

Rudolf Böhmler: Islamic finance – the European challenge

Speech by Mr Rudolf Böhmler, Member of the Executive Board of the Deutsche Bundesbank, at the 2nd Islamic Financial Services Forum: The European Challenge, Frankfurt am Main, 5 December 2007.

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Dear Governor Dr. Zeti,
Dear Governors,
Ladies and Gentlemen

First I would like to thank Professor Rifaat from the Islamic Financial Services Board and Mr. Tošovský from the Financial Stability Institute and their teams for organising this Forum. They've done a very good job, I think.

On behalf of the Deutsche Bundesbank, I would like to warmly welcome you to the second Islamic Financial Services Forum in Europe. I am particularly delighted that we are joined by numerous guests from the Middle and Far East who have travelled so far to be here in Frankfurt. This reflects the great importance attached to the market for Islam-compliant finance products here in Europe.

The interaction between financial investment and religious and ethical issues was and still is a key topic in Europe. At the beginning of the 20th century, Max Weber, one of Germany's most influential sociologists of religion, described the intertwining of economic activity, including saving and investment, and religious beliefs. He and other academics and scholars made us aware that religious traditions are never "carved in stone" but are constantly evolving to provide insight and answers to contemporary questions. This is true for the churches' codes of law, the Jewish Halakha and also the Islamic Sharia. "Sharia" means "path to the water source" and this in itself proves that it is not a finished, petrified work but is constantly searching for responsible solutions for issues affecting our daily lives. That we can come here today to learn with one another and from one another in mutual respect sends out a positive and powerful signal which extends beyond daily economic activities.

The forum is entitled "The European Challenge". This maxim has been carefully selected as Islamic finance indeed poses great challenges in more ways than one for Europe and thus also for **the** German financial centre, Frankfurt.

1. The banking industry – not only in Europe – is faced with the task of providing an adequate range of Sharia-compliant finance products to meet the growing demand and to develop new customer bases.
2. Legislators are called upon to lay the foundations for a level playing field for Islamic finance.
3. European banking supervisors have to rise to the challenge of adequately assessing the risks associated with Islam-compliant finance products.

I would like to start with a few ideas as to what the reasons for the existing gap between the supply of and demand for Islamic finance products may be and the challenges that this poses for the banking industry in Europe.

As you are all well aware, demand for Halal finance products has been skyrocketing across the globe for years. This is hardly surprising considering that approximately one person in four in the world is Muslim. In addition, wealth has increased in a number of – predominantly Arabic – countries not least due to rising commodity prices. This has meant that both the need for Halal investment opportunities has grown as well as the desire to finance mostly larger projects, such as building hotel complexes, in accordance with Sharia principles. This trend is being supported by the various possibilities of emulating more and more

conventional products in a way that complies with Islamic law through the use of modern techniques to structure relatively complicated financial transactions.

Furthermore, growing interest in Halal finance products has also been observed among non-Muslims. Private investors who also wish to factor ethical and/or religious aspects into their investment decisions can be sure that with products which have been approved by a Sharia board they are not investing in certain business areas, such as gambling. And devout Christians and Jews can be sure that the interest ban, which can also be valid for them has been observed. There is also an increasing number of professional investors who want to include Islamic finance products in their portfolios for reasons of diversification. This is true despite the reservation that many Sharia-compliant finance products cannot yet fully compete with conventional products as far as the price-performance ratio is concerned due to their intrinsically complicated structure.

The first challenge confronting the financial community, not just in Europe, with regard to Islamic finance is that the range of Sharia-compliant finance products is currently not sufficient to meet the substantial rise in demand. This is firstly because there is a shortage in the number of financial service providers offering solely Halal finance products or offering these products via Islamic windows. Secondly, there is a lack of qualified specialists for the Islamic finance market segment. Hopefully, institutions such as the “Institute of Islamic Banking and Insurance”, which is supported by German banks, will remedy this situation in the medium-term.

In addition to the two reasons I have just given for why the supply of Halal finance products does not yet meet the demand, in my opinion, there are two further aspects which pose challenges, particularly for financial centres in the European continent. Firstly, the supply of Sharia-compliant finance products is still largely geographically constrained. The bulk of Islam-compliant financial transactions take place in financial centres in the Middle East, Malaysia and – at European level – in London. Consequently, it is difficult for the large number of Muslims who live in continental Europe, for example in France or Germany, to access these services. German financial institutions’ involvement in Islamic finance has so far also largely been limited to these financial centres. There have been, and still are, initiatives – for example, by the federal state of Saxony-Anhalt and by Commerzbank and Deutsche Bank – to establish Halal finance products in Germany as well. However, so far these efforts have had rather limited success.

One reason for this brings me to the second aspect of why, in my opinion, a gap still exists between the supply of and demand for Halal products: the products are still aimed at a limited target demographic. The bulk of Islam-compliant financial products that are available outside traditional Islamic states and the United Kingdom are primarily aimed at wealthy private and institutional investors, mostly in the form of “Sukuks”, also known as Islamic bonds. Hardly any services are aimed at the more middle-class Muslim population of continental Europe. Thus for the approximately 3.5 million Muslims who make their home in Germany, an estimated 15-20% of whom have a keen interest in Islam-compliant bank products, there are hardly any possibilities for financing homes or to invest their assets in accordance with the rules of their faith, while at the same time productively. Although the above-average saving rate of Muslims living in Germany clearly indicates that market potential is waiting to be tapped, the investment products available to this target group are virtually inaccessible or not known.

One explanation is that institutions that offer Islam-compliant finance products in Germany do not advertise these products. Therefore, anyone who wants to invest in Halal finance products in Germany still has to explicitly ask for them at a bank. Furthermore, since, as already mentioned, the products are almost exclusively aimed at very wealthy investors from Islamic countries abroad and not at the German Muslim population, the product information is mostly only written in English. Above all, banks located in continental Europe face the challenge of using attractive Islam-compliant services – especially in the retail banking area –

as well as target group-oriented marketing to tap the dormant capital of the Muslim population.

However, a flourishing Islamic finance market is predicated on the existence of a comparable legal framework for conventional and Halal finance products. This brings me to the second “European challenge”: the creation of a uniform level playing field by legislators. The example of the UK shows that a market for Halal finance products can also function in non-Muslim countries. Back in 2004, the Islamic Bank of Britain obtained a licence from the Financial Services Authority (FSA), making it the first Sharia-compliant bank to open for business in the UK. Since then, the European Islamic Investment Bank has been established and numerous credit institutions (eg HSBC) have a so-called “Islamic window”. The British government’s efforts to create a level playing field for Islamic finance and conventional products have been successful in the City of London. The Deutsche Bundesbank would welcome a similar development here in Frankfurt, the German banking centre. However – as the example of the United Kingdom also shows – a precondition for this is a corresponding legal and, in particular, tax law framework. Existing obstacles must be analysed and – where reasonable – removed or mitigated.

Last but not least, banking supervisors, too, face new tasks as a result of Islamic finance. This brings me to the third aspect of these “European challenges”. German credit institutions already keep Halal finance products in their books or – as mentioned earlier – offer them themselves. The German supervisor – and, as you know, the Deutsche Bundesbank plays a particularly important role here – must now, therefore, begin to figure out how to assess Islamic finance products, their risks and amount of capital these institutions need to hold. As the turmoil on the markets for structured finance products has shown dramatically over the last few months, a decisive factor for adequate risk assessment is that banking supervisors and, in particular, institutions are able to fully comprehend the structure of the products on offer. For this reason too, the Deutsche Bundesbank welcomes the fact that the Islamic Financial Services Board has organised this forum here in Frankfurt.

The German government and German banking supervisors were quick to recognise the increasing importance of Islamic finance for the German and European markets. For this reason we – along with the UK – successfully pressed for the inclusion of provisions governing Halal finance products in the Capital Requirements Directive, which transposes the Basel II framework into European law.

Please allow me to conclude this welcome speech with a personal observation. Before I was appointed to the Executive Board of the Deutsche Bundesbank in the middle of this year, I worked for many years as State Secretary in the federal state of Baden-Württemberg where, above all, I dealt with issues relating to the integration of citizens with migrant backgrounds. I have always taken these issues very seriously. In fact, in 2004, I was the first politician in the Baden-Württemberg government to hold a speech at the Yaruz Sultan Selim mosque in Mannheim – Germany’s largest – on intensifying cooperation. As I mentioned previously, there are currently around 3.5 million Muslim citizens in Germany. According to a study carried out by the University of Tübingen, by 2030 this number will have almost doubled. Although a large part of the Muslims living in Germany have integrated well, unfortunately, there is also often a tendency for Muslims to segregate themselves from their Western surroundings. Often families and young people whose parents or grandparents came to Germany from the Arab states and Turkey shut themselves off from German society. To be quite honest, it was for this reason that I was initially rather sceptical towards the issue of “Islamic finance in Germany”. My concern was that the creation or support of additional Islamic financial services would support the creation of parallel societies in Germany.

I now believe that the development of a range of Halal finance products – particularly in retail banking – would make an important contribution to supporting the integration of our Muslim fellow citizens. If this enables these citizens to play an active role in business life in Germany and to build up material assets without conflicting with their beliefs, it will support, in

particular, those middle-class Muslims who are ready and willing to integrate. The example of a stable and financially successful middle class, in my opinion, will provide positive incentives which should prevent the development of parallel societies.

Ladies and gentlemen

“Islamic finance – the European challenge”: the challenges faced by banks, supervisors and legislators as a result of Islamic finance are by no means minor. I do believe, however, that it is worth the effort to face these challenges, not only both from a business and financial perspective but also most significantly for socio-political reasons. Let us take on these challenges together.

I would like to finish by wishing you all a successful and fruitful conference and hope you are able to make useful contacts.

Thank you very much for your attention.