THE OPERATION OF ISLAMIC BANKS ON THE BASIS OF AN EU EXAMPLE

AZ ISZLÁM BANKOK MŰKÖDÉSE EGY EU-S PÉLDA ALAPJÁN

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Abstract

The Al Rayan Bank (called IBB Bank until December 2014) was the first and greatest Islamic bank in the European Union before the Brexit. The Al Rayan Bank is a trade bank in Great Britain, functioning according to the principles of Islam, taking an eminent place among the Islamic financial institutions. The bank operating in Anglo-Saxon financial environment has shown such success to the world in recent years that can be an inspiration for investors of other Islamic financial institutions. The authors are doing the analysis of the balance structure of one of the most famous West-European Islamic banks. The authors analyzing the balance sheet of the Al Rayan Bank call attention to the necessity of the cooperation of conventional and Islamic banks due to the increasing similar claims of Muslims living in Europe by drawing conclusions. Besides these, they discuss the opportunities of cooperation as well. According to the authors, the Islamic banks and their institutions provide alternative opportunities in the regional financial system.

1. Introduction

We are doing the analysis of the balance structure of one of the most famous West-European Islamic banks, namely the Islamic Bank of Britain (IBB). In the end of 2011 the Islamic Bank of Britain had a total assets of 217 million pounds, at the end of 2012 it was 261 billion pounds that increased significantly by the end of 2013 to 368 million pounds and then in 2014 to 648 million pounds. Its motherbank is Qatar International Islamic Bank QIIB (in 2011 83,86%, in 2012 88,41% ownership), its seat is located in Birmingham. The bank was founded in 2004. Its capital adequacy was 28,1% in 2011, in 2012 it was 25%. Its auditor is KPMG. Though the first Islamic bank in the European continent was Bosna Bank International (BBI) founded in 2000, which is a significant financial institution of the Balkans due to its seat Sarajevo, it can be said that after the foundation of IBB (2004) it is the most successful European Islamic financial institution. The motherbanks of BBI (Islamic Development Bank 45,46%), Abu Dhabi Islamic Bank 27,27%, Dubai Islamic Bank 27,27% ownership) are its rivals as well. Currently, due to the competition that evolved in the financial markets, there is natural rivalry. Besides these, the success of IBB Islamic bank can be an example regarding the Balkanic investments and the inferences drawn from the analysis of the balance sheet are exemplary for the area as well. (IBB Annual Report and Financial Statements For the year ended 31 December 2011, 31 December 2012, 31 December 2013 and 31 December 2014).

2. The philosophy of Islamic finances

The unique Islamic (or participatory) banking system has only a bit more than half a century of history, yet it made successful and significant progress over the course of that period which persists today and this is expected to continue in the future. The model of the Islamic bank is based on the philosophy of profit sharing and participation (participatory banking), which provides the other name of such banks, in which depositors and debtors basically run a joint business in a way, for example that depositors partake in the acquisition of a device or machine so they can share in the profits later. The basis of the Islamic banking system and Islamic financial products is Saría law, this is why the aforementioned transactions and products are called Saría compatible. This is the most important difference between conventional banks and Islamic banks, as the Islamic banking system, financing, and investments are all based on religious grounds. The philosophy of banking follows and honors the tenets of Islam (Balázs & Balogh & Varga 2014).

Another significant difference is the prohibition of interest (usury), which is also based on religious considerations. Most likely this already existed in the Arab world at the time of Prophet Muhammad (may peace be with him) due to antique influence based on a notion of Aristotle. Aristotle believed that interest was unnatural, but it was not an unholy act as he did not use the word "ασεβεια" when discussing interest. This is important to point out, as in the Islamic world the prohibition of riba (interest) is the same as in Aristotle's notion, although in the eyes of Allah the violation of the rule of qard-el-hassan (fair loan), which is loaning without riba (interest), is already a sin. Islam concurs that interest - which is the growth of money - is illogical as money is a sterile entity incapable of growth, which means it is unnatural and anything that mocks nature cannot be right or acceptable. Interest is a central part of conventional banking. Therefore Islamic banks have a different approach to western banks. They follow a conservative investment strategy and operate with a low loan/deposit ratio which can be seen clearly from the balance sheets that are in the focus of this study, which we use to deduce stability in the face of a crisis. (Botos & Botos 2008)

Based on these facts, the principles of Islamic banking are the following:

1. Banks cannot charge interest (riba) after issued loans. They do not acknowledge the "time value" of money in the usual way, therefore they reject profit solely based on the passing of time. They also reject the idea of making money from money. The basic principle is that making profit is only legal through actual, real transactions, and behind every transaction there has to be real collateral, money is only an intermediary device.
2. Unwanted uncertainty ("gharar") and excessive risk taking ("mayseer" or "qimar") is to be avoided. This is why Islam specifically forbids speculation.
3. Islamic banks cannot finance activities or enterprises which can have a negative effect on society or considered illegal by the laws of Islam, for example gambling, or the production and consumption of alcohol or pork. This is called "haram".
4. Financing transactions must also contain an item of charity ("zakat"). Charity can be manifested in different ways, for instance banks can offer help to clients in difficult situations who need financing, with a process uniquely suited to meet the needs of a specific client, for example the "salam". Traditional commercial banks usually refuse to do this as financial assessment determines that these clients are ineligible for a loan due to high risk.

5. Finally, in most cases, after providing a loan in the traditional banking environment, the responsibility rests with the borrower. In Islamic banking, the bank and the borrower agree to share the risks, and the profits or losses of an enterprise are divided between the bank and the borrower. They often not only share the risk, but the bank also undertakes an ownership interest in the financed project or device, thus bringing Islamic banks closer to the real sector than traditional banks. This means that the attitude of Islamic banks is asset-based, which is opposite to the debt-based investment strategy of traditional banks. It can be concluded that the approach of traditional banks is risk-transfer while the approach of Islamic banks is risk-sharing, which is an essential distinction between the two systems.

The most important indicators in the Islamic banking system are the following: devices, deposits, loans, individual credit, capital and reserves, capital adequacy ratio, and foreign devices (Imran 2008).

3. Analysis of the Assets

The first title of the asset of the balance sheet serves liquidity that means meagre entry. The biggest entries of the asset of the balance sheet are the loans and the accounts receivable in the Islamic bank as well. The row with the largest sum of the balance sheet is the commodity Murabaha and Wakala receivables and other advances to banks. This entry gives 50% of total assets. The second biggest entry of the asset of the IBB balance sheet is the net investment in Home Purchase Plans which is nearly 45% of the total assets. These two entries cover almost the whole balance sheet total of the Islamic Bank of Britain. It is modulated by the increase of the significance of the net investment in commercial property finance and the investment securities-Sukuks since these forestall entry by entry the decreasing sum of commodity Murabaha and Wakala receivables and other advances to banks. Other elements of the asset, (intangible assets, property and equipment, investments in commercial property finance and from 2014 the deferred tax asset) concerning their contents, are equal to the proper rows of the local balance sheet. The sortment of other entries of the asset into profit and loss shares (PLS) and non-PLS affairs and the exposition of particular concrete affairs (Mudaraba, Musharaka, Qard- al Hasanah – charitable loans, etc.) were explained in another study. Due to several reasons the detailed analysis here is restricted to these two entries of the asset of the balance sheet and the essence of the Saría-compatible affair is summarized briefly (Varga & Wickert 2013).

Three assumptions should be materialized so that the affair could become Saría compatible: on one hand, the bank cannot bear the whole financial risk as coverage. At the same time, it can ask for assurance for the reduction of ethic risk, for instance for the prevention of the vanishing of the entrepreneur. On the other hand, the rate of return should be given strictly in percent and not in a lump (the profit should be divided). (Mahlknecht 2008) Finally, the moneylender cannot have a say in the operation of the entrepreneur, in leading the business the entrepreneur is completely free.

In the Murabaha construction the seller tells the buyers the price of the making and the acquisition of the product and then they agree in the extent of profit margin. The profit margin is halal-like, it is not interest because it does not depend on the period of the contract and the contract is not about lending money but selling and buying real assets. It is a common characteristic of these financing types that in contradistinction of PLSs in case of both letting and leasing, the return is predetermined and the affair also includes assurance. In fact, in these cases the bank adds a particular percent to the purchase price or to the additional expenses which is like profit margin regarding its content and the assets bought are serving as an assurance. Beside these, the bank can ask from the client more coverage (Gafoor 1999).

Wakala is such an Islamic financial product during which the bank ensures a particular amount of money for investment for a third person (for the agent). The bank and the agent previously agree in the assumptions and the rate of return. The third person is obliged to refund the money in case of non-accomplishment, carelessness or default of any of the rules of Wakala.

These affairs can be regarded as being avoiding risks and these do not differ from the constructions used by conventional banks. The difference is in terminology and some legal formality. These affairs however answer the requirements of the principals of Islam in the way that the rate of returns are more attached to the particular transactions than to duration.

According to the Islamic law, there are two acceptable ways of estate – financing, which can be regarded as financing mortgage (Salamon & Munif 2003). The Ijara method, basically, is a long-term back leasing agreement. The service provider (the lessor) buys the estate, becomes its legal owner and then makes a rental contract with the customer that he/she rents the estate for a particular period that basically means 25 years. In this period, the customer supplies regular paying to the service provider that includes partly the rental fee and partly the purchase price of the estate. In the end of the period when everything is paid, the customer receives the ownership of the estate (Balázs 2013).

The other method is the so-called Murabaha, where the service provider buys the estate but sells it immediately and the customer pays the original price and the agreed profit margin. The customer pays the higher price on the basis of the delayed paying in accord with the agreed schedule of amortization and in order to guarantee the refund the service provider receives the first charge in connection with the estate.

It is worth mentioning the so-called Sukuk, since they appear in the assets of the balance sheet of IBB in 2013 and in 2014, they increased to be a significant entry of it. Sukuk is such an institution of the Islamic financial system that is similar to the shares of western finance while it meets the requirements of the rules of Saría and Islamic religious law. As the structure of traditional bond including western interest is not allowed, in case of the Sukuk the investor group that turns it to account makes such an acknowledgement in which it rerents the bond in exchange for the rental fee predetermined by the drawer. The drawer makes a contractual promise in which he/she declares that he/she repurchases them later in the determined face-value. Sukuk represents the ownerships of the undivided shares as well in connection with the particular projects and investments connected to the material assets. The Sukuk investor wins a share in the material assets connected to investments. It results in a common share that does not mean a debt obligation to the drawer. Consequently, those who are entitled to Sukuk can ask for a part of the incomes. Though Sukuk became an important Islamic financial asset in the beginning of the second millennium for financing the finance assets with long-term projects, its significance increases nowadays as it can be seen in the balance sheet, too. Concerning the world, the Sukuk is getting more popular, which means an annual increase of 10-15% in global financial markets (Pollard & Samers 2017).

4. Analysis of the Liabilities

Examining the liability of the balance sheet it can be said that the value of liabilities reaches 92% of the total assets and it shows a significant increase compared to the previous years. Among the liabilities the largest entry is the liabilities to depositors. It is notable that this means an increase of 22% compared to the deposits of customers in 2011 that still increased in 2013 and produced an outstanding result in 2014.

The liability of the balance sheet of the Islamic bank includes two main entries, beside the equity the liabilities can be found here. In this study, I examine the deposits among the liabilities. The two main financing types of the liabilities to depositors can be the transactional and investment deposits.

The transactional deposit type relates to transactions. In the traditional bank system its equivalent is the demand deposit. The bank opens a bank account for the depositor and the depositor can use the money that is on this bank account any time. So the bank account of depositors (qard) is such a loan which is ungainful for both the depositor and the bank. The banks finance their activities from this money. Banks provide different services for the transactional depositors. The bank for this deposit type keeps 100% backup (Fekete & Tatay 2013).

The investment deposits are the other main financing sources of Islamic banks that are situated between the deposits and shares in contradistinction to the time-deposits provided by traditional banks. The whole result of investment deposits is divided, so the gain and the loss are shared with the depositors. The contract between the bank and the investor determines the split of gain and loss. In the division of the profit the parties agree before signing the contract. The division of the profit can only be changed with common agreement. There are two significant differences between common stockholders and investment depositors. The owner of the deposit has no word in how the bank should work. The second difference is that the dividends of shares are varied while the return of investment deposits is incessant.

„The Islam theologists as a thumb-rule advise that such a company should serve as the aim of the investment where the proportion of the external source and the equity is less than 1/3 and on the assets the proportion of cash and receivables is not more than 33%." (Balázs 2011).

The other liabilities row of the liability of the balance sheet includes the employee-related liabilities, the debts to suppliers, the taxes, rental fees, delayed incomes and the amount of money that should be paid after preferred stocks.

It can be between the liabilities if the bank issues an Islamic bond (Sukuk). Interest cannot be paid after islamic bonds (Sukuk), instead of this they pay rental fee as an asset backed bond to the investors from the incomes generated from the assets in hand.

On the basis of the Turkish Trade Law the Islamic bank is legally obliged to create backup. It can be used to cover loss if the bank runs out of the profit stabilisation reserve. Two legal backups should be created, shares cannot be paid from it (Szigetvári 2008).

Profit Stabilisation Reserve, which can be found in the liability of the balance sheet of the Islamic bank, cannot be found in the balance sheets of banks that work in the framework of then conventional bank system. But creating backup can be found in the liability of insurance banks. Another similarity between the western assurance and Islamic financial institutions is that refunding profits, which is usual in the assurance industry, can be indirectly equivated with the PLS (profit and loss sharing) model of Islamic bank (mudaraba, musharaka). In case of mudaraba the bank provides equity and the entrepreneur provides labour and market knowledge. In case of musharaka the bank receives company shares, a common investment occurs and they get shares in the proportion determined in the contract (Gálosi 2010).

A similarity between the methods of refunding profit and loss of the two industries is that both in PLS and in refunding profits a ratio can be found that declares appropriately how the participants of the affair get their shares from the profit and loss. The role of creating reserve, the amount of money for the coverage of the negative occasions of the future and risks, is anything else but a certain assurance of solvent operation in case of Islamic banks.

5. Consequences: the cooperation of the two bank systems

To end our study, we introduce some aspects of the cooperation of the Islamic and the traditional bank system. In our article we came to the consequence that according to one of the most important differences of the Islamic and the traditional bank system on the basis of the procyclic – anticyclic feature of the bank system, the traditional bank system deepens the crisis by the severity of the classification of the debtor, while the Islamic bank system decreases the depth of the crisis by lightening the liabilities of the debtor. The anticyclic economy and finance policy is one of the key questions of the traditional bank system and it is greatly exemplified by the introduction of the Basel III. system.

The second important element of the Islamic bank system where experiences can be borrowed is the share of risk in connection with the saver – borrower. The Islamic bank system is a lesson for that the depositor – at least partly – can be responsible for the investment and in this way the identity of interest of the trio of the saver-bank-borrower can be created.

On the basis of the economic indicators and the balance sheets we can come to the conclusion that there is an increasing need for the institutions of the Islamic financial system in the European financial market which is proved by the fact that the total assets of the IBB trebled within 4 years and it is also proved by the numbers showing increase and profit analysed above. Moreover, it is supported by the case of the Kveyt Turk Bank (KTB) that opened in July 2015, which is the first clearly Islamic bank of Germany besides the leading trade banks such as Citibank and Deutche Bank.

Though our analysis does not overhang the statements of the end of 2015, we can foresee that probably more serious effects will appear due to BREXIT. In the statements of the end of 2016, the effects of BREXIT will be perceptible. More of the scenario could be pointed out in case of the Islamic finance matters and the Al-Rayan Islamic Bank. According to one of the likely scenarios, due to the opening towards the Commonwealth and the establishing of closer links, the number of Islamic-type investments and the interest towards Islamic financial products could increase, which could imply a powerful enlargement. As opposed to this, we can foresee another possible scenario according to which such barriers could appear due to the repugnance for Islam and Muslims that would have an effect on the financial market and this repulsion could also be strengthened by the altering and severity of immigration and settlement policies. This process would obviously have a negative effect on the increase of the amount of Islamic financial products. We also have to admit that more scenarios exist as well, even parallel, so in connection with the trends, more specific conclusions could be formulated by the analysis of the data of the end of 2016.

Both in the western and the Balkan area there is an increasing need for the cooperation of the conventional and Islamic banks, which can be seen in the changes of laws of the particular countries and in the increase of the number of banks and also in the different financial institutions analysed in this study. The cooperation and harmonization of banks systems are an opportunity for the future in regional development and financing banks but it requires more research.

Appendix

Table 1.: Balance sheet of IBB on the basis of Statement of Financial Positon from 2010 to 2012

Balance sheet of IBB (in Pounds Sterling-GBP)	**2012**	**2011**	**2010**
(In the name of Allah, the Most Gracious, the Most Merciful)			
Assets			
Cash	686.302	851.438	559.791
Commodity Murabaha and Wakala receivables and other advances to banks	129.455.216	143.864.701	160.333.251
Consumer finance accounts and other advances to customers	306.292	886.235	2.310.206
Net investment in Home Purchase Plans	117.104.184	61.316.346	43.761.647
Net investment in Commercial Property Finance	11.611.726	7.107.440	132.739
Property and equipment	805.746	1.586.974	1.885.136
Intangible assets	307.457	349.362	363.222
Other assets	870.552	980.979	846.206
Total assets	261.147.475	216.943.475	218.192.198
Liability side of IBB	**2012**	**2011**	**2010**
Liabilities and equity			
Liabilities			
Deposits from banks	1.172.829	905.016	880.645
Deposits from customers	237.535.153	195.190.008	187.796.190
Other liabilities	2.363.851	3.778.785	3.317.104
Total liabilities	241.071.833	199.873.809	191.993.939
Called up share capital	35.464.700	25.464.700	25.464.700
Share premium	54.806.652	54.806.652	54.806.652
Retained deficit	-70.245.789	-63.247.007	-54.118.414
Profit stabilization reserve	50.079	45.321	45.321
Total equity	20.075.642	17.069.666	26.198.259
Total equity and liabilities	261.147.475	216.943.475	218.192.198

Source: https://www.alrayanbank.co.uk/media/262407/
al-rayan-bank-plc-financial-statements-31-december-2014-signed.pdf

Table 2.: Balance sheet of IBB on the basis of Statement of Financial Positon from 2013 to 2014

Balance sheet of IBB (in Pounds Sterling-GBP)	**2014**	**2013**
(In the name of Allah, the Most Gracious, the Most Merciful)		
Assets		
Cash	803.780	691.492
Commodity Murabaha and Wakala receivables and other advances to banks	83.285.338	104.820.956
Consumer finance accounts and other advances to customers	143.308	198.335
Net investment in Home Purchase Plans	311.574.308	207.091.407
Net investment in Commercial Property Finance	138.465.310	34.325.961
Property and equipment	261.209	403.095
Intangible assets /	357.466	426.459
Investment securities-Sukuks	109.360.094	18.998.439
Deferred tax asset	712.864	
Other assets	3.009.660	1.029.503
Total assets	647.973.337	367.985.647
Liability side of IBB	**2014**	**2013**
Liabilities and equity		
Liabilities		
Deposits from banks	31.728.248	20.661.155
Deposits from customers	509.802.583	320.373.032
Other liabilities	3.330.961	2.701.385
Total liabilities	544.861.792	343.735.572
Called up share capital	121.218.700	45.464.700
Share premium	54.806.652	54.806.652
Retained deficit	-74.545.400	-75.993.335
Profit stabilzation reserve	51.620	51.117
Fair value reserve	1.580.013	-79.059
Total equity	103.111.545	24.250.075
Total equity and liabilities	647.973.337	367.985.647

Source: https://www.alrayanbank.co.uk/media/262407/
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