# Yves Mersch: Prospects of Islamic finance – the view of a central bank in Europe

Closing keynote address by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the Islamic Finance Conference, Frankfurt am Main, 18 November 2010.

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Ladies and Gentlemen,

It is my pleasure to talk to an audience of such distinguished financial specialists. Before I embark on what Islamic finance means for central banking in Europe, I will have a look at the growing importance of the phenomenon, its characteristics in the context of financial stability in general and its performance during the financial crisis in particular. Finally, I will present the achievements within my own constituency to overcome the obstacles for an accelerated and safe spreading of Islamic finance in Europe.

### Islamic finance: growing importance

The development of modern Islamic finance roughly started more than four decades ago. At the very beginning it occupied a small niche visible in Islamic countries. In Malaysia the Pilgrim Fund (Tabung Haji) was established in 1969 as an Islamic savings institution. More recently Islamic finance has expanded out of this niche.

– Worldwide, the assets of Islamic finance institution have grown at double-digit rates for a decade. Even some conventional banks have embarked into the provision of Shari'ah compliant financial assets reaching an estimated 509 billion USD at the end of 2007 according to Moody's[1].

– Today, there are at least 70 countries that have some sort of Islamic financial services. Almost without exception, the major multinational banks offer some kind of these services.

– With the rise of the importance of Sovereign Wealth Funds (SWF), Islamic finance was pushed further. About a decade ago, many emerging countries started to accumulate huge foreign exchange reserves, most of them benefiting from rising oil, gas and other natural resources' prices, being supported by favorable macroeconomic policies. With assets under management of an estimated 3,000 bn USD in 2009, SWF represent twice the wealth of hedged funds. Muslim countries, oil exporters in particular, account for more than 50% of all SWF's assets – not all of which are Islamic finance products, though.

– While Islamic banking remains the main form of Islamic finance, Islamic Insurance companies (Takaful), mutual funds and Islamic bonds (Sukuk) have witnessed strong global growth. The Sukuk markets in particular have gained importance. In recent years, the issuance rose from less than 8 bn USD in 2003 to 50 bn USD by mid-2007.[2] After a sharp decline during the financial crisis, private sector estimates see global sukuk markets rebounding, expecting the total volume to surpass 20 bn USD in 2010.[3]

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1 Moody's, Islamic Finance Explores New Horizons in Africa, 2008, http://www.moody's.com.

2 Cakir, Selim / Raei, Faezeh: Sukuk vs. Eurobonds: Is There a Difference in Value-at-Risk?, IMF Working Paper, WP/07/237, Washington, 2007.

3 Chua, Tony: CIMB Islamic optimistic on sukuk issuance, in: Asian Banking and Finance, August 2010.

This development might well continue. As Muslim populations are under-banked, and there is an increased financial need for infrastructure projects like roads and housing in many Muslim countries, the demand for Shari'ah compliant financing is still growing. The International Organization of Securities Commissions predicts that as much as half of the savings of the world's estimated 1.2–1.6 bn Muslims will be in Islamic financial institutions by 2015.

The business model indeed could also be attractive outside the traditional Islamic territory, e.g. in Western countries with large Muslim populations, such as the UK, France or Germany.[4] According to estimates, the Muslim population in Europe currently adds up to almost 40 million[5]. Additionally, Islamic finance provides an alternative for ethical investment and can help investors independent of their religious orientation to diversify their portfolios and funding sources.

## Ethical foundations of Islamic finance: neither new nor exclusive

The obvious growing importance of Islamic finance calls for a deeper understanding of its underlying principles. The main feature of Islamic finance is the idea of justice. This is mainly achieved by four principles.

To a European observer the link between ethics or religion and finance seems awkward at first glance. This connection however is neither new nor exclusive to Islamic countries. It has a long tradition in economic thinking in the occidental world, too. Remember the reasoning of the German sociologist Max Weber. He argued that capitalism in northern Europe evolved when the Protestant ethic motivated people to engage in business and trade in the secular world, and to this end accumulated wealth for investment. In his view, the Calvinist ethic in particular was an unplanned driver behind capitalism.

Similarly, the founding father of modern economics, Adam Smith, stressed the importance of ethical foundations of markets. Prior to the "Wealth of nations" (1776), he published "The Theory of Moral Sentiments" in 1759 – a work, Smith himself considered to be a superior work to his magnum opus.

To sum up: Islamic Banks seek to maximize their profits just like other banks. They have to comply, however, with Shari'ah law – without being religious institutions.

## Making the financial system more resilient

For a central bank financial stability is a prerequisite for achieving its goal of a stable currency. The interplay between Islamic finance and financial stability is therefore of particular interest.

Generally, an increasing number of approaches in banking and finance should make the system safer overall because it reduces the concentration of funding sources on the macro level.

On one hand, the particular character of Islamic finance could make banking more resilient to potential financial shocks. The lack of exposure of opaque and complex assets and the absence of excessive leverage should protect Islamic banks from the impact of financial crises. Reliance on deposits rather than wholesale funding adds another layer of stability. On the other hand, the asset-based and risk-sharing nature of Islamic finance can make the business model more vulnerable to second round effects of a financial crisis, i.e. Islamic

[4] Imam, Patrick; Kpodar, Kangni: Islamic Banking: How has it diffused?, IMF Working Paper, WP/10/195, Washington, 2010.

[5] Lugos, Luis et al.: Finance islamique et droit français, in: Mapping the Global Muslim Population, Pew Forum on Religion & Public Life, 2009.

banks may suffer more from the real economic downturn that normally follows financial turbulences as the losses of the customers are partly shared. Moreover, the lack of product standardization and the missing harmonization of Islamic standards in general pose risks to the management of liquidity.

The judgment on the contribution of Islamic finance to financial stability is therefore ambiguous. In principle, Islamic finance can make the financial system more resilient, although it is more vulnerable towards negative spillover effects from the real economic sector. However, this potential can only be realized, when the regulatory and supervisory regime, the legal framework and payment and settlement systems are robust and current shortcomings in liquidity management are overcome.

### Experience during the current crisis

Although we still lack comprehensive and detailed research on the performance of Islamic finance during the financial crisis those pieces of empirical evidence that are available support the former reasoning.

According to a recent IMF study Islamic banks fared indeed better than conventional ones in 2008.[6] This result was however reversed in 2009 when the financial crisis hit the real economy. Overall, Islamic banks performed better within the last three years than their conventional counterparts. Thanks to higher solvency and lower leverage Islamic banks succeeded in matching relatively higher demand for credit at a time when Europe and the US dealt with the threat of a credit crunch.

Moreover, according to various credit rating agencies, the change in Islamic Banks' risk assessment has been better than that of conventional banks (with the exception of banks in the United Arab Emirates (UAE)).

### Ensuring a level playing field

As long as financial stability and the functioning of the transmission mechanism of monetary policy are not at risk, central banks should not interfere with the structure of finance. Ensuring a level playing field can be seen as a prerequisite for functioning financial markets. If the demand for Islamic compliant financial products is rising, obstacles for its further development should be abolished without contradicting the principles of appropriate supervision and regulation nor the prevalent operational framework of central banks. Therefore, the infrastructure and supervisory environment should be provided to allow efficient clearing of a sufficient number of investment-grade Islamic finance papers across the whole maturity spectrum. While banking authorities are committed to adapt and to be accommodating for Islamic finance within the European regulatory framework, it is crucial to require the same licensing and supervision standards from Islamic financial institutions as expected from conventional banks.[7] Real challenges however remain on the legal side for example asset transferability. But these complications are to a large extent shared with the conventional banking system.

Keeping that balance will be beneficial to both Islamic investors and the European financial system.

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6 Hasan, Maher; Dridi, Jemma: The Effects of the Global Crisis on Islamic and Conventional Banks: A Compartive Study, IMF Working Paper WP/10/201, Washington, 2010.

7 Mersch, Yves: Speech at the 5th Economic Forum Belgium-Luxembourg-Arab Counties, in Brussels, 17th November 2009.

## Luxembourg's pro active approach

In Luxembourg, private and public decision makers of the financial industry are motivated to establish a regional hub for Islamic finance, making use of Luxembourg's expertise in cross border finance.

Major steps have been taken already.

- The Central Bank of Luxembourg is a member of the Islamic Financial Services Board (IFSB), a standard setter for financial stability.
- Addressing shortcomings in the Sukuk market such as lack of liquidity and international recognition, small size of issuances, insufficient number of high quality issuers and focus on domestic markets, the IFSB coordinated the establishment of an International Islamic Liquidity Management Corporation (IILM) in October 2010 with the Banque centrale du Luxembourg as a founding member. This new corporation will issue investment grade Sukuk across the whole maturity spectrum in order to facilitate liquidity management for institutions offering Islamic Financial services (IIFS) and cross border investment flows.
- In 2002, the Luxembourg stock exchange was the first in Europe to receive a Sukuk listing. The number of Sukuk listed today on the Luxembourg stock exchange compares well with the leading stock exchanges in Europe.
- Luxembourg provides the infrastructure for the post trade related aspects of Shari'ah compliant securities transactions, namely in settlement and custody services. In May 2010, the Banque centrale du Luxembourg and Clearstream launched LuxCSD, a new Central Securities Depository for Luxembourg, which will enable the settlement of securities transactions in central bank money and thus be compliant with the highest standards of safety for market participants, providing at the same time a connection to the Euro system project Target2-Securities.
- The international expansion of Sukuk presupposes a higher degree of standardization, reliability in terms of Shari'ah compliance as well as robust accounting, legal, tax and regulatory frameworks. The adoption of best practice regulation and supervision requires sufficient differentiation among Sukuk types. Challenges for the expanding market are posed by sector risk due to an overreliance on real estate and construction, the involvement of different laws and jurisdictions together with enforceability issues.
- Luxembourg is the leading location for Shari'ah compliant investment funds in Europe. In 2008 the Grand Duchy set up a task force to identify possible hindrances to the local development of Islamic finance. Tax treatment for common Islamic finance transactions has been adjusted to ensure tax neutrality compared to conventional transactions.
- Skilled staff is essential to any provider of financial services. Dedicated training courses have been set up by the Luxembourg Institute for Training in Banking (IFBL), the Luxembourg School of Finance (LSF) and the university to meet the growing demand for education in Islamic finance.
- Next year in May, the Banque centrale du Luxembourg will host, for the first time in the Euro area, the Islamic Financial Services Board annual summit, a major four-day-conference.

## Concluding remarks

Islamic finance provides opportunities and challenges in the context of the agreed goal of enhancing global financial stability.

From the perspective of a European central banker, Islamic finance should be a complement to conventional banking and capital markets, not a substitute. Due to their characteristics, Shari'ah compliant financial products can enhance the stability of the financial system. Shortcomings in standardization and liquidity management must be tackled, however.

Cooperation between investors, issuers and regulatory and supervisory authorities is a pre-requisite for a successful integration beneficial to all stake holders. Luxembourg with its tradition as a specialized financial center will continue its endeavors to establish an international hub for Islamic finance.