AMERICAN UNIVERSITY OF BEIRUT

# EMERGENCE OF ISLAMIC FINANCE IN EUROPE

By
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# AN ABSTRACT OF THE PROJECT OF

Asaad Sari Arar for Master of Financial Economic

Major: Financial Economic

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In this project I will be studying the Emergence of Islamic finance in Europe. The main of the project is to test whether Islamic finance has been able to compete with conventional financial institution within the European context; in order to test this assumption the CAPM model was developed to test the Stoxx Islamic index Europe against the Stoxx 600 Index over a period spanning from 2005-2015, both were used as proxies to the markets. The results obtained within the project showed that Islamic finance have outperformed the market expectations as a whole, while slightly underperforming the market during periods after the crisis. Following the empirical tests we move on to formulating recommendations for Islamic finance to prosper in the European market as well as taking a look at the future prospects of Islamic finance in the European context.

# GLOSSARY:

- Al-Ajr: this is the commission or fees charged for a service.
- Gharar: this refers to the act of speculation which is prohibited in Islamic finance.
- Ijara: this is an agreement were by the financial institution buys the good and leases it back to the customer for a pre-determined period of time.
- Ijara-w-iqtina: this is an agreement similar to Ijara, with an extra stipulation where by the customer has the right to buy the good or asset after the leasing period is over.
- Mudaraba: Is an investment partnership were the Islamic financial institution will provide the capital needed by the investor, while all the business aspects are done by the investor himself. In this type of agreement the profits are shared by both parties with accordance to pre-determined agreement between them. While losses if any are the investor's responsibility. This investor is referred to as Mudareb, while the party who invests the capital is referred to as Rab el mal.
- Murabaha: It is a credit contract which states that a customer to obtain a good or assets they are in need of without taking an interest bearing loan. Where the financial institution would buy the product and then sell it to the customer on a deferred payment plan.
- Musharaka: this is an investment partnership that follows the PLS (profit and loss sharing) concept. Where profits are shared according to pre-determined ratios, while losses are re-pegged according to the initial investment.
- Riba: one of the main prohibitions of Islamic finance. It denotes any increase for the lender as predetermined condition in the loan agreement. In other words any risk-free income the lender receives from the loan. This mainly refers to interest.

- Shariah: refers to the Islamic laws stated in the Quran and the teachings of the Prophet.
- Shariah board: this is a committee found in any Islamic financial institutions. Its main job is to provide the guidelines and regulations for the financial institution, in order for it to develop its sharia compliant products.
- Sukuk: this could be seen as a sharia compliant bond, which provides a sukuk investor having ownership claims over the asset. Hence it is similar to an asset backed bond, these sukuks are issued governments and financial institutions.
- Takaful: this is referred to as Islamic insurance. Where funds are pooled together from investor based on mutual assistance, where participant play the role of the insurers and insured simultaneously. This type of idea was created due to the failure of conventional insurance to comply with Islamic law, since it is presumed to be similar to Gharar and Riba.

# CONTENTS

# CHAPTER ONE: OVERVIEW OF ISLAMIC FINANCE

## A. Importance of the topic:

Selection of a dissertation topic is complicated and time consuming task. In fact, it is the most important activity in dissertation writing. Islamic Finance is my research field and it was the prime motivation for me to go for a dissertation topic on emergence of Islamic banking in Europe. The topic interests me because it has enough research-able material associated to it. The Islamic Finance students are not encourage to select a topic or area in which no researcher has done as they will have to face the problem in terms of information collection.

The subject of Islamic banking is to various degrees connected to other subjects such as religion, history and politics. I have chosen the topic as it would be impossible to give a clear picture of Islamic banking without also discussing these subjects to some extent. Much literature has been written on the subject throughout several decades, much of which is not in English. This dissertation is not an attempt to give a complete presentation of the Islamic Banking system but rather to present its emergence and fundamental parts in Europe related to it and to give an overview of the present situation in some selected countries.

The primary objective behind this research project is to take a look at the growth and emergence of Islamic finance in the European market and how they have performed within these developed markets through empirical and econometric tests. In my opinion this study is important due to the lack of studies that have been found on the topic within the European market in specific, due to the infancy of the sector within the market.

## B. Introduction:

Successful Financial markets over time have become one of the most if not the most integral element within a successful economy. Hence, in order for a country to thrive in a dynamic framework similar to world's economy, they need to build a solid and sustainable financial base. This in turn would enable it to withstand economic fluctuations that might be faced due to global financial framework (Arabi, 2014)

When speaking about financial sector of any economy multiple entities or parties should be discussed; such as financial intermediaries, financial service providers, governments, worldwide economic agencies and private investors. As well as a number of interrelated markets in which they conduct their business. One important element in differentiating between a successful and unsuccessful financial sector is the role and strength of its financial institutions (banks), which are considered the pillars of any financial sector (ZarRokh, n.d.).

Banking is the fastest growing sector in any economy irrespective on how mature it is developed; this is a testimony to its importance in supporting the development of any economy. Over time we have seen the emergence of different types of Financial Institutions each focusing on different aspects of business within the financial sector and customers with varying needs, behavior, and principles. In 1975, Islamic Shariah based financial institutions came into existence as a new entrant to the financial system. Subsequently, this form of banking became the fastest growing generally worldwide but in particular in Middle Eastern and Islamic countries. In the recent past American and European markets witnessed growth in Islamic financial products and institutions. A number of countries in Europe such as: Germany, France and Luxembourg are leading the way in integrating this new form of finance into their economies. In this project I will be studying whether or not these new financial institutions would be able to survive and compete with conventional banks within developed financial markets as they did in other markets; such as the GCC (Gulf Cooperation Council), Turkey and Malaysia. Hence, the question arises if Islamic finance would be able to one day become a leading banking system within the world's financial markets (Wilson, 1987).

Following the global economic crises that the world witnessed in 2008 one constant trend emerged which was that financial institutions (mainly banks) where the most affected by this economic downturn. Taking a closer look at the financial institutions affected we could see that conventional commercial banks were hit much harder than their sharia based counterparts, hence leading to the idea that sharia based Institutions are better structured to withstand economic downturns ((Arabi, 2014).

Hence raising the question whether these new institutions would be able to compete with the existing conventional banks and at some point in the future replace them.

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 sharia 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 sharia financial principles and the teaching of the Old Testament (Wilson, 1997).

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. Although Islam is sometimes viewed as prescriptive and concerned with restricting choice, Islamic finance is about widening choice, and in particular about providing alternatives to interest based finance. The aim is to develop financial products that are seen as ethical and within the realm of socially responsible investment (Wilson, 1997).

## C. Brief history of Islamic banking

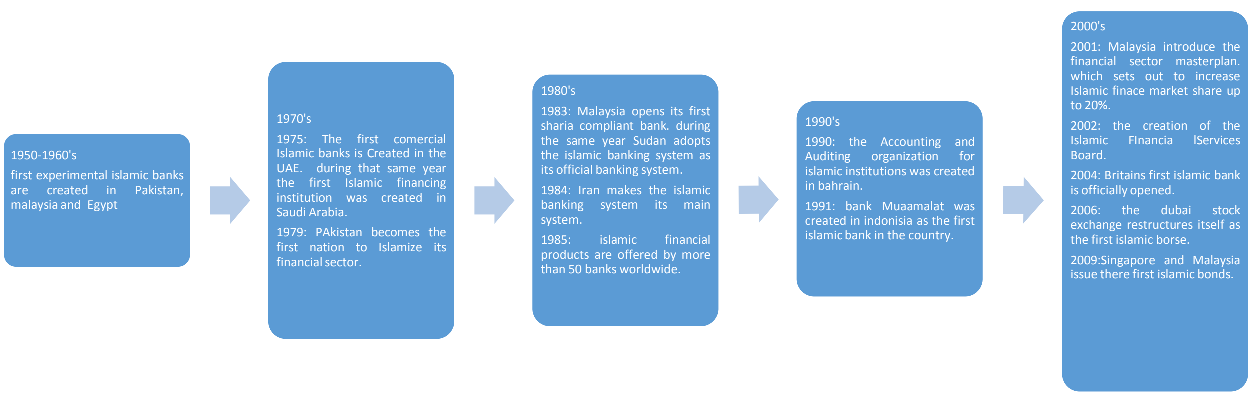
The earliest writings on the subject of Islamic banking and finance date back to the forties of the twentieth century (Siddiqi: 1981, pp.29-30) and the earliest practice can be traced to early sixties (Ahmad: 1995, pp.21-23). The literature showed ambivalence between the model of an intermediary designed after conventional commercial banks and one like an investment company serving individuals seeking profits as well as the community needing development. Models of commercial banking based on two-tier Mudarabah came from economists aspiring to build an alternative to a system of banking and finance hinged on interest. Some of them placed the issue in the larger context of the struggle between capitalism and socialism in which Muslim intellectuals projected Islam as having a different approach resulting in a distinct economic system with its own financial institutions. Community initiatives looked forward to something workable while avoiding interest.

The nineteen-sixties saw the establishment of an interest-free bank in Karachi, that of Tabung Haji in Malaysia, and saving-investment banks in Mit Ghamr in Egypt, that were based on sharing profits and avoided interest. Only Tabung Haji(Tabung Haji:1995) survived, thanks to its roots in the community, its narrow focus, official blessings and clear structure as a business. Early in the nineteen seventies came the Dubai Islamic Bank, taking deposits in current as well as investment accounts and engaging in profit-making activities directly as well as through working partners. The Islamic Development Bank, which started operations in 1975, was designed to serve Muslim countries and communities by arranging finance for trade and development on non-interest bases. By late nineteen-seventies there were half a dozen more banks in the private sector in Egypt, Jordan, Kuwait, and the Gulf. The following decade saw a rapid expansion bringing the number of banks to dozens by the end of the decade. To banks were now added non-bank financial institutions, like investment companies and insurance companies (IAIB: 1997).

The idea of Islamic banking was first brought up in the late 1940's by Anwar Qureshi, Naiem Siddiqi and Mahmoud Ahmed. These were followed by Mudawidi and Muhammad Hamidallah's more technical papers. But all these scholars reached one common point which was the need for financial institutions within Islamic countries. Hence leading to the idea of Murabaha as an alternate solution to interest, which is considered as riba. Murabaha is a form of credit sale that is in compliance with the Sharia law; it is very similar to traditional buy and sell agreements. A trading contract would require a buyer, a seller, a product or commodity, place of delivery, quantity, price, and a time of delivery. Thus, the buyer and seller would agree to exchange a commercial transaction based on a buying and selling concepts where the seller agrees to pay cost + profit for tendered service, product or commodity. Hence giving Muslims an alternative mode of financing based on true economic activity driven by supply and demand, in addition to a method of operation based on profits rather than on interest bearing loans, which is forbidden under the Shariah law due to its speculative nature ((Anwar, 2003).

The world witnessed positive steps towards the development of this industry, over the next couple of decades, Islamic finance started materializing mainly due to political interests and more importantly due to the emergence of young Muslim economists whom devoted most of their studies to this topic. During the 1970's the world witnessed a rise in the number of conferences and institutions devoted to the sole purpose of Islamic banking and finance; such as "the conference of Minister of Finance in Islamic countries" in 1970 held Karachi, The Egyptian study in 1972, "the first International Conference in Islamic Economics" in 1976 held in Mecca this has helped in creating awareness within the masses that grasped the attention of investors and customers. The hard work of these conferences and institutions as well as the confidence from investors and customers led to the creation of the first interest free bank in 1975 named "The Islamic Development bank". Later that year the first privately owned Islamic bank was established by a group of private investors from a number of different countries, and the bank was named Dubai Islamic Bank. These two initiatives taken in 1975 triggered a ripple effect in other Muslim countries followed by two new institutions a couple of years later; Faisal Islamic bank in Egypt and Sudan as well as the government run institution in Kuwait named “the Kuwait finance house”. During the late 1980s and 1990’s; ten years after the establishment of the first private interest free bank, Islamic finance spread out to Europe. The total number of institutions reached to almost 50 Islamic banks predominantly in Muslim countries; but some were found Denmark, Luxemburg, Switzerland and the UK.

During the 1980’s the concept of Islamic banking has turned to become a force and a reality to be reckoned with in terms of its ability to gain market share and development of this basket of products and offerings to customers, thus discussions about this industry segment moved from how it would operate to measuring the performance and how they would affect the economies in which they are operating in. One of the leading scholar’s on this topic was Akram Khan. The following timeline would help illustrate how Islamic finance grew from the 1950’s-2008. (ARIFF and ROSLY, 2011).




Following the discussion on how Islamic finance has grown overtime and what milestones these institutions have achieved during this timeline, I will be moving to discussing the difference between them and conventional financial institutions; hence giving us a full scope of how they differ in comparison to conventional institutions.

## D. Islamic vs Conventional banks:

### I. Economic activity:

Before discussing Islamic banking in a European context and the reasons behind why it is one of the fastest growing sectors within the world market; an explanation of the main differences between the two forms of financial institutions i.e. Islamic Shariah Based Institutions and Conventional financial institutions is a must in order to understand the functionality of each in performing its objectives in the same economic environment (Ahmad, Rustam and Dent, 2011).

The idea of Islamic banking as mentioned previously was developed in the 20$^{th}$ century and was institutionalized in the second part of the century when the Islamic Sharia ideology became widespread. As well as the emergence of Islamic scholars and philosophers that studied the Capitalist and economic systems of the world; highlighting the weaknesses of these systems. Of all the pillars of capitalism interest was the one widely criticized since it conflicts with one of the main teachings of Islam that states RIBA (usury) is prohibited. Hence the main source of income (interest) to conventional financial institutions is considered a forbidden method of conducting business by Islamic principles due to its speculative behavior, in addition to the fact that money is generating money from speculative transactions without adding any economic value through proper supply and demand forces of goods and services. Hence driven by belief and need of those who are seeking principled and an ethical form of financing an alternative method was needed and the appearance of Sharia based financing emerged to operate from the teachings of Islam and all of its sources. Needless to say that Islam was always dealing in trade since existence, and today principles are based on these teachings, awareness and knowledge (Ribā and Islamic Banking Put on Retrial, 2013).

In this section I would be discussing the similarities and differences between Islamic and conventional institutions in terms of how they operate. Looking at the general picture both forms of institutions provide the same services and plays similar roles in the economy but the differences lie in the method in which they provide those services. Their service are categorized into two main categories; the first being mobilization of savings to investors, businesses and entrepreneurs. The Second is the provision of utility services such as consultancy services, facilitating of international trade and transferring of funds. While the difference mainly lies in the mechanisms used to achieve their objective ((P., 2013).

1. Deposits: initially we are going to look at both the differences and similarities of these institutions in terms of deposits. Deposits in both institutions are collected in a similar manner from potential depositors and used in order to invest and gain money. Meanwhile, the difference lies primarily in the method of repayment and the acquiring of return on these deposits. Conventional have a predetermined fixed interest rate that is paid on the deposits and these amounts are invested at the institutions own risk, consequently the institution would reap all the rewards of any successful investment they would undertake. Hence in conventional financial

institutions, savers are rewarded through interest payments while in Islamic banks they are rewarded by Mudaraba and Musharaka (following their PLS system) where the depositors are considered as shareholders since they do share the Bank profits and losses generated from banking activity under Sharia principles. Moreover, it must be noted that the rates quoted by Islamic banks are only indicative based on historical performance under certain products like Mudaraba (Shaikh, 2013).

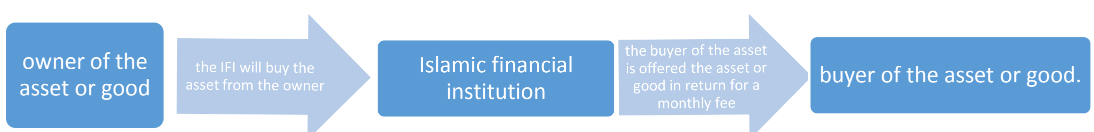
2. Financing and Investment decisions: after taking the deposits of savers, both types of institutions would use these resources by lending the money out to businesses and investors for expected return. Hence, they would be undertaking on the second phase of saving mobilization. However, the main difference lies in the agreement the institutions make when giving the loans. While conventional financial institutions charge interest on the loan; Islamic Banks on the contrary do not follow this model since charging interest is not allowed. Hence Islamic banks charge a profit margin and a limited percentage as fee rather than interest on the client. This leads to different methods of conducting business when it comes to the usual banking services offered, which will be discussed in the following paragraphs (Azadinamin, n.d.).

- Overdrafts and credit cards: under conventional banks clients would be able to overdraw on their accounts through the use of credit cards. This means they would be able to spend up to a certain limit assigned to them by the bank and would pay back the money through installments subjected to interest charge. While in Islamic banks this is not possible, since interest is prohibited. This is only offered by

Islamic banks through the process of Murabaha; where the bank would facilitate the purchase of goods rather than the cash. Additionally, conventional financial institutions start charging interest once the service is being used, while in Islamic banks profit is charged once the goods and services are delivered. Another difference also arises in case if a borrower defaults; in this case conventional financial institutions would be able to charge interest for an extended period while Islamic financial institutions do not have this option under Murabaha. Therefore, their only option would be to blacklist the party that defaulted from future services or there would be a stipulation within the initial contract stating a penalty would be charged, but even if penalty is charged the received value would not go to the bank but rather to charity (Azadinamin, n.d.).

- Loans: Conventional financial institutions give loans, whereas Islamic institutions provide financing, although the final outcome too many would seem the same but the main difference lies in the method followed to achieve an end. Typically, financial institutions offer short, medium and long term loans depending on the purpose of the loans; with conventional institutions charging interest on loans irrespective of its type, thus interest is decided depending on several factors such as duration, client's reputation and purpose. While under the Islamic financial system financing is given through Murabaha, Mudaraba, Ijara, Ijara-w-iqtina or Musharaka contracts. Deciding which type of contract would be used depends mainly on the duration of the financing; Murabaha is the vehicle used to provide short-term financing, while medium to long-term loans are executed through Mudaraba or Musharaka. In the case of Islamic banks firms should provide the bank with a viable risk and return model and prove the project they are entering is viable and profitable (Azadinamin, n.d.).

- Leasing: the idea of leasing is when a financial institutions buys the asset that a customer wants or needs and ownership could be transferred or not to the lease. The same service is provided by Islamic financial institutions through Ijara; which states that the bank would provide the customer with the good that they need without transferring of ownership, while the customer pays rent installments. A few difference arise between the two systems; first all risks through the ijaraa process is borne by the financial institutions, second if the client defaults no extra rent can be asked of them in the ijaraa process only a penalty can be imposed if that is previously stated in the initial contract. A third argument against Ijara is that the bank could ask no repair payment and if the good is damaged or destroyed no extra payments could be asked from the customer. Hence Islamic institutions face higher risks in comparison to their conventional counterparts. The process of Ijara is illustrated in the figure below:




3. Structure:

In terms of structure Islamic and conventional banks are very similar to one another, since both are in the same business. But as we know Islamic banks are prohibited from dealing with any type of business that is prohibited under the Islamic Sharia teachings. The following diagrams would be a better illustration of both institutions structure.

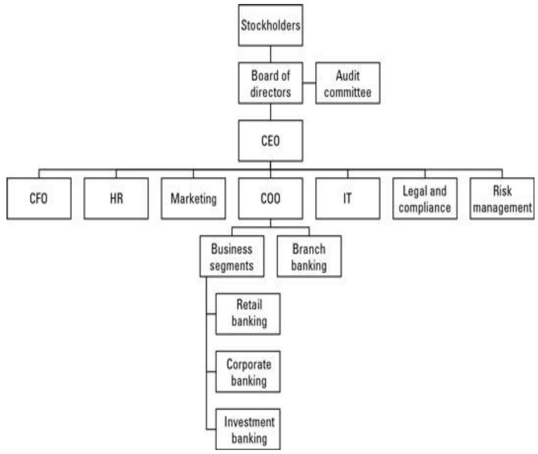



Figure 1: conventionnel  Financial institution structure

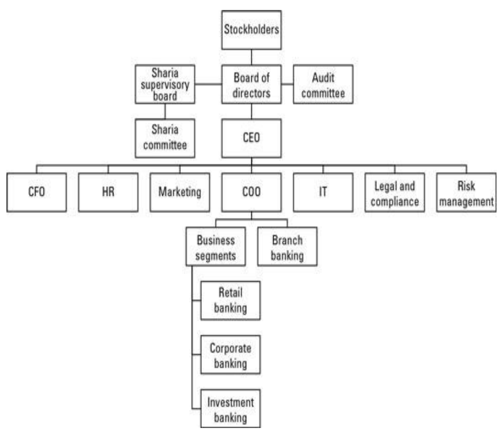



Figure 2: Islamic financial institution structure

As we can see from the above images the structure of both types of banks is very similar with shareholders being on the top, followed by the board of directors and audit committee in the conventional bank structure. While for Islamic banks there is a third entity the Sharia supervisory board and sharia committee which are in charge of deciding what business activities could be undertaken and whether they are within the Islamic guidelines and rulings.

### E. The Growth of Islamic finance in Europe:

In today's financial framework Islamic financial institutions and financial systems are witnessed as an alternative to conventional banks for Muslims wanting to perform all their financial transactions within the boundaries of Shariah, while subsequently giving non-Muslims a more ethical way of conducting business. Hence it's branching out to the European market, since the 1990's Islamic finance in general has grown substantially in the worldwide financial market and this is mainly shown by the increase of Islamic financial assets from 150 billion USD in the 1990's to 1.9 trillion USD in 2013; of which Islamic banking holds 1.3 trillion. Hence showing it as the most important and vital part of the Islamic financial framework. This substantial growth could be attested to the following reason:

i. The ever growing Muslim population within non-Muslim countries whom demand sharia compliant financial institutions.
ii. The growing popularity of the idea that Islamic finance can promote further growth within economies rather than deter it due to its rigid bylaws.
iii. The support of many jurisdictions to help the growth of Islamic financial markets and integrating them into their own.
iv. The growing need to finding alternative solution in the wake of the latest European financial crisis and as a precaution to any future crisis.
v. As well as the aim of attracting the financial liquidity from the emerging markets where Islamic finance is an important part.

This growth in the Islamic banking sector has not been a uniform one across all European countries; with France, Germany, Luxembourg, Ireland, Italy and the UK adopting the Islamic banking sector and integrating it into their respective economies (Ahmed, 2014).

1. France: Islamic finance sector has been one of the largest and fastest growing in the region since there was very strong support for from the French financial authorities ever since its introduction in 2007 when “the Islamic Commission” was established. Since that time two Islamic alternative where given to conventional banking, the first being Shariah compliant Investment funds and the second is sukuk listings. Since at the time the application of Islamic banking in France was in its infancy stage; French regulatory authorities took a few steps in order to allow Islamic finance to grow in their economy. The first step was taken in 2008 where amendments were made to taxation. These amendments allowed payments made by sukuk issuers to be treated as interest paid on bonds; from a taxation perspective hence being deductible from disposable income. It also exempted international or non-resident sukuk investors from withholding tax in France. In 2011 France introduced its first Islamic depositing system as part of one of its conventional banks. After the success of 2011’s Islamic deposit system a 10 year Murabaha contract was introduced, this was met with a high level of demand by the majority of retail clients (Ahmed, 2014).

    Nowadays Islamic funding in France has about 147.2 million of total assets, which almost evenly split between money and equity markets. One main aspect that helped the strong growth of Islamic finance in France was the large Muslim population mainly from North Africa.

2. Germany: the country first adopted Islamic finance in 2004 when it issued its first sukuk which was demanded greatly, 60% were demanded by investors in the UAE and Bahrain while the remaining 40% were demanded by investors across Europe. In 2009 foreign Islamic financial Institutions were granted permission by BAFIN (Federal Financial Supervisory Authority) to conduct business within Germany in a limited area since they were not given a fully-fledged banking license. While German Institutions are also entering Foreign Islamic finance markets through their subsidiaries and partners in leading Islamic markets such as London, Dubai and Kuala Lumpur (ARIFF and ROSLY, 2011).

    Germanys prospect in Islamic finance are very bright due to many factors. First is that it is the largest and most efficient European economy today. Second is that it has the largest Muslim population in Europe. Third German exporters started using Islamic financing as an alternative to conventional ways of financing. The last reason is that Islamic trade finance products would help Germany strengthen ties and trade with some of its trade partners such as Turkey. This strengthening in ties with Turkey is embodied by the announcement of the first fully fledged Islamic financial institution in Germany will be launched in July of 2015, this entity would act as a subsidiary of Turkish lender Kuveyet Turk. The institution would be named KT bank AG and would conduct its business activities out of its headquarters in Frankfurt (ARIFF and ROSLY, 2011).

3. Italy: Italy’s economy has been one of the fastest growing economies within the EU. The Italian government has taken many steps towards tapping into the Islamic finance industry. But they have taken a different approach to entering the market first by hosting a number of conferences about the topic in order to educate the country about the topic. According to estimates by the end of 2015 Islamic retail banking could reach 5.8 billion and make revenues of 218.6 million dollars. With these figures rising to 33.4 billion USD and 1.2 billion USD in 2050.
4. Ireland: In Ireland a strong base for Islamic finance has been put in place. Where tax provisions have been developed specifically for this purpose. The first was a tax treaty with Muslim nations, while the second special tax rules for Islamic financial instruments. Ireland also has reduced obstacles facing Islamic finance hence making it one of the most attractive economies for Islamic banking. This can be seen through the diversification of the Islamic funds in Ireland.
5. Luxemburg: Luxemburg was the first European country to enter the Islamic finance sector in 2002, as well as being one of the largest and most attractive option for any Islamic financial operations, this is mainly due to the proactive stance its government has taken in order to attract Islamic funds. Since the country has a small Muslim population this means most of its business would be cross-border. In 2009 Luxemburg’s position was significantly enhanced when its central bank became the first in European CB to be inducted into the IFSB.
6. United Kingdom: the UK is known to have the most developed and advanced Islamic finance sector. With the country having the first fully operational sharia compliant retail bank and currently that number has grown to five Islamic banks.

In 2005 the first corporate sukuk was launched in Europe. During that time the British government worked to reduce all possible obstacles facing these "corporate sukuk" leading to the formation of the "Islamic finance task force" in 2013. In the UK Islamic finance has grown to the point that around 25 UK based law firms have specific department's related to the topic.

The British government also amended its fiscal and regulatory environment in order to help Islamic Finance to grow and level the playing field between conventional and Islamic financial institutions. These amendments included the abolishment of taxes on capital gains on sukuk issuance, treating income payment like interest on bonds hence being tax deductible, taking FSA initiatives to ensure treatment of Islamic finance is consistent with their objectives and principles (ARIFF and ROSLY, 2011).

## F. Arguments against Islamic banking:

1. The first Argument against Islamic banking is that many of them incorporate all different banking activities under their banner. Since they are involved in commercial, retail and investment banking which makes it harder for regulatory authorities to regulate their business activities.
2. One of the main ideas of Islamic banking is the concept of profit/loss sharing between the bank and the customer. Hence putting the customer at a higher risk than a conventional bank in fields such as capital adequacy, transparency and customer protection.

3. Islamic banks have a different way of conducting businesses than conventional banks when it comes to investment and mobilization of resources; as mentioned in the above section. Hence making it harder for regulatory authorities which as we have seen in the previous section caused most of the European countries interested in entering the Islamic finance sector to amend some of the laws and regulation in order to accommodate them.
4. Islamic banks use the Shariah as a guideline for any operation they undertake, which is usually interpreted by Muslim scholars. Hence here is where the problem of a lack standardization in what is considered acceptable or not arises. Since as in topic the interpretation may differ from one scholar to the other therefore no concrete answer is found for some topics. Therefore it has become a normal practice for Islamic banks to appoint their own sharia board whose job is to decide what is and is not in line with the sharia law. This is costly and time consuming for the banks themselves as well as confusing for regulators.
5. Liquidity and capital requirements: the Basle committee's strict requirements are another hurdle that may prevent Islamic banks from prospering in the world financial market. This is because they tend to overestimate the risk that is attached to Islamic banks assets hence making them seem riskier than conventional bank's assets. This problem arises because conventional banks keep most of their asset in fixed interest bearing deposits which are easier to measure than the ventures and investments were assets of Islamic banks are invested.

6. Another problem for Islamic banks is that they are not able to use the Central Bank's role as a lender of last resort during harsh economic times because of the interest payments they would be obliged to pay.
7. The last problem is that Islamic finance would face in countries that have not amended their taxation policies and regulations in order to accommodate Islamic financial institutions. Since one main problem with this is that interest payments on bonds is used as tax shield but since Islamic financial institutions are prohibited from dealing with interest they would not have the privilege of a tax shield under the laws for conventional banks. Hence as I stated in the previous section we saw that most if not all EU countries have amended their laws mainly on taxation among other factors in order to accommodate and assist the growth of Islamic finance in their economies.

## G. Arguments in favor of Islamic banking:

1. The first advantage of Islamic finance is the efficient allocation of resources which is derived from the profit and loss sharing mechanism used within Islamic banks.
2. Islamic banks and financial institutions would help economic growth greatly since both the financial intermediary (the bank) and the consumer are both working for the most efficient and profitable investment for both parties.
3. Islamic banks in general offer higher liquidity than conventional banks, this is a direct result of their PLS method that they follow. Due to the PLS technique they have a much higher ability to mobilize their capital. Hence they are less likely to face a run on their deposits.

4. Unlike conventional banks they have no fixed obligations such as interest payments on deposits. Hence freeing up their resources that can be invested in economically profitable activities.
5. From ethical perspective Islamic banks are a more attractive option than conventional banks. Since business activities that they invest in are chosen carefully so that they are in compliance with the sharia. Hence investing in more socially acceptable and attractive investments.
6. The last argument for Islamic banking is that it destabilizes speculation since they don't operate according to speculative transaction like conventional banks, hence having the best interest of the depositor in mind.

## H. Literature review:

In this section I will be looking at some previous works comparing between Islamic and conventional banks. Each study will be taking this subject from a different perspective in order to help us have a more complete view of how each of these banks function and deal with different economic conditions and situations.

I. The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study"

This research is done by Maher Hassan and Jemma Dridi. In this paper the authors compared between Islamic and conventional banks and how each was affected by the 2008 crisis. The comparison was made in terms of profitability, credit and asset growth, and external ratings in a group of countries where the two types of banks have significant market share. In their paper the authors took the UAE, Bahrain, Jordan, Saudi Arabia, Turkey, Malaysia and Kuwait; since in these countries Islamic banks are an integral part of their banking sectors. In this sample 120 Islamic banks are used which account to almost 80% of Islamic banking in the world if we exclude Iran. In their study it has shown that Islamic banks have a higher capital adequacy capacity and have a lower leverage multiplier (capital/assets) as well as a much smaller investment portfolio when compared to conventional banks. On the other hand during the same period Islamic banks in this sample have shown higher profitability whether it was measured by the ROA or ROE (Hassan and Lewis, 2007).

Moving on to the empirical tests that were done by the researchers, they test the performances of both Islamic and conventional banks in each countries specific economy in for main areas which were profitability, bank assets, bank lending and bank rating. The tests were done through comparison of raw data and profitability, liquidity, capital adequacy ratios as well as through running ols regressions. First in terms of profitability we could see that on average Islamic banks performed better in 2008, except in the UAE, Qatar and Malaysia. But on the other hand when effects hit the real economy Islamic banks were affected more than their conventional counterparts. But in the overall picture Islamic banks maintained a higher ROA and ROE than conventional banks. Hence showing that they are more immuned to the direct impact of financial crises but are more affected when the real economy in hit. While when credit growth is taken into consideration Islamic banks results have shown that they have a higher growth rate when compared to conventional banks (almost double). Hence this implies that market share of Islamic banks is growing and that these institution lead to stability within the economy. This was the general consensus that was reached by the researchers with the only exceptions being Bahrain and Qatar. While in terms of asset growth results showed those Islamic banks have maintained a growth rate double than that of conventional banks. The last criteria for the comparison was through the external rating of the Islamic and conventional banks. These ratings showed us that in general Islamic banks had either similar or favorable rating when compared to conventional banks, with the exception of the UAE. In the conclusion of the paper the authors highlighted the obstacles facing Islamic banks sustainability and stable growth patterns (Hassan and Lewis, 2007).

II. A second study I will be reviewing is "Comparative Performance Study of Conventional and Islamic Banking in Pakistan"

A paper by Muhammed Hanif, Mahvish Tareq, Arshiya Taher and Wajeeh al-Mumeneen. The importance of this paper is comparing between Islamic and conventional banks in a more balanced context where they are already more competitive than in the European context hence giving us an idea of what Islamic banking could achieve in years to come. The aim of the research was to study how Islamic and conventional banks have been functioning in Pakistan from 2005 till 2009, in order to answer the following research questions:

1. Which of the banking stream is relatively more profitable?
2. Which of the banking sector is relatively more liquid?
3. Which of the banking sector is exposed to relatively more credit risk?
4. Which of the banking stream is more solvent?

5. Which of the banks is best performer in both streams?
6. Which of the banking stream has relatively more satisfied customers?

The sample taken for this study was made up of 22 conventional banks and 5 Islamic banks in order to test the relationship between risk and return which is covered by the first four questions; through financial statement and ratio analysis while the last question was answered through customer surveys.

The results of the empirical studies were as follows:

1. Profitability: for measuring profitability of banks during this period the ROE, ROA and COSR were compared; the results showed that conventional banks were better off in this aspect.
2. Liquidity: when comparing liquidity risk for both types of institutions we realize that the results are similar to those we got for the profitability measures where conventional banks were better off. The researchers use the NetLTA, LdCDSF and NetLD&B in order to test for liquidity.
3. Credit Risk: the third criteria chosen by the researchers to test the performance of conventional and Islamic banks was through credit risk using the EQTA, EQL and IMLGL ratios. The results showed that Islamic banks a more efficient in this aspect.
4. Solvency: the last part of the performance measurements is the solvency management comparison were Islamic banks drastically outperform conventional banks as seen by the results obtained in their paper.

The previous empirical tests have helped us reach a conclusion about all the research questions the researchers raised except the last question relating to customer satisfaction and choice. Hence the most efficient way to answer that question was through customer surveys.

In conclusion of their research paper the researchers stated that their results might have been affected by the unequal distribution of the sample. Since 22 conventional banks were studied compared to 5 Islamic banks hence this might be the reason for the low profitability and liquidity of Islamic banks.

III. "Liquidity and Risk Analysis of Islamic Banking System during Global Financial Crises"

A paper done by Azam Shafique, Muhammad Asim Faheem and Iqra Abdullah. In this research paper the researchers look at how Islamic banks fared during the financial crisis of 2008; the results of this paper were interesting when compared to the findings of in Mohammed Hanif's paper discussed above. Since in this paper they reached the conclusion that one of the factor is the greater liquidity that Islamic banks have compared to conventional banks. Since in the previous paper which does a comparative study between the two type's institutions it showed that Islamic banks are worse of in terms of liquidity. This could be attributed to the bias within the sample (22 conventional and 5 Islamic) taken for the study. In this paper the authors took a more theoretical approach to explaining why Islamic banks were more immune to the 2008 financial crisis rather than the more common and accurate empirical method. Hence giving us a different angle on the topic. In this paper the authors look at Islamic banks as a stabilizing instrument during times of crises as they have shown in the 2008 since the effects on them were minimal when compared to what has happened to conventional banks. One the of the main reason the authors have taken this stance towards Islamic banks due to the lack of speculation in their business activities which according to the authors of paper was one of the main reasons of the financial crisis since it was the large number of loans given by banks to the housing sector that lead to the 2008 crisis. Another argument that was used by the researchers is that Islamic bank shave higher liquidity also makes it a much safer option than conventional banks as shown by the majority of the studies done on the subject.

IV. "The Global Financial Crisis: Response of Fourteen Islamic Banks"

A project done by Farah Nahlawi, in this project the author studies the response of 14 Islamic banks to the 2008 financial crisis, the sample within the paper was taken from Saudi Arabia, UAE, Kuwait, UK, Malaysia, Qatar and Bahrain. While the sample period was dated from 2007-2012 in order to allow the researcher to test through all periods pre, during and post crisis.

The methodology followed in this project was broken up in to two main parts; the first being through ratio analysis which include profitability (ROE, ROA, Leverage multiplier, Net profit margin), liquidity (NCP, net loans to deposits), credit quality (NPL, Provision to gross loans) and capital adequacy ratios.

While the second part of the empirical tests consisted of a regression analysis of by the financial ratios regressed on macroeconomic variables of each economy.

The findings of the project were that in terms of profitability Islamic banks were affected negatively by the crisis in periods before and during it. But recovered in the after the crisis in terms of leverage multipliers and ROE.

While in terms of liquidity Islamic banks were not highly affected by the crisis since their liquidity ratios were not affected significantly. Hence showing their resilience towards financial crises.

In terms of credit risk and quality the ratios showed that the banks credit risk increased during the sample period, which is expected during economic downturns. While credit quality deteriorated. While in terms of Capital adequacy the deterioration in this ratio was rather negligible.

Hence in conclusion of the ratio analysis the author was able to conclude that these Islamic banks had a plan to deal with an economic fluctuation that could occur during crises; which would help maintain the stability of these institutions and support the economy.

Another finding of the paper was shown when the regression analysis was run; that implied that the macroeconomic variables were insignificant in explaining the changes in the financial ratios in terms of profitability, net loans to deposits and non-performing to gross loans ratios. However the growth in real GDP was the only variable that had a significant effect on the capital adequacy ratio; this affect was positive and significant. While significant affects could also be seen on ROA since there was a positive relationship between Money growth and ROA.

While a significant negative relationship could be witnessed on the leverage multiplier and non-performing to gross loans ratio, while reserves had a positive effects on the leverage multiplier but negative on the capital adequacy ratio and net loans to deposits.

Hence all papers that I have reviewed on the topic have allowed us to reach the same conclusion. Which states that Islamic banks are much better equipped to deal with any economic fluctuations that they might face in today’s dynamic world markets (Hassan and Lewis, 2007)?

# CHAPTER TWO: METHODOLOGY AND DATA

## A. Data and Data Collection:

In this section I will be discussing the methodology I will follow throughout my empirical testing. The main purpose of this paper was to reach a conclusion whether Islamic banks would be able to withstand and flourish within the European market. As well as formulating some necessary recommendations for Islamic financial institution on how they should structure themselves, the necessary regulatory bodies and market conditions in order to succeed in western financial systems. In this project I will be using the Capital Asset Pricing model to test the expected return of Islamic indices compared to conventional Indices. I will be using these indices as proxies for Islamic and conventional financial institutions due to the lack of sufficient information about Islamic financial institutions in Europe, since the industry is still in its infancy stage and any other tests would not be very accurate nor will it allow us to reach any concrete results. By comparing the different indices we would be able to formulate an idea of how Islamic finance has been doing with respect to conventional financial institutions in Europe and whether they were over or underperforming.

In my study I will be using the Stoxx Europe Islamic index which includes 2 sub-indices; the Stoxx Europe Islamic 50 and Euro Stoxx Islamic 50 as my proxy to Islamic financial institutions, while I will use the Stoxx 600 European index a proxy for the European markets as a whole. Hence being able to benchmark how Islamic financial institutions performed against a larger sample and against the market.

The Data I will be using is as I stated before the Stoxx Europe Islamic index, while the Stoxx 600 European index for the European market and the Euribor 3month T-bill for the risk free rate. Daily data of the variables closing value will be collected for a 10-year period spanning from January 2005 up to January 2015 allowing us to cover periods of pre-crisis, during crisis and post crisis. The daily data was obtained from the Bloomberg and Reuters Databases.

The Stoxx Europe Islamic index includes all firms and companies that are in the Stoxx 600 European index that abide by sharia principles. This is checked through a two-stage screening process for any company wanting to be included in the Islamic index. The first step of screening is checking whether the firms are involved in any business activities prohibited by the Islamic law. These include the following activities:

- Tobacco
- Alcohol
- Gambling
- Non-halal food production
- Entertainment and music production
- Advertisement
- Hotels
- Non Islamic banks and financial institutions
- Trading of gold and silver
- Weapons and Arms production

While the second phase of screening is with regards to the financial position and ratios of the firms and those include:

- Interest and non-sharia compliant income cannot compromise more than 5% of the total income of the firm.
- The ratio of non-sharia debt cannot exceed 33% of total assets or total market capitalization.
- Also the ratio for interest bearing assets cannot exceed 33% of total assets or total market capitalization.

## B. Methodology:

The method I will be following in this paper is applying the Capital Asset Pricing Model or CAPM, to measure the performance of Islamic finance products in Europe vs conventional financing products. Hence giving us an idea of how these two products compare to one another, with focus on risk and return; which would help us see whether the more conservative Islamic financing is less rewarding in comparison to conventional financing due to their supposedly lower risk level. Before going into a detailed description of the empirical tests that will be performed a recap of the CAPM will be done. Through the CAPM model I will be looking at the Jensen's alpha hence allowing us to conclude whether Islamic financial institutions are outperforming their expectations or not.

### i. CAPM:

The Capital Asset Pricing model is a theoretical financial model that test the relationship between risk and return. The rationale behind the model is that investors need to find a balance between the time value of money represented by the risk free rate and the risk involved in any portfolio. The model is mainly used to measure a security's or specific portfolios expected return and comparing it to a market portfolios expected return. The model makes the following assumptions:

- Investor's goal is Maximization of utility.
- They are rational and risk-averse (hence not risk lovers).
- Investors' portfolios are diversified across a number of investments
- Investor are price takers; meaning they have no effect on the prices in the market
- Lending and borrowing are not restricted under risk free rate.
- No transaction costs.
- Homogenous expectations.
- All information is readily available.

The models Mathematical representation is as follows:

$$E(R_i) - R_f = \beta_i(E(R_m) - R_f)$$

Ri: this represent the return on the investor's portfolio or stock.

Rf: this represents the return on the risk free rate

Rm: this reflects the return on the market portfolio

Beta: represents the systematic risk in the CAPM model.

ii. Explanation of the methodology:

As I have stated in the beginning of this chapter I will be performing the CAPM model on the Stoxx Islamic European market Index, in order to measure the performance of Islamic financial index against the market and the returns that they give to their investor or buyers.

The reason I have followed this method of testing rather than using a sample of Islamic financial institutions in the European framework is due to the lack of data available on these institutions since the industry is still in its infancy stage and doesn't compromise a large portion of the market and has a very negligible market share. Due to those reasons I found that using the CAPM on the Islamic market index would give us a better idea of how the Industry is functioning within the European context. Through the CAPM model I will be looking at the Jensen's alpha hence allowing us to conclude how Islamic financial index have been performing during this period and whether or not they are outperforming or underperforming with respect to conventional financial index and the market.

My empirical testing will be broken into two main parts:

- The first will be applying the model on the Islamic Index with the Stoxx Europe 600 market Index taken as the Market portfolio, testing how the returns on the Islamic index are compared to the market return over the whole period from 2005-2015.
- The second part of the Empirical tests would be consisted of breaking up the sample period into two sub-periods which would allow us to test the effects of the financial crises on the expected returns of the Islamic Indices and their

performances bench marked against the market, while the second sub-period would allow us to test how the Islamic indices fared in the years after the financial crisis and when the Financial markets were getting back on track.

- Period 1: 2007-2012 which is the period pre-crisis and crisis.
- Period 2: 2013-2015which includes the post crisis.

The Idea behind the breakup of the timeframe is that through this technique we would be able to measure the performance of Islamic financial index during all periods of an economic cycle.

- Following the application of these tests and interpreting the results this will give us a much clearer Idea of how Islamic finance has fared in the European financial framework, whether it could be successful. In addition to the case studies I have performed in the previous chapter with results of both studies we would be able to formulate whether Islamic banking could succeed in the European market and whether one day it could replace the conventional banking system. As well as the recommendations on how these financial institution should be structured to reach those goals and how the market should accommodate them.

# CHAPTER THREE: EMPIRICAL TESTING

## A. Unit root testing:

Before conducting the CAPM the first step would be testing our series whether or not they are stationary. The testing method I have used the Augmented Dickey Fuller or ADF unit root test. In order to check whether all the series are stationary and at what level are they stationary the p-value should be less than the significance levels or the t-stat is greater than the t-critical means that the series is stationary. The results of the chosen series were as follows:

### i. Stoxx 600 Europe (Market index):

The Stoxx 600 series showed stationary properties at first difference at all the significance levels of 1, 5 and 10% Levels, since the P-value is 0.0001 which is less than 1, 5 and 10% significance levels we could conclude that the series is stationary at first difference.

Null Hypothesis: D(CLOSE_STOXX_600) has a unit root
Exogenous: Constant
Lag Length: 0 (Automatic - based on SIC, maxlag=27)

| | | t-Statistic | Prob.* |
|---|---|---|---|
| Augmented Dickey-Fuller test statistic | | -51.69614 | 0.0001 |
| Test critical values: | 1% level | -3.432709 | |
| | 5% level | -2.862468 | |
| | 10% level | -2.567309 | |

*MacKinnon (1996) one-sided p-values.

ii. Stoxx Islamic European index (investor's portfolio):

The Stoxx Islamic European series exhibits stationary properties at first difference at all the significance levels of 1, 5 and 10% Levels, since the P-value is 0.0001 which is less than 1, 5 and 10% significance levels we could conclude that the series is stationary at first difference. Hence the findings are similar to the Stoxx 600 European market index.

Null Hypothesis: D(CLOSING_STOXX_ISLAMIC_EU) has a unit root
Exogenous: Constant
Lag Length: 0 (Automatic - based on SIC, maxlag=27)

| | | t-Statistic | Prob.* |
|---|---|---|---|
| Augmented Dickey-Fuller test statistic | | -51.44409 | 0.0001 |
| Test critical values: | 1% level | 3.432709 | |
| | 5% level | 2.862468 | |
| | 10% level | 2.567309 | |

*MacKinnon (1996) one-sided p-values.

iii. Euribor three month rate (risk free rate; rf):

The Euribor three month rate series also exhibits stationary properties at first difference at all three significance levels. Since its p-value is 0 and t-statistic is greater than the t-critical.

Null Hypothesis: D(EURIBOR_3M) has a unit root
Exogenous: Constant
Lag Length: 4 (Automatic - based on SIC, maxlag=27)

| | | t-Statistic | Prob.* |
|---|---|---|---|
| Augmented Dickey-Fuller test statistic | | -10.07064 | 0.0000 |
| Test critical values: | 1% level | -3.432713 | |
| | 5% level | -2.862470 | |
| | 10% level | -2.567310 | |

*MacKinnon (1996) one-sided p-values.

## B. CAPM:

### i. Testing the whole sample 2005-2015:

The first part of the CAPM analysis will be conducting the test on our whole sample that spans over a ten year period of daily data. The results I reached are found in the following table:

Dependent Variable: RJ_RF
Method: Least Squares
Date: 04/05/15 Time: 18:47
Sample (adjusted): 1/30/2005 1/30/2015
Included observations: 2563 after adjustments
RJ_RF=C(1)+C(2)*RM_RF

| | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C(1) | 9.52E-05 | 4.71E-05 | 2.022797 | 0.0432 |
| C(2) | 0.926714 | 0.006321 | 146.6048 | 0.0000 |

| | | | |
|---|---|---|---|
| R-squared | 0.893531 | Mean dependent var | 0.000726 |
| Adjusted R-squared | 0.893490 | S.D. dependent var | 0.007274 |
| S.E. of regression | 0.002374 | Akaike info criterion | -9.247879 |
| Sum squared resid | 0.014431 | Schwarz criterion | -9.243315 |
| Log likelihood | 11853.16 | Hannan-Quinn criter. | -9.246224 |
| F-statistic | 21492.98 | Durbin-Watson stat | 1.967842 |
| Prob(F-statistic) | 0.000000 | | |

The table above represents the regression of the CAPM model over the whole sample and this shows us some interesting findings. The first finding we would look at is the Beta coefficient which is represented by the C (2); whose value is 0.926714 and is significant in the regression hence showing that the returns of Islamic financial index is less volatile than the returns of the market portfolio. Another thing we notice is the high r-squared value which was found to be 0.893531 and adjusted r-squared at 0.893490; this is useful because it shows us that the performance of Islamic index during this period is almost 89.3 percent correlated to the performance of conventional index in the market.

Hence any fluctuations in the market portfolio will cause considerable fluctuations in the performance of the Islamic index. The third conclusion that is important for us to look at is the Jensen's alpha coefficient; which is a theoretical financial measurement tool that measures the average return of the portfolio over that which is predicted by the CAPM model. This would allow us to check whether Islamic Indexes are over or underperforming the market indices. The Alpha Is represented by the intercept coefficient of the CAPM regression and could yield one of the following results:

- If alpha is positive and not significant this would show that the stock or portfolio is performing similar to the market.
- If alpha is positive and significant this would show that the stock or portfolio is over performing in the market.
- If alpha is negative and not significant this would imply that the stock or portfolio is slightly underperforming in the market.
- If alpha is negative and significant this would imply that the stock or portfolio is underperforming badly in the market.

In our case when the Islamic index is regressed on the market index we observe that the alpha has a value of 9.52E-05 which is a positive value with a p-value of 0.0432 which is less than 0.05 and 0.1 which are the significance levels at the 5 and 10 percent. Hence showing us that during this ten year period Islamic financial index have outperformed the market expectations and outperformed conventional financial index.

ii. Testing the period from 2007-2012:

The second part of the empirical analysis will be from 2007-2012; this will be done in order to check the performance of Islamic financial index and their expected returns during the financial crisis. This will help in giving us an idea of whether Islamic financial institutions business activities are actually more resistant to economic shocks. The results obtained from performing the CAPM over this sub-period of the sample gave us the following results shown in table below:

Dependent Variable: RJ_RF
Method: Least Squares
Date: 04/06/15 Time: 17:44
Sample (adjusted): 1/01/2007 12/31/2012
Included observations: 1544 after adjustments
RJ_RF=C(1)+C(2)*RM_RF

| | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C(1) | 0.000140 | 4.55E-05 | 3.070919 | 0.0022 |
| C(2) | 0.929791 | 0.006286 | 147.9048 | 0.0000 |

| | | | |
|---|---|---|---|
| R-squared | 0.934153 | Mean dependent var | 0.000852 |
| Adjusted R-squared | 0.934110 | S.D. dependent var | 0.006921 |
| S.E. of regression | 0.001777 | Akaike info criterion | -9.826926 |
| Sum squared resid | 0.004867 | Schwarz criterion | -9.820006 |
| Log likelihood | 7588.387 | Hannan-Quinn criter. | -9.824351 |
| F-statistic | 21875.84 | Durbin-Watson stat | 1.831310 |
| Prob(F-statistic) | 0.000000 | | |

The results shown in the table above display some interesting results, the first thing we are able to notice that the beta is 0.929791 and significant since its p-value is zero. This result shows us that the expected returns of Islamic financial index is less volatile than the market returns hence it is less effected by economic downturns during this period and it also shows that the Islamic indices are of a bearish rather than bullish nature. This conclusion is consistent with the idea that Islamic financial institutions were less effected by the financial crisis of 2008 and that they might be able to help in stabilizing the economy at times of economic crises. The second important value to look at is the Jensen alpha which is shown in the table by the C (1) coefficient whose value is 0.000140 and is considered significant. Hence since the value of alpha is positive and is significant due to its p-value (0.0022) being lower than the 5 and 10 percent levels, this would allow us to conclude that during this period the Islamic indices are outperforming their expected returns within the market and are performing better than the market or conventional indices. The last important result to look at is the values of the r-squared and the adjusted r-squared values, which were 0.934153 and 0.934110 respectively. These results show that there is a high correlation between Islamic and conventional European market indices.

iii. Testing the period from 2013-2015:

This part of the analysis will take into consideration the period after which the European economy started recuperating from the 2008 financial crises up to today and whether Islamic financial  institution are still performing at the same rate or not. The results for this sub period were as is shown in the table below.

Dependent Variable: RJ_RF
Method: Least Squares
Date: 04/06/15 Time: 18:40
Sample (adjusted): 1/01/2013 1/30/2015
Included observations: 532 after adjustments
RJ_RF=C(1)+C(2)*RM_RF

| | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C(1) | -5.81E-06 | 2.88E-05 | -0.201361 | 0.8405 |
| C(2) | 0.993642 | 0.002814 | 53.1580 | 0.0000 |

| | | | |
|---|---|---|---|
| R-squared | 0.995768 | Mean dependent var | 0.001197 |
| Adjusted R-squared | 0.995760 | S.D. dependent var | 0.010143 |
| S.E. of regression | 0.000660 | Akaike info criterion | -11.80353 |
| Sum squared resid | 0.000231 | Schwarz criterion | -11.78745 |
| Log likelihood | 3141.738 | Hannan-Quinn criter. | -11.79724 |
| F-statistic | 124720.6 | Durbin-Watson stat | 1.879289 |
| Prob(F-statistic) | 0.000000 | | |

The results in the table above show the results of the CAPM model during a period where the European market was getting back on its feet after the 2008 financial crises. The first interesting result is that the value of beta in this case was 0.993642 and was significant, which the highest beta we have obtained throughout our tests, hence is showing that during time of normal economic conditions Islamic financial index are more volatile than during tight economic conditions. While when looking at the value of Jensen's alpha the most interesting result is obtained since its value was-5.81E-06 as well as being non-significant during this period. This result is very important since previous studies and researches have shown that Islamic financial institutions are not directly affected during recessions but have a lagged effect when the real economy is affected which means in the period following any economic downturn which is in line with the conclusion reached by Jemma Dridi and Maher Hassan in their research which was discussed in the literature review section of the project. As I stated before when the alpha has a negative value that is non-significant this means that the portfolio or stock is underperforming the market expectation, which is the case we have here. While the r-squared and adjusted r-squared 0.995768 and 0.995760which implies that there is a high correlation between the Islamic financial index and the Market index.

## C. Final Remarks:

After performing the CAPM model to the data sets we could see that using the Indices as a proxy for financial institutions performance of the sample period I have chosen, show that results are consistent with the findings of other papers on the topic of Islamic finance, but the use of this method for the European market allowed us to formulate an idea of how their performances are within the European context showing that Islamic finance has a chance of making in it Europe and western markets if it is given the right opportunities and conditions to flourish in. The next section of the project will use the results we have obtained from the Empirical tests with the facts obtained from the case studies and the reasons behind the failures of the financial institutions that were in question would allow us to design a model were Islamic banks could flourish within the European market and the conditions needed for it to continue its steady growth in the European context.

# CHAPTER FOUR: HOW ISLAMIC FINANCE CAN GROW IN EUROPE

In this section I will be discussing how Islamic finance should be allowed to grow within the European market for it to flourish, in order to do that a blueprint should be found through looking at one the most advanced Islamic financial systems in today's financial world which is the Malaysian case (refer to appendix). This way we would be able to get a clearer look at what amendments should be done to European financial sector to accommodate Islamic finance into their economies.

## A. Recommendations required to design the Islamic Financial Institutions in Europe:

- The first recommendation is that the European Financial regulatory authorities should set a long term strategy on how Islamic finance will grow. This strategy should be similar to the strategy followed by Malaysia. In other words the European authorities should take the Malaysian case as a blueprint for their strategy.
- The second recommendation is that there should be a specialized regulatory authority that follows up and inspects all business activities done by these institutions. This body should come up with guidelines and regulations by which Islamic financial institutions should abide by. This regulatory authority should have the same tasks as the FSA in the UK, but as we have seen in the cases of RBS and HBOS there were deficiencies in the FSA regulations. Therefore this

regulatory body should come up with clear and strict guidelines that the Islamic institutions should abide by and be held responsible if they fail to do so, in order to prevent them from reaching the same fate as RBS and HBOS were negligence from the FSA aided in their Failure.

- The third recommendation is also linked to the HSBOS case study (refer to appendix), where we witnessed a case of a very aggressive growth strategy backfiring in the firms face. Hence showing that in order for Islamic finance to grow and succeed in the European market it would need to follow a growth strategy; were it will be able to grow at a steady and sustainable rate. In other words their strategies should aim for long-term growth and sustainability rather than aggressive and quick growth.

- The fourth recommendation European financial authorities should help in facilitating the required infrastructure required for an Islamic financial market to be set up similar to the method followed by the Malaysian financial sector; i.e. government grants in order for the sector to be able to start its operations. Such initiatives have already been taken by countries such as the UK, France, Italy, Germany, Ireland and Luxemburg, but in order for Islamic to be able to prosper in the European market as whole and not just in some parts it requires such initiatives to include the whole European community.
- The fifth recommendation is derived from the result of the investigations into the Failures of RBS and HBOS. In both cases we witnessed that the management were

held accountable even if not fully accountable, but played a role in the failure of the bank. For example in HBOS's case it was because most senior managers and personal were more knowledgeable in retail, therefore the mainly losses that lead to banks failure were incurred through their corporate and international business divisions. Hence there should be a thorough screening process of the candidates which will be responsible to leading these institutions. Since they should have the knowledge and expertise in the Islamic finance sector in order to be able to deal with situations they might face and make the right decisions according to the knowledge and experience from within the industry.

- The sixth recommendation is that Islamic financial institutions should be marketed by themselves and the regulatory bodies responsible, because the European market is one of most competitive and harsh financial markets to enter. This could be done through more than way, either by appealing to how Islamic financial institutions were able to withstand economic fluctuations better than conventional ones, or through the stabilizing effect they have during these crises in which they could help in monetary policy implementations as well as stabilizing the economies in during harsh economic times. These reasons are all shown and proven to be true in the empirical testing portion of the project were it showed that the Islamic financial index was able to over perform its expected levels. These findings were in line with findings of most of the literature that could be found on the topic.

- The seventh recommendation would be that since they are breaking into a new market Islamic finance should be subject to much higher standards than conventional financial institutions, in order to increase their appeal to the public. Since they are the new entrants to the market while conventional banks have already established themselves in the market.
- The eighth recommendation is that regulatory authorities should give the Islamic financial industry all the right tools; for example grants and subsidies in order to allow them to come up with new and innovative ways to diversify their products. So they can compete with conventional financial services and products.
- The ninth recommendations for Islamic finance would need to improve its transparency measures and compliance with the International financial framework. This could be only done by first formulating a unified and homogeneous set of rules and regulations for Islamic finance.
- The tenth recommendation is that Islamic financial institutions should have a more efficient and standardized structure or model in order for them to succeed in the European financial environment.
- The eleventh recommendation is in relation with Maher Hassan's and Jemma Dridi's as well as Farah Nahlawi's paper discussed in the literature review section of the project. Where they reached the conclusion that Islamic banks better asset growth during the crisis led to them contributing to the stabilization of the economy and growth rate. Hence showing the importance of giving Islamic

financial institutions the necessary conditions to grow and become fully functional in.

- Another recommendation is that regulatory authorities themselves should use some of the self-imposed policies and regulations by Islamic financial institutions, and standardize them on the whole financial sectors. This would have a two way advantage as it would help in facilitating the introduction of Islamic finance as well as offering conventional financial institutions more resilience towards future crises (Nahlawi, 2013).

# CHAPTER FIVE: CONCLUSION

Numerous studies and researches have been done on whether Islamic financial institutes should be considered a complement or substitute to conventional financial institutions. The high growth rate of Sharia complaint finance in western societies in the 21st century was mainly due to the fragility of the financial system at the time and these new financial products were seen as a stabilizing tool for the economy which is in line with the results we obtained from the CAPM tests.

Nowadays Islamic finance cannot be viewed as a substitute to conventional finance in the European and more generally the western context since the Islamic financial industry is still in its infancy stage in the western hemisphere. On the contrary it is viewed as a more conservative complement to conventional finance or a much needed ethical framework into the western financial market. Hence as a conclusion Islamic and conventional finance are perfectly compatible working together. However with a more standardized and complete Islamic financial Institutions are needed if they are to grow within western economies and become more competitive within those markets.

In conclusion we could say that through all studies that have been performed on the topic of Islamic finance is a viable option for the European financial sector to diversify itself, as long as a clear and precise strategy is developed in order to accommodate this financial sector.

Throughout this project I have been able to identify the key issues that should be addressed in order such a diversified financial market to become possible, since through the empirical tests that I have performed Islamic finance has proven to be performing better that what is expected of it even at this very early stage in its development in the European financial market. Moreover Islamic finance has also proven to be a stabilizing tool for economies during times of economic hardships.

Hence as a final remark the main question at the start of this project was whether Sharia compliant or Islamic finance could compete with and at one point replace conventional financial institutions. The answer to this question is as I have stated before that Sharia compliant finance is more of a conservative or ethical complement to conventional finance and would require the right market and regulatory frame work to compete with conventional finance.

Future Prospects:

Although Islamic banking and financial services have been offered from Europe for almost three decades in many respects the industry is still in its infancy. Much of the business activity has been focused on shariah compliant ant institutions from the Gulf and Muslim investors of high net worth, but this has resulted in activity being somewhat cyclical and linked to oil market developments (Bi, 2007). The impact on Europe's resident Muslim population has been marginal, and mostly confined to the United Kingdom, even though France and Germany have much larger Muslim populations, with that of France exceeding five million. The Gulf and wider Muslim world is likely to continue to generate substantial Islamic finance business for London as an international financial centre and Europe's leading investment banks and asset managers, but the longer term prospects are more likely to be shaped by developments within Europe and further European Union enlargements.

There are two major issues, the first being whether retail Islamic banking services can be provided for continental Europe's Muslim population and if this is desirable. Secondly there is the issue of European Union enlargement to encompass countries and regions with long established Muslim populations in the Balkans, and Turkey, the most populous state in Europe, with over 72 million Muslims.

Although the European Union functions as a single market, banking and financial regulation is devolved to member states. In the United Kingdom the Financial Services Authority has played a pro-active role with respect to Islamic banking and finance and been broadly supportive, but that has not been the position elsewhere in Europe, where central banks and other regulatory authorities have shown little interest. There is also a negative perception of shariah, especially amongst right wing and nationalist politicians, which potentially inhibits the spread of Islamic banking and finance. What is not always appreciated is that shariah compliance in finance is a choice, and not about the imposition of shariah on those, including Muslims, who want to lead secular lives and manage their financial affairs in a conventional manner. Some critics assert that Islamic finance is simply another facet of segregation and places Muslim banking in a ghetto, but those who rebut this argument point out, as shown earlier, that many leading European banks are now heavily involved in Islamic finance. There is certainly potential to develop more shariah compliant savings and financing products for Europe's Muslim community, as well as distribute Islamic takaful insurance which remains in its infancy in Europe, despite the involvement of firms such as Allianz and Prudential in the takaful industry in the Gulf. At present the worldwide value of takaful premiums amounts to $1.7 billion, but less than one percent of this is spent in Europe (Dingwalland  Flockhart, 2007).

The greatest potential for Islamic finance in Europe is undoubtedly in Turkey where Islamic banking has been established since the 1980s although it remains on the fringes of the financial system, accounting for less than five percent of deposits, and opinions on its merits are politicized as already indicated. Turkey currently has six special finance houses, as Islamic banks in the country are designated, most being under joint Gulf and Turkish ownership.

The largest shariah compliant bank, Ihlas Finance House, collapsed during the financial crisis of 2001-2002, but depositors were compensated through Central Bank and the Ministry of Finance which helped maintain public confidence in the special finance houses. The leading institutions are Kuveyt Turk Participation Bank, which was established in 1989, and is majority owned by Kuwait Finance House and the Kuwait Social Security Fund, (www.kuveyturk.com.tr/en) and Bank Asya, which is under majority Turkish ownership, and dates from 1996 (www.asyafinans.com.tr/en). Kuveyt Turk has a network of 79 branches while Bank Asya has 111 branches spread throughout the country, but with the largest number in Istanbul and Ankara. Both banks receive most of their deposits through profit sharing Mudaraba counts, and Kuveryt Turk, like its Kuwait parent, is heavily involved in leasing finance using an Ijara structure.

Turkey has the greatest potential for expansion of banking in Europe, including Islamic banking, as the fastest growing economy, with GDP growth averaging 7.5 percent over the period from 2004 to 2006; and although this slowed to 5.7 percent in 2007, growth is expected to accelerate to 6.2 percent for 2008. (OECD, 2007). Turkey of course starts from a low base given its per capita GDP of under $8,000, but it has attracted foreign direct investment of almost $10 billion annually since 2005 and remittances, mainly from Turks working in the European Union, average almost $ 1 billion annually.95 Turkey can serve as a bridge between the European Union and the wider Muslim World and in the longer term it is likely to be Istanbul, not London, which becomes Europe's leading centre for Islamic banking and finance.

# APPENDIX

## A. Case Studies:

In this appendix I conducted case studies on Major commercial banks that have failed within the European market. In order to help in the development of our model on how Islamic banks should be structured to succeed in Europe and become major shareholders in European Financial sector. The two cases that I will study are the case of the Royal Bank of Scotland and the Case of HBOS; in both case these institutions failed due to one reason or the other. The aim of these case studies is to look at those reasons and evaluate how these failures could have been prevented and learning from them, as well as a case study on the Malaysian financial sector.  Through this we could then reach what should be done through regulatory amendments, changes to market conditions, or from a management perspective on how Islamic financial institutions should be structured so that they succeed in the European market. This in parallel with the literature reviews which gave us an idea of what results to expect and helped us in viewing the topic from different perspectives and the empirical tests that will be performed later on in the paper where the performance of Islamic finance will be tested opposite the market; allowing us to see how they have performed in Europe and whether they could succeed, as well as what conditions they need to prosper.

### i. The Case of Royal Bank of Scotland:

The first case I would be taking is the case of the Royal Bank of Scotland and the reason why it has failed and needed to be bailed out by the UK government in 2008 for 20,000,000,000 pounds. In October 2008 RBS needed the assistance of the UK government so that it could stay in business; this assistance was in the form of a 45.5 billion pound injection of capital equity which is now equivalent to a 20billion stake in RBS. In 2011 the FSA issued a report discussing the reasons behind RBS's failure. In the FSA report six key reasons were highlighted as being the reasons behind RBS's Failure:

- The first reason is the RBS's capital position which was much lower than what was actually reported by the bank; this was due to the deficient definition of regulatory capital and this in turn led to RBS having a worse capital position than most of its competitors. This could have been prevented if BASEL III minimum capital requirements were instilled pre-crisis. Since the review team found that RBS's tier 1 capital was at 2% compared to 4.5%; the minimum tier 1 capital requirement after the 2008 crisis and a high of 9.5%. Hence if this regulation was instilled at the time RBS would not have failed as it did.
- The second reason was RBS's heavy reliance on its wholesale banking sector; mainly on short term wholesale funding. This reflected RBS's assumption that it would always be able to fund itself which by now has been rejected by what has transpired in 2008. While also showing the banks faulty regulations and supervisory board as well as its flawed liquidity regime.
- A third reason were the rising concerns due to the Aggressive growth plans that RBS has followed. These uncertainties led to a loss in confidence in the bank; they included uncertainties surrounding the scale of future loan losses and credit trading losses. These concerns were subsequently justified in 2009 and 2010. Due to the 14.1 and 9.1 billion loan impairments taken by the bank respectively.

- There was also the large losses in the value of credit trading that RBS incurred which further reflects the banks deficient strategy.
- The ABN AMRO acquisition was also one of the main reasons for RBS's failure since it increased the banks' exposure to risky assets as well decreasing an already low capital ratio while straining its liquidity capacity simultaneously. But none the less RBS went on with the acquisition on the basis of due diligence which was not sufficient due to the major risks that were involved in the transaction. But in this case the FSA also shoulders some of the blame since its response to the transaction was not sufficient.
- The last reason is the market failure that occurred during the 2008 crisis were all banks were negatively affected by the market crash due to the interrelation between bank and shadow banking systems. But the most extreme case were those of banks with bad asset quality, capital adequacy and liquidity standing. RBS was one of those banks.

In hindsight the FSA's review team's report on the topic caused the following questions with respect to management, governance and quality of capital to arise:

- Was RBS's board as effective as their hierarchal guidelines suggest or where they overstated in the in those guidelines and rules?
- The second aspect questioned was the CEO's style in management and whether it discouraged RBS from doing effective business.
- RBS's priorities were also question and whether liquidity, capital and asset quality took a backseat to profit, revenues and earnings/share.

- Another aspect was whether the banks board had full information of risk associated with all suggested proposals given to them as well whether or not the board had the right risk management skills in order to decide was project to undertake and what they should stay away from.

The review team conclusion also questioned the FSA's regulations in relation to the ABN AMRO acquisition. The main points of concern were:

- The FSA didn't decide assess the risks of the acquisition correctly and the arrow letter gave little emphasis to the risks involved. Even though no FSA regulations were broken but a task force should have been assigned to assess the risks of such a major acquisition.
- The lack of any supervisory body to monitor the non-sterling transaction of these banks.
- The third issue was the lack of governance within RBS to challenge the CEO's decisions.
- Not addressing whether there were any inadequacies and deficiencies in the board's decision making.

In the case of RBS's failure we could conclude that it was mainly due to poor management decisions as well as the deficient FSA rules and regulation that were altered following the 2008 crisis in order to avoid the same issues faced by RBS in the future cases.

ii. The Case of HBOS:

The second case I will be discussing is the case HBOS's failure, the reasons behind its failure, what parties should be held accountable and how it could have been prevented. HBOS was created as a result of the merger between the bank of Scotland and Halifax in 2001 hence changing the landscape of the banking sector in the UK from the big four of banking into a big five. By the end of 2001 HBOS had assets worth 275 billion pounds. The banks board and CEO were targeting rapid growth for HBOS with ROE increasing from 17% in 2001 to 20% by 2004. Hence increasing earning/share from 56 pence/share to around 80 pence/share. They were able to achieve this goal since their earning/share in 2004 became 84 pence/share and a ROE of 19.8%. This precise strategy which HBOS followed planted the seeds of its failure since the bank since its formation followed an asset-led growth strategy of an aggressive nature. This was contradictory to popular belief at the time that HBOS is a conservative bank. Hence this strategy implied the acceptance of a higher level of risk that accompanied such an aggressive strategy. The problems start arising for HBOS in two of its major departments which were corporate, and international business. First we will take a closer inspecting look into the corporate banking division. We could see that this division embodied the banks general strategy of aggressive growth, this was very obvious when one of the banks high ranking executives stated that HBOS aim of becoming the best real-estate bank in the country. Following with this claim property investment grew at a much faster rate than the division as a whole were in 2008 it accumulated up to 58% of the net expansion in outstanding loans. Other factor from the corporate division also aided in the bank's failure such as; the close relationship between the banks property loans and its equity and leveraged loans, large individual loans given in their later years having its largest single borrower loan at 2.9billion pounds in 2008 compared to 963,000 in 2002. While also having a low debt, equity and joint venture participation. The failure within the corporate department of the bank was mainly due to the lack of expertise in this field in banking since most of the chief executives were more retail oriented rather than corporate. Hence showing that there were deficiencies in how the division was run, in hindsight the FSA investigation was able to conclude that HBOS's rapid growth in the corporate division was due to its high risk taking strategy rather than superior performances; showing that there was naivety and a lack of long term planning for short-term expansion.

The International business division within the bank sought out a growth strategy abroad similar to that used by the corporate division in the UK. Its main goals were to grow and be a market leading bank in Ireland and Australia with its businesses aimed at the property markets just like in the UK. This strategy backfired since the asset-led growth cause HBOS's impairment of loans total 10.9billion pounds which is equivalent to 36% of the loans on HBOS's books in 2008 and 60% of all impaired loans in Ireland during the Irish banking crisis. This loss was larger than any of its Irish counterparts other than the Anglo Irish bank which also failed during the same period. While the more disturbing issues were in the banks Australian branch were the impairment losses the bank accumulated as a portion of its loans was greater than in the UK market standing at 28% of loans in 2008. What makes this figure all the more problematic is that it was incurred in the Australian market were not a single bank needed bailing out during the crisis and remained profitable. Hence giving further evidence to the problems in the banks growth strategy. In conclusion we are able to observe that the effects of the incurred losses in the Corporate and International divisions on their own were enough to put the bank in a position where they are in need of recapitalization, accompanied by the 7.5 billion losses the bank accumulated in its treasury division altogether led to the bank going into insolvency.

Just like in RBS's case the bank was not the only entity to be held accountable due to the FSA's negligence in addressing the risks that accompanied HBOS's business decisions and strategies. This was mainly due to the inadequate regulation that the FSA had prior to 2008. The FSA first identified some issues in 2004 that later contributed to the fall of HBSO but did not pressure the bank to find a long term solution for the problem but rather were happy with the bank papering over the cracks and just solving the problem in the short run which came back to haunt them in 2008. While in 2007 was looking at all the wrong neglecting looking at liquidity and credit issues and well as completely forgetting about asset quality supervision which if was taken seriously would have alarmed them of HBOS's problem before it was too late. Another factor was BASEL II lax controls over capital adequacy were banks could formulate their own risk weightings. Hence showing that in two different case of bank failures there was fundamental mistake with the regulations of the FSA and a better regulatory system should prevail.

Following this two case studies we now have an idea of why these financial institutions have failed and what went wrong for them. This would help us formulate a list of recommendations that might be followed by the Islamic financial institutions aiming to break into the European market in order for them not to commit the same mistakes as the banks in these case studies.

iii. The Malaysian Case:

Malaysia started working to create its Islamic financial market in 1983, it decided then to follow a three staged approach into introducing Islamic finance into its economy. These three stages were supposed to be completed by 2010. The three stage strategy was as follows:

- Stage One (1983- 1992): this stage consisted of the creation of acts and regulations for Islamic financial institutions to function within hence giving them a market structure were they can conduct business activities in. the Acts that were made during that period were for Islamic banking, takaful and sharia compliant activities getting government funding. The second objective during this period was the Establishment of the first full Islamic bank in the country as well as the first takaful company. Hence in other words the first stage of the strategy was to building the foundations for Islamic finance to grow.

- Stage Two ( 1993-2000) : the second stage of the strategy included performing amendments to the legislative regulations in order to allow conventional financial institutions to operate within this new found market through the creation of Islamic windows. While also during this stage a Sharia Advisory council was created to allow the Islamic finance index to grow and expand further. While the last objective of this stage was the establishment of interbank money market not dependent on interest rates since it is forbidden for Islamic financial institutions to deal with interest. Hence the main goal during this stage was to build all required institutions for the Islamic financial system to operate as any conventional market in addition to the generation of more business activities within the newly formed sector as well as creating a vibrant market system.

- Stage Three (2001-2010): the main aim during the third a final stage was reaching the best strategic position of the market while in parallel international integration of foreign players into the market. All these were needed so that an efficient and comprehensive Islamic market would be created in a way that I would progressively grow over time. In order to reach these goals a four step strategy was implemented:
- Creating a regulatory framework for the Islamic market.
- As well as a Sharia framework.
- Advancing and diversifying the products and services offered.
- While increasing the knowledge towards Islamic finance and educating people about the benefits of Islamic finance.

During this stage the Malaysian FSMP (Financial Sector Master Plan) was created stating that its aim is to create a stable, competitive and dynamic financial system. In the FSMP's 119 recommendations the following were directed towards the Islamic financial systems:

- Building a strong basis for Islamic finance through the formation of board committees, benchmarking and employing people with the right qualifications and expertise in the appropriate areas and divisions.

- Increase the number of firms that deal with takaful operations in order to expand the sector.

Results of the FSMP showed that Islamic finance and takaful both were strengthened during the first phase of implementation of the master plan. This was evident with the increased market share of Islamic banks in the banking sector from 6.9% of total assets in 2000 to 9.8%, from 7.4% to 10.4% in total deposits and from 5.3% to 10.3% of total financing in the banking sector. While the takaful sector also grew over the same period, as its share in the insurance market increased from 3.9% to 5.9% of total assets and from the same value to 6% in total contribution to the market. While this same period saw great infrastructure advancements made in the Islamic financial system in parallel to the conventional system.

During the third stage the Islamic financial services board was formed, while a liberalization of the Malaysian Islamic financial sector was done so that foreign Islamic financial institutions can enter the market. Hence creating Malaysian International Islamic financial center.

Today, Malaysia has a full-fledged Islamic financial system operating parallel to conventional financial system. In terms of products and services, there are more than 40 different Islamic financial products currently available in a country. However, differentiating fixed assets and overhead expenses are problematic in case of IBS banks. Usually, an IBS bank consists of a team overseeing Islamic banking transactions. Product development, marketing and other policy issues are conducted at the respective headquarters. At the branch level, there is no delineation over Islamic and conventional transactions. Each branch officer is expected to deal with both systems. Islamic and conventional transactions share the share computers and automated teller machines (ATMs) facilities. To some extent, overhead expenses on wages/salaries, office equipment and furniture etc. can be accounted for at the bank's headquarter, but not at the branch level. The same applies to security systems, land and office premises as these cannot be divided into the Islamic and conventional individual components (Rosley, 2003).

Overall Islamic banking industry in Malaysia has continued to register strong expansion during 2003 to account for 9.7% of the total assets of the banking system (8.9% in 2002), 10.4% of total deposits (10.2% in 2002) and 10.3% of total financing (8.1% in 2002). The improved performance was characterized by strong growth in financing activities for the purchase of transport vehicles and residential property.

The thrust of Islamic financial policy in 2004 will continue to be directed at further strengthening the fundamental essential for progressive Islamic banking industry. The Central Bank is focusing on strengthening the institutional infrastructure, enhancing the regulatory framework, strengthening the Shariah and legal infrastructure as well as enhancing intellectual capital development and consumer education. In 2003, the Central Bank of Malaysia brought forward liberalization in Islamic banking to allow three full-fledged foreign Islamic banks to be set-up in Malaysia.

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