIs are exclusively focused on catering the high net worth individuals. The core concern of these elite investors is to gain above average returns on investments without violating their religious obligations. Hence, the products offered are tailored according to the needs of each individual. Thus, there is no one uniform policy to be followed. In this way, the whole phenomenon of Islamic finance is on stake as many products are adopted from conventional banking system and tailored or labeled as Shariah-compliant. As a matter of fact such replication of conventional products is yet again putting not only Islamic banking on stake but Islam as a religion as well. Other challenges include minimal disclosure – including intellectual capital disclosure (Nawaz and Goj, 2013) practices of IFIs, which generates asymmetry of information in the market and has direct effect on the customer intellectual capital (RIC). Due to the limitations set here, it is not possible to cover all of the issues in the current settings. Nonetheless, if the effort provokes any potential intellectual to address the aforementioned issues then the purpose of this paper is achieved.

## **6. Future Outlook of Shariah-compliant Business in Europe**

### ***6.1. Projected Muslim Population in Europe***

As projected by the Pew Research Centers' Forum on Religion & Public Life (2011), majority of the European Muslims will keep living in Eastern Europe, however, a huge increase in Europe's Muslim population in absolute numbers is expected to occur in Germany, France, Italy, and the UK and some other countries in Western, Northern and Southern Europe (see Figure 1).

#### **Figure 1: [Insert about here]**

This increase will primarily be driven by the continued migration in Western and Northern Europe, where the Muslim population will reach double-digit. For instance, in 2030 the Muslim population as a percentage of the total population, in Austria is projected to reach 9.3 per cent, Belgium 10.2 per cent, France 10.3 per cent, Germany and the UK around 8.2 per cent (Pew Research Center, 2011). In synthesizing the above argument, despite the aforementioned potential threats facing Islamic finance business in Europe, there exists a bright prospect for Islamic finance. As mentioned earlier, the Muslim immigrants will still flow into Europe in the coming years whereas the local Muslim population is also on the rise. This indicates a future demand for Shariah-compliant retail and investment products and services within Europe. Islamic financial institutions need to come up with such a strategy that is customer oriented on retail level and not just focused on high-net-worth individuals alone. A combination of both will be the best suitable solution, where potential clients are attracted



through innovative products and services while the existing customers are retained though improved quality of services offered.

## 7. Conclusion

An acute shortage of human intellectual capital (HIC), which in terms of Islamic finance is the lack of well-versed Shariah scholars (advisors), is one of the most significant challenges facing Islamic finance industry. Second, there is a need for a comprehensive and standardized Shariah-framework to strengthen the structure of Islamic finance. Third core issue is the customer focus as most of the Islamic financial institutions particularly those operating in Europe are exclusively focused on catering the high-net-worth individuals rooted in the Arabian Peninsula and ignoring the needs of those local Muslims residing in Europe. Thus, Islamic financial institutions need to improve their human intellectual capital (HIC) stock. By doing so, banks will be able to utilize their structural intellectual capital (SIC) and systems in an efficient manner which will result in improved customer services (RIC) quality.

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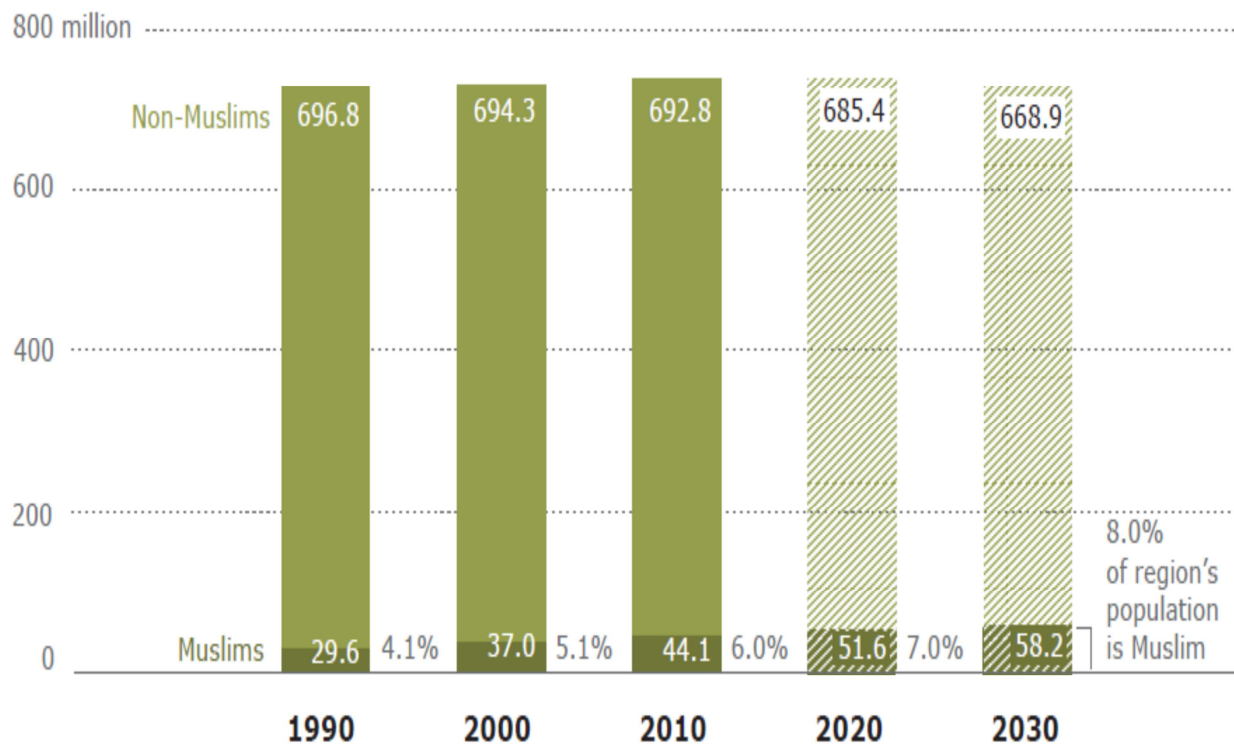
## Notes

<sup>i</sup> BANK is derived from the word BANCO which means an accumulation of either stock or money. In 1157, at the establishment of Bank of Venice, Germans were influential in Italy. According to some commentators, BANK is derived from the German word BANCK which means, joint stock funds meaning – a heap or mound. Later on, when the Germans occupied major part of Italy, the word BANCK was Italianized into BANK. Another believe is that Bank is derived from BANCUS or BANQUE which means a bench. It refers to the ancient times, where Jews use to conduct their money exchange business in Lombardy at the market place sitting on benches. In case, if the banker does not meet the obligations, the same bench was broken into pieces and that led to the origin of the word ‘bankrupt’ (Gomez, 2011).

<sup>ii</sup> Generally, riba refers to any predetermined payment over and above the actual capital (Kettell, 2011). In other words, any increase in the principle amount of money charged by the lender constitutes riba (Warde, 2001).

<sup>iii</sup> Islamic religious law primarily, derived from the Holy Qur’an and Sunnah (Nawaz, 2013).

**Figure 1:** Projected Distribution of Muslims as a Share of Overall Population (1990-2030)



**Sources:** Pew Research Center's Forum on Religion & Public Life (2011, p. 121) The Future of the Global Muslim Population: Projections for 2010-2030.

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