

# Insight into Islamic Banking: Looking behind the Curtains of Islamic Finance

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**Master's Thesis in**

**Corporate Finance & Financial Management**

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## **Abstract**

Islamic banking and especially financial products complying with Islamic Law have been gaining momentum over the last couple of years and are becoming more and more a focal point even for conventional banks here in Switzerland. This paper takes a deep dive in to Islamic financial products, explaining the difference in set-up between conventional banking products and their Islamic counterparts. Furthermore, it presents up to date market figures for the most powerful innovation in the sector of Islamic debt securities: Sukuk. Finally, it examines the development of Islamic banking in Switzerland.

## **Executive Summary**

### **Problem Definition**

Islam is a global religion that provides guidelines on dos and don'ts for each aspect of life. Thus behavioral rules are also imposed on the financial sector. From the 1970's, when the first Islamic banks were founded, up to today, the Islamic financial sector has seen a tremendous growth in assets, which are expected to reach USD 2.1trn by the end of 2014. The major part of this sector is located in the Middle East, South East Asia and London as a local center for Europe. The fundamental distinction between the conventional and the Islamic banking and finance industry is that, unlike conventional banks, Islamic financial institutions cannot base their business upon interest. As a consequence this industry relies rather on equity-like instruments, where the bank and the client share risk and return according to pre-agreed terms. Several questions emerge: how does an Islamic financial institution manage to earn money? How does it maintain its liquidity? And last but not least, what kinds of capital markets exist where lenders meet borrowers?

Switzerland is a global hub for off-shore and on-shore wealth management. The Swiss financial industry relies on tradition, neutrality, a thriving economy and a strong Swiss Franc. London, the other global player in the financial sector is not only outperforming Switzerland when it comes to investment banking services but also with regard to Islamic finance. A fair question to ask is what kind of approaches Swiss banks would have to take to attract Muslim clients desiring to conduct their banking activities in accordance with Islam. Moreover, since the erosion of banking secrecy is triggering outflows from western European clients, there is a need to compensate with new clients mostly from Emerging Markets, among them; clients from Muslim countries.

### **Objective of the Study and Approach**

This paper aims to take a deep dive into the Islamic banking and finance industry. A solid comparison between conventional and Islamic financial products is provided and the capital markets eligible for Muslim clients are assessed. Additionally an overview of the development of Islamic finance in Switzerland is given. A literature review has been conducted including expert interviews. Up to date data market figures have been acquired to provide actual volumes of Islamic debt securities, and time series of respective indexes have been used to provide a comparison between conventional and Islamic securities of different asset classes.

The paper contains six chapters. After the introduction, chapter two introduces the Shari'a principles. Chapter three explains the most common Shari'a compliant methods used for investments and financing as well as for liquidity management. Chapter four focuses on the capital markets Muslims can tap for funding or investments. The fifth chapter introduces the most innovative Islamic financial product, Sukuk, an asset backed security commonly known as Islamic bond. The sixth chapter gives insight into the Swiss financial industry and its relation to Islamic banking.

To avoid confusion the terminology used in this thesis is adopted from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

## Results

This paper revealed that Islamic and conventional banking have much in common; the main difference lies in the way business is structured, from collecting savings, raising debt and granting financing facilities to clients. Furthermore the same asset classes as for conventional finance also exist for Shari'a conscious clients. Due to the different way of structuring business, Islamic financial institutions and Islamic investors are exposed to other risk while receiving the same profits as in the conventional financial system. Additionally, doing business according to Islam involves higher structuring costs.

With regards to the engagement of Swiss banks in the Islamic banking and finance sector, the efforts and services are limited and little interest is shown in this topic apart from a few exceptions.