The EU and the GCC: Challenges and Prospects under the Swedish EU Presidency

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Islamic Banking and Finance and Its Role in the GCC-EU Relationship: Principles, Developments and the Bridge Role of Islamic Finance

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Islamic Moral Economy: An Introduction

Islamic Banking and Finance (henceforth IBF) emerged in the 1970s as a part of the larger paradigm of Islamic moral economy (henceforth IME), which is a modern definition of divinely ordered rules and principles related to economic and financial activities, instruments, contracts and choices. The ontological and epistemological sources of these principles are enshrined in the Holy Book of Islam, namely the *Qur'an*, and in the sayings (*hadith*) and the traditions (*sunnah*) of the Prophet Muhammad.

The practice of Islamic financing and business, in different ways, mechanisms and magnitudes, continued to exist throughout the centuries in the periphery of the Muslim World without any institutionalization until the 1970s. With the creation of independent nation states, the economic and financial systems of the Muslim countries were constructed in a manner dependent on Western practices, norms, instruments and institutions. However, due to the failure of economic development in the Muslim World in particular and in the developing world in general until the 1970s, with a modernist understanding, an identity search through constructivist attempts was made to find the Islamic equivalent of modern institutions, including economics and finance. Thus, as part of identity politics, the term 'Islamic economics' was coined to define the economic and financial sphere in the Muslim world by essentializing the particular behavioral norms peculiar to Muslims as instructed in Islamic teaching; and it aims at creating a human centric economic development policy as opposed to the materialistic development strategies offered by capitalism and socialism, which were considered as failed and deemed as 'foreign' to the value system of the Muslims.

Against the rationalist, self-maximizing and efficiency-oriented capitalist market economy, IME emerged to stress the importance of moral behavior in the market place by filtering the market mechanism to produce socially optimal economic choices in which social justice was claimed to be the essential element. Thus, with such construction emphasis comes the expected shift from a neo-classical notion of efficiency to a morally informed equity. Consequently, in addition to the normative principles found in the Qur'an, with the positive and normative principles derived from the tradition and sayings of the Prophet Muhammad (*sunnah*), a new economic and financial paradigm has been attempted in its modern version.

It is the 'moral economy nature' of this construction that distinguishes it from conventional finance and banking, as it aims at producing disciplined or morally filtered economics and financing which should not lead the individuals, but rather should be led by individuals as regulated by the moral economy principles of Islam. In other words, by making direct and strong reference to moral economy, which implies particularly 'social justice', 'growth with purification', 'harmony with natural and social environment', 'allocation of resources according to social priorities alongside financial ones', and the 'prohibition of interest', IME is a novel mechanism of looking at economic and financial reality.

While it is true that unprecedented achievements have been made in the development of the IBF sector over the last 35 years,[1] it is now a fact that Islamic finance opted out of the identity politics of IME in the 1990s following the influence of internalization and globalization. In addition to the impact of globalization, particularly choosing 'commercial banking' as a model, the IBF sector now focuses on efficiency and profitability rather than 'social justice' and 'growth with harmony,' representing a convergence to conventional finance. While this should be considered as an important source of global recognition, such a shift in paradigm and operation is also due to the overwhelming power of the global financial system, as IBF has now become a 'hybrid' or 'heterogeneous' product of global financial systems rather than the product of a particular value system, namely Islam. Thus, Islamic finance no longer has the claim of being an 'alternative' system, but rather now provides alternative financial products within the existing global financial system. Hence,

1. Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (London: Palgrave Macmillan, 2005).

in its current form, IBF institutions work very much with the same objectives as conventional banking and financial institutions minus the interest, which is replaced by legally sophisticated financial concepts and instruments. This, therefore, facilitates but also explains the integration of IBF into the global financial system.

While such changes in the discourse and operation of IBF have enabled the sector to expand in an unprecedentedly successful manner, there has recently been an internal debate focusing on the divergence between the ideals, as represented by IME, and the realities of IBF, indicating that the 'commercial nature' of IBF may result in a similar financial crisis as in the West, unless a return to the 'basics' of IME is ensured.[2]

1. Essential Features and Development of IBF

As an operational and institutional part of the IME, IBF in a modern institutional sense emerged in the 1970s as a novel financing method to fulfil the expectations of an 'authenticity' search. However, in reality the institutional emergence and the development of IBF was very much related to managing the wealth, mainly created in the GCC region as a result of oil boom, in a religiously-informed manner, as Islam as a religion offers instructions related to the economic and financial aspect of life. The historical institutions and financial constructs which shaped financial activities in the Muslim world over the centuries testify to the applied nature of these instructions. However, in its current institutional format, IBF represents the modern version of those traditional principles.

When IBF emerged in its modern version in the early 1970s, the initial perception in the West was not necessarily encouraging, with the BBC and the *Wall Street Journal* of the 1990s identifying it as 'voodoo economics' to indicate the impossibility of such a system.[3] However, by the 1990s, due to the success it demonstrated, IBF managed

2. M. Nejatullah Siddiqi, "What Went Wrong?" (Keynote Address at the Roundtable on Islamic Economics: Current State of Knowledge and Development of Discipline held at Jeddah, Saudi Arabia on May 26-27, 2004 under joint auspices of the Islamic Research and Training Institute, Jeddah; and the Arab Planning Institute, Kuwait), available at http://www.siddiqi.com/mns/Keynote_May2004_Jeddah.html, accessed on December 13, 2006; Zubair Hasan, "Islamic Banking at the Crossroads: Theory versus Practice" in *Islamic Perspectives on Wealth Creation* eds. M. Iqbal and R. Wilson (Edinburgh: Edinburgh University Press, 2005); M Umer Chapra, "The Global Finance Crisis," Kyoto Series of Islamic Area Studies no. 2., Research Center for Islamic Area Studies, Kyoto University, Japan, 2009.
3. Abbas Mirakhor, "Hopes for the Future of Islamic Finance" (Lecture delivered at the 'Documentation in Islamic Finance Conference' organized by the Institute of Islamic Banking and Insurance (London) and IRTI-Islamic Development Bank, July 17-18, 2002, London), available

to capture the attention of the main players in international financial and banking circles. Subsequently, through product innovation and financial engineering, IBF has become part of the international financial markets recognized as 'heterogeneous' financial products. The pragmatist position of IBF institutions, which now shies away from identity politics, played an important role in this growth and international recognition. As a result, in its current form, IBF focuses on *Shari'ah* compliance by fulfilling the legal (*Shari'ah*) norms rather than Islamic moral principles and hence the attachment is to the 'form' rather than 'spirit.'

a. Features of Islamic Banking and Finance

When mentioning IBF, the first reference is normally made to the prohibition of interest in Islam, which, as a normative proposition, is shared with other revealed religions in their most historical forms. While IBF benefits from the above-mentioned value system, there are certain features, which define its operations. These are:

(i) *Prohibition of interest* or *riba*, which is explicitly revealed in the Qur'an. While the main reason for this is mostly mentioned as 'social justice,' Umer Chapra[4] refers to the social but also economic consequentialist reasons and rationale for this prohibition. In other words, he, among others, articulates that in addition to economic and financial priorities, social priorities in the society should be favored in the search for efficiency and optimality; and hence prohibition of interest provides a stable and socially efficient economic environment.

(ii) An important consequence of the prohibition of interest is the *prohibition of fixed return* as provided by interest.[5] In other words, IME does not allow capital to gain fixed return without incurring any risks due to its peculiar power through the banking system. On the contrary, capital should be able to gain whatever return is due for its share through an economic activity in the real economy rather than in the financial economy. Thus, by prohibiting interest, IME aims at productive economic activity or *asset-based financing* over the debt-based system, the latter being the main feature of conventional banking and finance. Thus, the asset-backing principle requires that all financial activities must be referred to as tangible assets.[6]

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at: <URL: http://www.islamicmortgages.co.uk/index. php?id=282>.

4. M. Umer Chapra, *Islam and the Economic Challenge* (Leicester: The Islamic Foundation, 1992); and *The Future of Economics: An Islamic Perspective* (Leicester: The Islamic Foundation, 2000).

5. Muhammad Ayub, *Understanding Islamic Finance* (Chichester, West Sussex: John Wiley & Sons Ltd., 2007).

6. Zubair Iqbal and Abbas Mirakhor, *Introduction to Islamic Finance: Theory and Practice* (New York:

(iii) The IME position related to money, which states that *money does not have any inherent value in itself* and therefore money cannot be created through the credit system,[7] provides another rationale for the prohibition of interest.

(iv) By prohibiting interest, IME does not undermine the position of capital, but rather changes the nature of the relationship between capital and work. Therefore, the principle of *profit and loss sharing* (PLS) is the essential axis around which economic and business activity takes places.[8] This prevents the capital owner from shifting the entire risk onto the borrower, and hence it aims at establishing justice between work effort and return, and between work effort and capital. This implies that *risk sharing* is another important feature of IBF.[9]

(v) An important feature which is a consequence of the profit-and-loss sharing principle is the *participatory nature of economic and business activity through participatory financing*. Through profit-and-loss sharing, Islamic financial instruments, capital and labor merge to establish partnerships through their individual contributions. The *shuratic (consultative) method of governing* business is, thus, a natural outcome of this process, which is expected to lead to democratic processes in political governance as well.[10]

(vi) By essentializing *productive economic and business activity*, in addition to prohibiting interest, uncertainty (*gharar*), speculation and gambling is also prohibited with the same rationale of emphasizing *asset-based productive economic activity* (Iqbal and Mirakhor, 2006).[11] However, new legal (*fiqhi*) scholarship is in favor of acceptable levels of uncertainty to facilitate modern financial instruments.

These essential features can be summarized in the Qur'anic injunction that "trade is allowed, *riba* (interest) is prohibited." Thus, profit becomes the essential return for business activity, while the definition of trade in IME is rather broad to include the return on all productive economic and business activities. Comparison between profit and interest can summarized as follows:

John Wiley & Sons (Asia) Pte Ltd., 2006).

7. M. Umer Chapra, *Towards Just a Monetary System* (Leicester: Islamic Foundation, 1985).

8. Muhammad Ayub, *Understanding Islamic Finance*, op.cit..

9. M. Nejatullah Siddiqi, *Partnership and Profit Sharing in Islamic Law* (Leicester: Islamic Foundation, 1985).

10. Murat Cizakca, "Democracy, Economic Development and Maqasid Al-Shari'ah," *Review of Islamic Economics* 11, no. 1 (2007): 101-118.

11. Zubair Iqbal and Abbas Mirakhor, op. cit.

Table 1: Comparing Interest and Profit

Interest	Profit
Return on capital	Return on a project
Interest is guaranteed	Risk of loss is involved
Fixed return	Variable return
Return on deposit	Return on joint ventures

In institutional and operational terms, further features of IBF can be listed as:[12]

(i) Community banking aiming at serving communities not markets

(ii) Responsible finance, as it builds systematic checks on financial providers and restrains consumer indebtedness; ethical investment, and CSR initiatives

(iii) Alternative paradigm in terms of stability from linking financial services to the productive, real economy; and also that it provides a moral compass for capitalism;

(iv) Fulfils aspirations in the sense that it widens ownership base of society and offers 'success with authenticity.'

b. History and Trends in IBF

It is a reality that the IBF industry has advanced from niche to critical mass in the last 35 years, and "is one of the fastest growing industries, having posted 'double-digit' annual growth rates."[13] As mentioned above, while the principles and notions of IME have existed for centuries, the institutionalization of these principles in the form of IBF institutions is relatively new.

Mitghamr Saving Associations was established as the first IBF in Egypt in 1963 in the form of an Islamic social banking institution aimed at providing credit to small artisans and entrepreneurs.[14] Due to changing political circumstances, this experiment did not last long, though it did pave the way for the Nasser Social Bank in 1971. Another experiment was launched in Malaysia in 1967 in the form of saving associations (Tabung Hajji Malaysia), which, since then, aim to invest

12. Iqbal Khan, "Islamic Finance: Relevance and Growth in the Modern Financial Age" (Presentation made at the Islamic Finance Seminar organized by Harvard Islamic Finance Project at the London School of Economics, London, UK, on February 1, 2007).

13. Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (London: Palgrave-Macmillan, 2005)

14. Anne Elizabeth Mayer. "Islamic Banking and Credit Policies in the Sadat Era: The Social Origin of Islamic Banking in Egypt," *Arab Law Quarterly* 1 no. 1 (1985): 32-50.

the savings of potential Muslim pilgrims to help them finance their pilgrimage to Makkah.

In later years, IBF institutions managed to penetrate other financial systems by taking advantage of the opportunities created through economic restructuring and liberalization of the financial system in most Muslim countries. In addition, due to the impetus provided by globalization, IBF institutions were internationalized and managed to enter the international financial systems by providing *Shari'ah*-compliant financial products.

The major institutionalization came with the establishment of the Islamic Development Bank in 1974 as a result of the political mandate provided by the Organization of Islamic Conference, which aimed to act as the development-oriented 'World Bank' of the Muslim world.[15] This was followed by the establishment of the Dubai Islamic Bank in 1975, which remains the biggest Islamic bank in the world (apart from the entirely Islamized banking system of Iran), and the Kuwait Finance House in 1977.[16]

Institutionalization and the financing capacity and asset base of IBFs have shown unprecedented growth since the 1990s. While there were 176 IBFs operating around the globe in 1997,[17] these increased to 261 in 2006.[18] By 2009, the number of IBF institutions had increased to about 500 operating in 75 countries.[19] South and South-East Asia have the highest number of IBF institutions, followed by Africa and the GCC region. In terms of asset base, however, the share of the GCC IBFs is over 70 percent of the entire sector. Thus, "what started as a small rural banking experiment in the remote villages of Egypt has now reached a level where many mega-international banks are offering Islamic banking products."[20]

With around 15-20 percent growth rate per annum, the asset base of the IBFs has reached about $822 billion globally.[21] It is estimated that within a decade, the

15. Iqbal and Molyneux, op. cit.

16. Rodney Wilson, "The Development of Islamic Finance in the GCC" (Working Paper of the Kuwait Programme on Development, Governance and Globalisation in the Gulf States, The Centre for the Study of Global Governance, London School of Economics, 2009).

17. Mervyn K. Lewis and Latifa M. Algaoud, Islamic Banking (Cheltenham: Edward Elgar, 2001).

18. Mohammed Boudjelal, "Three Decades of Experimentation: Rethinking the Theory of Islamic Banking," *Review of Islamic Economics*, 10, no. 1(2006): 23-39.

19. The Banker, Top 500 Islamic Financial Institutions. Supplement, (November 2009) London: FT Times Business Ltd.

20. Iqbal and Molyneux, op. cit., 1.

21. The Banker, op. cit.

IBF industry will capture half the savings of the Muslim world.[22] In this market-driven industry with global opportunities, the GCC and Malaysia remain the leading region/country in the world.[23] In particular, Malaysia is also leading in terms of maturity and sophistication of products.

It is important to note that in response to the need to regulate this rapid growth in the IBF sector, a number of self-regulating and standards bodies have also been formed to help in the consolidation of the industry. These include the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Malaysia-based Islamic Financial Services Board (IFSB). Global developments include the creation of Islamic capital markets and financial markets in the GCC and Malaysia. In particular, developments in Islamic bonds or *sukuk* have immensely contributed to the growth of Islamic capital markets.

2. Convergence between IBF and Conventional Banking and Finance: Sources of European Recognition

The aforementioned value-oriented features of IBF emanating from IME have been compromised for the sake of efficiency, profitability and competitiveness since the 1990s due to globalization and internationalization, but also because of a rational reading of the Qur'anic principles. As mentioned above, unlike the original institutional nature of social banking, adapting a commercial banking model in IBF has been the main reason for such a paradigmatic operational shift.

In the developments and trends in the operations of IBF, it is now clear that debt-based financing has become the major source of financing in the IBF industry as in conventional banking.[24] On average, from 1984 to 2006, *murabahah* instrument financing (mark-up priced financing products, which are debt-based) constituted 88.1 percent of the mode of financing for the Bank Islam Malaysia Berhad and 67.3 percent for the Dubai Islamic Bank for the period of 1988 to 2006. For the same period, however, *mudarabah* and *musharakah* instruments of financing (both joint venture capital products and hence asset-based) remained on average about 1.7 percent for the Bank Islam Malaysia Berhad and 9.3 percent for the Dubai Islamic Bank.[25] Hence, considering that in IME, equity or profit-and-loss sharing

22. Iqbal Khan, "Islamic Finance: Relevance and Growth in the Modern Financial Age," op. cit.

23. The Banker, op. cit.

24. Mehmet Asutay, "A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System," *Kyoto Journal of Islamic Area Studies* 1, no. 2 (2007): 3-18.

25. Shinsuke Nagaoka, "Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections

financing is considered superior to debt-like financial instruments, IBF institutions greater involvement in debt-like financing is an indication that IBF has deviated from the aspirational stand and has converged towards more conventional banking and finance.

It should also be noted that due to mimicking of the conventional financial products, speculation and uncertainty have also been brought into IBF through potential futures, derivatives and options. This indicates a convergence towards conventional banking and divergence away from the moral economy nature.

Regarding the above-mentioned operational features, IBF institutions do not serve communities, but rather (similar to conventional banks) they serve markets.[26] Therefore, the claim that IBF fulfils aspirations in the sense that it widens the ownership base of society has not been achieved either, as IBF institutions have not engaged with communities.[27] In addition, the responsible financing aspect of IBF can be questioned, in particular in terms of ethical investment and corporate social responsibility initiatives.[28] Moreover, the value proposition that IBF is an alternative paradigm in terms of stability by linking financial services to the productive real economy is being abused with debt-based products such as *tawarruq*, which is a very critical debt-based instrument.[29]

As the above discussion indicates, in its current commercial form, IBF has converged with conventional banking and finance by adopting efficiency against equity consideration, while the latter is the foundation of IBF. This convergence is not only in the working mechanism, but also in values, as IBF institutions have gone beyond the traditional value system. This indeed explains why it has become popularly accepted in the international financial markets, despite the name 'Islamic.' In other words, if IBF had stayed with its original discourse of an authentic identity

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on Murabahah Contracts and Islamic Debt Securities," *Kyoto Bulletin of Islamic Area Studies*, 1, no. 2 (2007): 72-91.

26. Mehmet Asutay, "A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System," op. cit.

27. Salma Sarially, "Evaluating the 'Social Responsibility' of Islamic Finance: Learning from the Experiences of Socially Responsible Investment Funds," (Proceedings of the International Conference in Islamic Economics and Finance, Islamic Economics and Banking in the 21st Century, Jakarta, Indonesia, November 21-24, 2005, Volume 1); 2005; Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics and Practice* (New York: Cambridge University Press, 2006); Mehmet Asutay, "A Political Economy Approach to Islamic Economics: Systemic Understanding for an Alternative Economic System," op. cit.

28. Sarially, op. cit.

29. M. Nejatullah Siddiqi, "What Went Wrong?" op. cit.

search, the surge that has been witnessed in IBF activity as has been observed in present times may not have taken place on a global level.

Considering the original nature of IBF as an ethical financing system, it would have been expected that the direction of the convergence should have been from conventional finance and banking towards IBF, with the objective of moderating the excessive capitalist practices and financial as well as the economic crisis inclination inherently existing in the conventional banking and finance system. This is due to the fact that the value proposition of IBF is important for the establishment of a sound financial architecture.

However, it is the convergence towards conventional banking and the adoption of commercial banking as a model that helped IBF to be internationalized and receive acceptance beyond the Muslim world.

3. Islamic Banking and Finance in Europe

The term 'Islam' has different connotations in a European context, originating in a historically-constructed view. These viewpoints have been sustained through various political events domestically and externally during contemporary times. Therefore, "Islam all too often resonates negatively in Europe, with much non-Muslim public opinion uncomfortable with Islamic culture and values. Secular and Christian opinion is at best suspicious of *shariah*, Islamic law, and indeed often antagonistic. The notion of wanting to apply *shariah* principle to banking and finance is treated with scepticism if not outright hostility, especially as there is no concept of Christian or Jewish banking, even if there are some parallels between *shariah* financial principles and the teaching of the Old Testament."[30] This is true for most of continental Europe, though the UK appears to have a more pragmatic approach towards Islamic legal issues.[31] These divergent attitudes also exist towards IBF;[32] the initial developments in European IBF took place in the UK during the 1980s rather than in continental Europe, as London insisted on remaining the European center for IBF.

The development of IBF in Europe can be attributed to two main causes:

30. Rodney Wilson, "Islamic Finance in Europe," RSCAS Policy Papers No. 2007/02, Robert Schuman Centre for Advanced Studies, European University Institute, 2007.

31. Jorgen S. Nielsen, *Muslims in Western Europe* (Edinburgh: Edinburgh University Press, 2004); Lauren Fulton, (n.d.) Islamic Law: Europe's Shari'a Debate, available at http://www.euro-islam.info/key-issues/islamic-law/.

32. Fulton, op. cit.

firstly, the prevention of financial exclusion, and secondly and most importantly, to attract the large capital accumulated in the GCC region.

As Islam prohibits interest, large Muslim communities in EU countries have refrained from engaging with conventional financial institutions, including banks. For example, in the UK, large sections of the Muslim community avoided taking conventional mortgages for their housing needs. The lack of specially-designed *Shari'ah*-complaint financial products resulted in financial exclusion for many Muslims, with adverse socio-economic consequences. Thus, the development of IBF in the EU, at least in the case of the UK, is partially due to the policies designed to overcome such financial exclusion.

However, another important reason for the development of IBF in the UK in particular, and in certain EU countries in general, is the dire need for foreign capital, which contributes to the economic growth of the host country. Considering the large amounts of capital accumulation in the GCC countries, in particular within the Sovereign Wealth Funds,[33] most of the countries in the world have been developing strategies to attract these funds to overcome their capital shortage. Since most of the GCC investors aim for *Shari'ah*-compliant investment or Islamic financing, European countries, alongside others, have responded to the conditions of capital supply by opting to develop national frameworks to facilitate IBF.

This second reasoning is crucial to develop strategies to facilitate the provision of IBF in certain EU countries. Through such strategies, the financial exclusion of Muslim communities can be overcome as a by-product of the process, at least within the concept of 'equal opportunities.' Considering the large Muslim communities in the UK, Germany and France, it is clear that there is excellent potential for retail IBF as well, and the developments in the UK are, in this regard, exemplary.

In analyzing the emergence of IBF in Europe, Rodney Wilson states that *Shari'ah*-compliant liquidity management for the Middle East IBF institutions was handled in Europe from the early 1980s.[34] However, it should be noted that European banks have been involved in the Middle East financial environment since the 1920s at various levels.[35]

The first operational bank was the Al Baraka Islamic Bank in London in 1982, which continued to operate as a retail and investment IBF until 1993 with

33. Mehmet Asutay, "GCC Sovereign Wealth Funds and Their Role in the European and American Markets," *Equilibri* 12, no. 3 (2008): 335-354.

34. Rodney Wilson, "Islamic Banking in the West", in *Handbook of Islamic Banking* eds. M. Kabir Hassan and Mervyn K. Lewis (Cheltenham: Edward Elgar, 2007).

35. Rodney Wilson, "Islamic Finance in Europe," op. cit.

a number of branches. However, due to the adverse financial circumstances and non-facilitatory regulatory environment, it had to close in 1993.[36] The second institutional attempt was the setting up of the United Bank of Kuwait's Islamic Banking Unit in London in 1991. It provided investment and later retail banking services before it merged with the Al Ahli Bank under the new operational name of the Al Ahli United Bank in the early years of this decade.

The establishment of the first full-fledged Islamic high street bank in the UK was in 2004, when the Islamic Bank of Britain was established to provide retail services with branches in cities with a strong Muslim community. HSBC's Amanah moved into the retail market by offering Islamic mortgages in 2004 too, followed by Lloyds-TSB which provided similar services through its Islamic window starting in 2005. The Arab Banking Cooperation began to provide similar retail services through Bristol and the West Building Society in 2004 alongside Ahli United Bank's Islamic mortgage services in cooperation with West Bromwich Building Society.[37] Through their Islamic windows, other conventional banks, such as the Halifax Bank of Scotland (HBOS) and the Bank of Scotland, started to provide Islamic mortgages in 2004. In addition, Barclays, "...Citibank, Dresdner Kleinwort Benson and ANZ Grindlays are active in arranging the short-term Islamic trade finance for Western blue-chip end-users" from London.[38]

Over the years, further institutionalization took place in the UK. As a result, three more Islamic banks were established in London as fully *Shari'ah*-compliant wholesale or investment banks: the European Islamic Investment Bank in 2005, the Bank of Middle East and London in 2007, and Gatehouse in 2008. In addition to banking institutions, a large number of London-based financial institutions and law firms have also been involved in Islamic financing for many years, mainly as fund managers.

The positive developments in the UK have been possible because of the encouraging attitude of the government, which went beyond the political agenda and focused on the financial and economic value of IBF propositions. The chairman of the Financial Service Authority (FSA), Sir Howard Davies, stated in 2002 that "… we have a clear economic interest, as a nation, in trying to ensure that the conditions for a flourishing Islamic financial market are in place in London."[39]

36. Rodney Wilson, "Islamic Banking in the West," op. cit.

37. Ibid.

38. Ricardo Baba, "Islamic Financial Centres," in *Handbook of Islamic Banking* eds. M. Kabir Hassan and Mervyn K.Lewis (Cheltenham: Edward Elgar, 2007), 398.

39. Howard Davies, "Islamic Finance and the FSA," *Review of Islamic Economics*, no. 12 (2002): 105.

He further continued: "We see no objection of principle to the establishment of an Islamic bank in the UK. Indeed, we would welcome a soundly financed and prudently managed Islamic financial institution in this country, which would be good for Muslim consumers, good for innovation and diversity in our markets, and good for London as an international financial centre."[40] Such a positive attitude by the financial bureaucracy encouraged the government to introduce new legislation; and since 2003, the government has provided legislative and regulative changes to facilitate the efficient operations of IBF in the UK. It should be noted that this strategy fits into the Labor government's economic and financial policies to overcome financial exclusion and sustain London's position as a financial hub. As part of this policy, attempts were made and structures were developed to keep London as an IBF center. The government has further expanded its commitment to the expansion of IBF in the UK by making legislative changes to issue sovereign Islamic bonds, or *sukuk*, from 2007 onward – a process which has not been finalized yet.

Since such positive and direct engagement with IBF was not made until recent times by other European countries, mainly because of the rigid secular attitudes and skepticism towards *Shari'ah*,[41] developments in IBF have been rather slow in the EU countries. However, now due to the introduction of more pragmatic policies by the governments in many European countries, IBF is thriving, and the financial opportunities offered by IBF are now recognized by governments as well as European banking and financial institutions.

While it is true that European banks, including Deutsche Bank, are involved in short-term Islamic liquidity management in the GCC region, alongside London, Geneva has always been an important center for Islamic wealth management. Many of the European financial institutions and banks are involved in Islamic wealth management and funds through various partnerships with GCC-based financial institutions. It should be noted that the first *sukuk*, or Islamic bond, in Europe was issued by the German Federal State of Saxony-Anhalt in 2004, which required a number of regulative arrangements within the existing legal system.

It is important to note the recent changes in the attitude of the French government, which now has a positive and dynamic view on IBF. While until recently, France entirely ruled out the IBF option (due to its staunch secularist attitude), the Sarkozy government initiated a policy change after 2008 to facilitate IBF in order to encourage foreign investments from the GCC region. Therefore,

40. Ibid.

41. Wilson, "Islamic Finance in Europe," op. cit.; Fulton, n.d., op. cit.

French authorities are now amending the law as part of their facilitatory policy,[42] and the country has amended its civil law to issue *sukuk* also.[43] This pragmatist policy was made possible with French financial bureaucracy locating rules similar to Islamic financial principles in the current and historic French legal system[44] to justify the introduction of IBF in France and avoid political risk. Regardless of such pragmatism, these developments will indeed attract capital from the GCC region, but also may develop retail banking which can help the large Muslim communities in France to avoid financial exclusion, because, as the *Banker* states, the formation of new Islamic banks and Islamic windows is on its way in France.[45]

Among other EU countries, Luxembourg has been involved in offshore IBF for many years.[46] In 2009, Italy initiated a discussion through its central bank to search for opportunities in IBF and look into potential areas of regulative change to facilitate IBF. Lastly, Ireland also has limited IBF presence and operations and is working towards the introduction of facilitatory regulative change.

In sum, IBF is now thriving within many EU member countries. Since each country has different financial architectures, they all have a unique way of dealing with IBF. Regardless, the development of IBF in Europe, as well as further involvement of European banks in IBF domestically and in the GCC, is a growing reality. This suggests that the EU authorities have to internalize this reality into their economic and financial policy making, and as a result we can hope to see a common EU-IBF white paper in the coming years.

4. Islamic Banking and Finance and Conventional Finance in Europe: Mutual Contribution and Lessons

While Islam is often correlated with 'limitations' in a European context, IBF, on the other hand, provides 'choices' to Muslims and non-Muslims alike, both in the Muslim world and in Europe. Thus, the availability of IBF in the EU helps contribute to pluralism within the political culture in Europe, as political pluralism necessitates pluralism in other realms of life, including finance. Financial pluralism

42. Gilles Saint Marc, "Islamic Finance and French Law" (Presented at the Paris Europlace International Financial Forum, on July 2, 2008, Paris).

43. Mushtak Parker, "Civil Code Amendment to Help the Sukuk Market Take off in France," *Arab News*, October 5, 2009.

44. Marc, op. cit.

45. The Banker, op. cit.

46. Wilson, "Islamic Banking in the West", op. cit.

in the form of IBF in Europe helps Muslims in the EU countries to overcome financial exclusion – as a result, financial and social developments can go hand in hand.

The significance of IBF in the GCC-EU relationship also becomes clear through institutionalization and knowledge transfers. Since the beginning of the 20th century, the financial structures and operations of the GCC countries were shaped by the European banks. However, "...now European banks are importing *shariah* compliant products from the Arab World, not only for their overseas Arab clients, but more significantly for the growing Muslim population of Europe".[47] Thus, the emergence of IBF and its adoption into the EU member countries "is making the Euro-Arab financial relationship more a partnership of equals in the twenty first century."[48] This change helps the GCC financial sectors to move out of the 'dependence' mood into 'interdependence' relationships, while the European financial systems now can learn from their Arab counterparts. This completes the bi-directional learning, thereby contributing to the development of social capital through financial development for both sides.

Additionally, an important contribution of IBF in the EU context is in financial development. The relevant literature shows that financial development and innovation is positively correlated with economic growth. Considering that IBF constitutes financial innovation, this is expected to lead to financial development through offering *Shari'ah*-compliant financial products. Consequently, it is expected that this shift will attract foreign investment and cash flows from the GCC region; experts expect that the consequent expansion of the financial base would have a positive impact on economic growth through increased capital accumulation.

The chronic financial and economic crises being experienced in the Western economic and financial systems are a clear indication of the inherent problems in the capitalist system. Therefore, new financial structures have been discussed in policy circles of the industrialized countries, including in the EU. In order to moderate the excesses of the capitalist financial system, ethics and social justice should be considered as important building blocks in the new financial architecture. While the underlying value proposition of IME may not be consistent with the 'laicism' or secularism as practised in the EU countries, the realities of the current financial crisis indicate that, in one way or another, 'moral' has to come into financial and banking activities to prevent 'excesses', 'deviations', 'greed', and 'money creation through

47. Wilson, "Islamic Finance in Europe," op. cit., 1.

48. Ibid.

financialisation,' which have facilitated the global financial crisis. Considering that secular ethics also necessitate the same 'good practices' in banking and finance, IME's value propositions become important to establish a stable international financial architecture in which IBF and conventional banking and finance can work together. Integrating the moral proposition of IME in conventional financing could be the new face of capitalism, indeed, in a secular sense. Considering the growing ethical finance movement, particularly in the UK, IME should not be considered as an outsider, and with the integration of IBF into the EU countries, attempts could be made to further ethical financing in the EU context.

IBF, on the other hand, has some lessons to learn from the EU experience in banking and finance. Corporate Social Responsibility (CSR) and Corporate Governance (CG) mechanisms have been well developed in the EU countries; and there are similarities in the philosophical bases of CSR and CG in both the paradigms. However, the EU financial and business sectors have developed relevant institutions to incorporate CSR and CG issues into their systems, a process which is in its infancy in the GCC IBF system. Thus, the EU experiences and developments in these areas could be adopted by the IBF sector to consolidate its position and fully integrate and develop the moral features of its institutions not only to provide socially acceptable financing, but also to develop corporate identities beyond 'simple business mind.' Although CSR and CG structures proposed by IME are more dynamic and comprehensive, IBF mostly mimics the conventional institutions. Therefore, further ethical developments in conventional banking and finance will provide an opportunity to develop the operational and value propositions of IBF institutionally.

Importantly, despite IBF's institutional origins in social banking, it has adopted commercial banking successfully, which has led to the development of a 'capitalist spirit' within IBF. On the other hand, the EU's institutional position on social banking is rather encouraging, as it aims to prioritize 'social banking' and 'narrow banking' in a bid to further community development and individual empowerment to enhance social capital.[49] Thus, IBF can also learn from public policy and private sector initiatives for social banking in the EU and thereby 're-learn' the IME's 'divine' wisdom from its European counterparts.

Clearly, there are lessons to be learnt from the experiences and theoretical frameworks of both these areas of banking and finance which would be of mutual

49. Ed Mayo and Christopher Guene, "Introduction: A Problem Here to Stay," in *Banking and Social Cohesion: Alternative Responses to a Global Market* eds. C. Guene and E. Mayo (Charlbury, Oxfordshire: Jon Carpenter, 2001).

benefit; and hence convergence should work in both directions; so far Islamic finance has mimicked conventional banking and finance through a uni-directional relationship. Convergence in both directions will contribute to 'pluralism' rather than promoting the stagnation of a prevailing financial hegemony.

5. Islamic Banking and Finance as a Bridge to Civilizational Dialogue: Generating Multiple Modernities

The perceptions of Islam in the West, and the perceptions of the West in the Muslim world, have not been positive historically or in contemporary times. Thus, a civilizational dialogue must be pursued to overcome the difficulties between the two traditions. After identifying the mutually beneficial areas above, this paper suggests that IBF can act as an important part of this dialogue.

IBF can be a cultural and political bridge between the GCC and the EU. For this, Islamic finance should be considered as part of a multiple modernities project, which in a rational way brings two different worlds together. In other words, with the facilitation and integration of IBF into some of the EU countries, there is an implicit recognition of a religion-based financing in Europe, indicating the recognition of the Islamic rationale and logic behind IBF, which delves beyond the 'universal and hegemonic modernity' proposition of Europe. Thus, unprecedented developments in IBF in Europe reveal not only that *Shari'ah* as a mechanistic and rationale system is accepted in the West, but also that the ontological and epistemological sources of IBF (namely the *Qur'an* and the *Sunnah*) are also, as a by-product, recognized, even if it is for pragmatic financial reasons. This implies again an 'equal partnership' beyond the 'modern' and 'traditional' dichotomy as imposed by the West on the 'rest,' and vice versa.

Islamic ontology and epistemology, the sources of IBF, have always been considered beyond the 'universal truth' of the modernity project, which assumed that the world will converge towards the Eurocentric definition of a homogenous civilization.[50] Therefore, causality of knowledge transfer and development is always considered to be from the West to the 'rest.' However, realities demonstrate that this has not been possible, nor will it be in the future. Take the example of IBF, an institution based on the different ontology and epistemology of Islam, which entered into the 'rational' legal and regulative environment of Europe. In this case,

50. See for the nature of modernity and multiple modernities discussion, S. Eisenstadt, and W. Schluchter, "Introduction: Paths to Early Modernities: A Comparative View," *Daedalus* 127 no. 3 (1998): 1-18; S. Eisenstadt, "Multiple Modernities," *Daedalus* 129, no. 1 (2000): 1-29.

modernity is re-produced by the 'other', here by Islam, in the form of an *alternative modernity*. In this case, IBF borrows the institutions of the 'modernity' and therefore 'Islamises the products and institutions of modernity' with its own ontology and epistemology, creating 'multiple modernities.'

IBF, thus, is not post-modern, but rather modern as it endogenizes or 'Islamises' the institutional and methodological framework of modern 'conventional' banking, rather than creating its own authentic institutions and operations (the latter strategy would have produced alternative institutions and hence would have been considered as post-modern). Thus, two different moderns exist together within the 'multiple modernities' framework. This, of course, represents a convergence between the two worlds, as the Muslim world has been practising the 'modern' for many decades, and now through IBF, Europe is experiencing the alternative form of modern or 'Islamic' modern.

Of course, such a process may not be easily accepted in some of the EU countries such as staunchly secular France, as recognition of IBF implies that *Shari'ah*-oriented judgments and mechanisms have to be internalized or endogenized in the existing secular legal and regulative environment. For instance, each of the IBF institutions must have a *Shari'ah* board consisting of *Shari'ah* scholars to guarantee the Islamicity or the *Shari'ah* compliance of the financial products offered. Therefore, given the negative public opinion of Islam within the current political climate in Europe, the facilitation of IBF in the EU countries requires political will. The UK, as mentioned above, has shown the political will to introduce IBF due to IBF's financial contribution to the country. Because of recent financial difficulties, the new French government has also recognized the benefits it can get from IBF. However, in keeping with its political culture, the French government had to politically justify this move beyond the financial rationale. Therefore, as mentioned above, Marc articulates how politicians attempted to find precedents in the historical and contemporary French legal system to justify *Shari'ah* compliancy, thereby proving that such principles were and are part of French law too.[51] By doing this, the French government attempted to be politically correct to avoid 'disturbing the apple cart.'

In this multiple modernities framework, it should be noted that causality of convergence runs both ways; IBF has modernized the Islamic proposition even as it has moved away from the essential values of this moral economy to fit into the international commercial banking and financial system.[52] Through this process, the

51. Marc, op. cit.

52. Mehmet Asutay, "Locating Islamic Finance in Multiple Modernities Framework: Searching for a Place in Secular Public Sphere through Banking and Finance" (Paper prepared to be presented at

IBF has gained recognition in the West. The same reconciliatory process has been pursued by some European countries who accept IBF with its *Shari'ah* dimension despite the fact that 'modernity' rejects it. Thus, IBF has played a reconciliatory role between the two civilizations through the articulation of 'multiple modernities'.

In sum, through IBF, the perceived 'universal or hegemonic modernity' accepts the existence and practice of socially constructed multiple modernities, contributing to pluralism and going beyond 'dependence' into 'interdependence.' This move can be seen to help promote a 'world of equals' beyond the hierarchical social order. Thus, IBF can also play an important role in the civilizational dialogue by overcoming the contentious relationship between the Muslim world and the West through finance.

Conclusion

IBF is a novel financing method with a particular value and operational proposition which has existed in its modern form in the GCC region since the mid-1970s. Since the 1990s, it has become an important partner in the global financial system, and currently, IBF has proved that it is a sustainable reality, evidenced by its resilience and growth even during a period of financial crisis. Thus, it provides alternative opportunities for all countries regardless of its religious nature, as in its modern version it represents 'commercial banking' with a specific legal method, namely *Shari'ah* compliance.

IBF's contribution to the EU economies is unquestionable, as Davies argues above,[53] and further developments in IBF in the EU are expected in the coming years. The lack of a common financial system in the EU will complicate the task of expansion of IBF, but the experiences and social capital of the countries that have already adopted the system will help other countries to locate ways in which they can make amendments to their legal and regulative environment. For example, the French financial authorities benefited from the British experience and the Italian financial environment followed the French and the British example.

This paper suggests that in addition to its contribution to the economies of the EU countries, IBF can play an important role in reconciling the political differences between the GCC and the EU countries, and hence can act as a bridge

the International Conference on "Re-imaging the Shari'ah: Theory, Practice and Muslim Pluralism at Play," organized by Warwick Law School, September 13-16, 2009, Warwick in Venice - The Palazzo Pesaro-Papafava, Venice.

53. Howard Davies, "Islamic Finance and the FSA," op. cit.

to civilizational dialogue. In the past, it was trade that managed to bring the worlds together for a peaceful coexistence; IBF can play that role in contemporary times. The same spirit and wisdom of the past centuries can shed light on the new encounters between the two worlds through financing activities. The hope is to move away from 'dependence' on the European norms in financing to 'interdependence' in which parties are equal in terms of institutions, operations, as well as knowledge. In this context, the attitudes of the EU countries will play a key role in determining the success or failure of the new system. While many countries such as the UK, Switzerland, France and Luxembourg, have shown positive and facilitating trends so far, only time will tell where such a dialogue will lead.

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