

INDUSTRY UPDATE

# Islamic Banking: A New Player in the Eurozone SRI Market

Ahmet Kudsi Arslan<sup>1</sup>

In March 2015, major news from the Islamic banking market spread like lightning across the Eurozone banking world – KT Bank AG, the first and only fully-fledged bank with Islamic business model, coming from a Turkish-Kuwaiti background, was about to start operations in Germany in July of the same year. At the outset, this was a demanding challenge: would the implementation of Islamic banking as a new, unfamiliar banking concept in mainland Europe lead to controversy? Would the Muslim community take on the new products and services enthusiastically, and how would the representatives of the conventional Western banking system react to the value-based finance model from the East? It soon became evident that the domestic bankers shared the cosmopolitan and unifying vision of the Islamic banking concept – the market responded friendly and immensely curious to this then unknown, yet promising, faith-based banking model. The Muslim community showed great interest and conventional clients and investors focusing on socially responsible investments (SRI) acknowledged Islamic banking's ethical value. The news media exposure of the Islamic banking pioneer in Germany and in the Eurozone amounted to more than 1,500 articles in all major news media within the first few weeks. The bank itself registers an incessant flow of client inquiries until today. This article aims to explain how the Islamic banking business model progressed from the regulatory introduction, founding and establishment phase by its first mover towards its recognition as ethical banking alternative for the Eurozone economy.

## Islamic finance – a continual global success story

Islamic finance is a growing business segment all over the world – in Muslim and also in non-Muslim countries. More than 500 Islamic financial institutions in more than 70 countries administer estimated sharia-compliant assets of more than 2 trillion USD. Growth rates of more than 15 % outnumber those of the conventional banking

system. Sukuk, sharia-compliant bonds, serve increasingly as an alternative to the conventional bond business. At the G20 meeting of finance and labor ministers in September 2015 in Ankara, Turkey, Islamic banking was politically acknowledged for its positive effects on national economies and benefits for the society, in the framework of the following statement from the then German Federal Minister of Finance, Wolfgang Schäuble: "Islamic finance instruments are of growing importance in the world economy". Schäuble said further that international finance institutions should increasingly concentrate on integrating Islamic finance models into the global financing structure.

## Islamic banking in Western economies

A successful role model for an Islamic banking enterprise in a Western economy is the flourishing development of Al Rayan Bank PLC, the first British bank operating according to Islamic principles. The former Islamic Bank of Britain was granted authorization by the Financial Services Authority FSA in August 2004. This was the same year in which the mother bank of KT Bank, Kuveyt Türk Participation Bank with headquarters in Istanbul, established in 1989, started to lay groundwork in Germany with opening a German branch to introduce Islamic banking to the Euro area and to inform the general public about the religious finance model. Kuveyt Türk is the leading participation bank in Turkey working with Islamic principles, the largest Islamic bank in Turkey according to asset size, and has, as of today, more than 5,800 employees, 400 branches in Turkey, and a branch in Bahrain. Kuveyt Türk entered the sukuk market as pioneer in 2010 and has recently even broken the Turkish market record by carrying out the Sukuk issuance of the largest ever amount in Turkish Lira – 400 million – in a single transaction in the sector. Kuveyt Türk's main shareholder is – with 62 per cent – the Kuwait Finance House, one of the foremost Islamic financial institutions in the world. Established in 1977 in Kuwait, today's KFH Group network spans across seven regions worldwide

1- Ahmet Kudsi Arslan, Chairman of the Management Board, KT Bank.

from Saudi-Arabia to Malaysia, with 430 branches, over 790 ATMs and approximately 8,600 employees.

## Eurozone Islamic banking trailblazer

In view of this consolidated background, KT Bank entered the German market in 2010, when it was granted a license for non-EEA deposit broking by the Federal Financial Supervisory Authority BaFin. Following this, in March 2015, after having applied in 2012, the BaFin granted KT Bank as first bank with Islamic business model a full banking license under German law for the provision of deposit and credit business in Germany. KT Bank commenced operations in July 2015 with headquarters in Frankfurt and – up to today – 4 branches in the cities of Berlin, Cologne, Frankfurt and Mannheim as well as with 90 employees.

These efforts are combined with a clear vision for the Euro economy – the bank aspires to be a leading ethical bank while focusing on Turkish and non-Turkish Muslim communities as well as SRI customers in mainland Europe, being open to clients of all religions and nationalities.

## Islamic banking products and services in Germany

KT Bank provides Islamic deposit and credit business products and services and payment transactions for retail and corporate clients as well as services for financial institutions. The bank is a member of the German Banks Compensation Scheme (EdB), which secures clients' deposits up to € 100,000. Considering Muslims' financial requirements, the comprehensive, regularly updated portfolio includes a wide range of products and services, from free-of-charge current accounts with free online banking, debit Mastercards and investment opportunities based on profit-sharing and participation schemes up to real estate financing, instalment credits for larger acquisitions and investor loans for business financing. A bank that is not lending money conventionally, but financing real goods to avoid interest, was, until the launch of KT Bank, unheard of in the German market. And yet, clients became quickly aware that they can also enjoy all amenities of a conventional full-service bank, with services like safe deposit box rental, foreign exchange and, given the bank's background, remittances to Turkey. Moreover, KT Bank provides financial institutions with account & clearing services, vostro account services and FX trading.

## Regulatory challenges

The requirements for establishing a comprehensive, sharia-compliant portfolio in a Western economy are by no means fulfilled by 'business as usual' procedures – hence it took substantial regulatory cooperation efforts with the German authorities

in order to introduce the Islamic finance model in the market. KT Bank officially established the previously unfamiliar Islamic banking model in the Eurozone as a solo player. In terms of the required banking license application, the bank cooperated strongly with the supervisory authority to ensure that it complies with all regulatory, legal, and fiscal requirements applicable for conventional banks. With regards to specific challenges, such as Islamic car purchase and real estate financing, the bank had to develop approaches to comply with the German legislation. The Islamic real estate financing products structured as murabaha transaction – a sales contract where the buyer and seller agree on a markup – serve as example in practice: Following a positive creditworthiness check of the client and a valuation of the property in demand, the bank, together with the client, sets up a civil-law partnership in Germany, the so-called "Gesellschaft bürgerlichen Rechts" (GbR) in order to avoid having to pay land transfer tax twice. After that, the GbR buys the property from the vendor, with both the client and the bank receiving shares in the GbR that correspond to the capital contribution involved. Then the client buys the bank's shares in the GbR, and pays off the purchase price over the agreed term. This procedure is not more complicated nor time-consuming than a „conventional“ real estate financing in Germany. There is only one additional signature involved – for a financing package that is true to Muslim ethical convictions. KT Bank's single-period real estate financing package runs for up to 10 years and features a fixed monthly instalment. It is called a "single-period" option because the bank sells its share in the property concerned as a single transaction to the buyer.

## Halal and no hedge funds

Besides operating as a trader, buying commodities for its clients and reselling them with a profit markup, KT Bank operates the Islamic deposit business in Germany as an "entrepreneur" and participating project partner based on profit and loss participation. This partnership basis mirrors the general cooperative origin of the whole banking sector. The bank's clients invest via a participation account, the bank invests in the real economy, and the profit then achieved is shared in accordance with an allocation formula agreed beforehand, e.g. 85 %. The size of the client's respective share in the profits will depend on the term involved and the size of the investment. With an allocation formula of 85 %, the bank's client receives 85 % and KT Bank 15 % of the profit generated by the deposit. Due to reasons of sharia-compliance, KT Bank cannot guarantee fixed profits for the deposits, yet aspires to achieve profits for its clients that are aligned with the current market level.

As financing is based on a pool that contains all

client deposits, every depositor gets a share of the average return of all projects. Due to the return of the investment into these projects and thus into the real economy, “real” and asset-backed values are being created. Clients and investors thus contribute to the productive capital of the economy. These participation investment options differ substantially from the structures of derivatives that violate the Islamic proposition that money is only a medium of exchange, as well as from the concept of hedge funds with their high affinity to risk. KT Bank does not invest into such financial constructs due to sharia constraints.

Instead, KT Bank invests into German, regional projects of many areas like real estate, the food and automotive sector, as well as wholesale and retail. Small and medium-sized enterprises, SMEs, play an important role, as a large part of the bank’s clients in Germany are successful entrepreneurs of Turkish origin. In general, 100,000 Turkish entrepreneurs in Germany are active across 50 different sectors, creating more than 500,000 jobs.

## Germany – emerging market potential for Islamic banking

Germany was chosen as base to launch Islamic banking in the Eurozone many years ago and generally seems the foreordained country to introduce the Islamic banking model in mainland Europe. As a strong economy with Frankfurt as the financial capital of Europe and headquarters of the European Central Bank, Germany is being anticipated to profit from Brexit long-term. Alongside France and the United Kingdom, the country is being classified as one of the predestined Western key markets for Islamic finance due to Muslim migration. The market potential is huge, with currently 4,7 million Muslims living in the country, the majority being of Turkish origin.

Moreover, there is an ongoing growth trend within the Turkish Muslim population in Germany since the last decade. The contribution of Turkish companies to the German economy is substantial. Beyond that, Germany is the biggest producer and exporter of goods in Europe and also historically Turkey’s longest trading partner. The MENA region is also an important market for German companies. In front of its Turkish-Kuwaiti background, the first Islamic bank in the Eurozone bridges the trade between these countries and also creates extensive cooperation and synergy effect among intercompany relations.

## Huge growth potential within the Muslim community

How was the concept of Islamic banking adopted by the main target group, the Muslim community,

during the last 3 years? In the operative field, KT Bank identified a large explanation need concerning Islamic banking products within the Muslim community. This is reflected in the only 5 % of the German Muslim population that adhere to Islamic banking yet. Client consultancy at KT Bank is thus time-consuming, intense and individual. Measured against the number of millions of Muslims living in the country, the KT Bank pioneers anticipate a huge growth potential. Furthermore, net incomes of Muslim households in Germany are on the rise, and Muslims have a remarkable savings rate of nearly double the national average.

## Universally ethical qualities of Islamic finance models

The performances of the conventional finance sector during the last decades have shown that interest and artificial inflation of prices based on debt rather than on real value are some of the main reasons why bubbles form, burst, and then lead to recessions. After the financial crisis, people around the world, especially those in conventional economies, became more aware of value-based finance models, banking regulations and undue risk taking. Analyzing the value-based methodology of the Islamic banking model during 3 years of operational business development in the Euro market, it became apparent that Islamic banking principles do not only fulfill the requirements of the Muslim community, but also the ethical standards of the German majority society. Euro clients are becoming increasingly aware of the universally ethical qualities of Islamic banking’s Qur’an-based values. The product portfolio of Germany’s first and only sharia-compliant bank is thus attracting value-conscious clients of all beliefs. Islamic banking is currently being established in Western markets as sub-category of the ethical banking segment.

## Islamic banking client groups in Germany

Due to the nature of the business model and the background of the bank, KT Bank has expected from the beginning that a major part of its client base would be of Turkish and Arabic origin as well as of Muslim faith. Whilst there are no exact or detailed statistics on the origin or religious affiliation of the clients, as these data are not being queried or collected, the majority of clients, approximately 50 %, are of Turkish, and 35 % are of Arabic origin. The remaining 15 % are Germans and German residents of other nationalities. The client structure of KT Bank represents 60 nationalities, with many coming from European neighboring countries like Denmark.

## Future outlook – Islamic banking

## solutions for Eurozone challenges

In 2017, KT Bank officially declared the completion of the founding and establishment phase of the bank in the German market after the successful market launch. The bank's key topics in 2017 were the achievement of a growing client base, 80 per cent asset growth as well as the development of the retail, corporate and institutional product portfolio and up-to-date services. A 2017 highlight was the upward trend of the German property market which increased the call of GCC investors for sharia-compliant real estate opportunities. Moreover, the historical interest rate low boosted the general appeal for investments into participation accounts, whose profit rates are up to today outperforming those of the conventional fixed deposit sector. According to 2017 year-end results, total KT Bank assets reached 191 million euro and total equity was 60 million euro. In 2018, the growth path continues, with a current loan portfolio of more than 170 million euro. The market will see a lot of new sharia-compliant products and services, among them Islamic financial showpieces like a credit card with instalment, an Islamic alternative to overdraft unheard of in Germany which is running

successfully in the Turkish Islamic banking sector and is anticipated to also attract a lot of non-Muslim clients. Most vital is also the strategic enhancement of the online direct banking infrastructure as there is strong demand from currently out of more than 70 countries to open sharia-compliant accounts in Germany.

## Inspiring cultural change in the finance industry?

Faith and finance, profit and ethics – this group of attributes together complete the concept of Islamic banking, which has already proven to be an enrichment to western conventional business ethics. Islamic banking captures the global economic zeitgeist, prioritizes unequivocal values over a narrow focus on profits, and supports the real economy whilst featuring an universally ethical belief system. All of these qualities have triggered huge awareness not only of the Muslim community, but also of Euro clients. Will Islamic banking help to transform the Western conventional finance sector after a decade of ongoing crisis? The Islamic bankers in the Eurozone believe it will help.

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