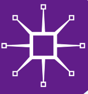

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Islamic Finance in Europe

A Cross Analysis of 10 European Countries

Edited by
Mohyedine Hajjar

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Mohyedine Hajjar
Editor

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Editor
Mohyedine Hajjar
Pantheon-Sorbonne University
Paris, France

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Notes on Contributors

Ibrahim Zeyyad Cekici holds a PhD in Law. He is a Lawyer in Paris Bar. He is specialized in Business Law and Islamic Finance. He was the director of the first Islamic Finance executive MBA in the Business School of Strasbourg, Strasbourg University. He wrote a thesis on Islamic Credit Operation in French Law and has authored several papers. He still gives courses and conferences in different universities in France and several countries and advises companies and financial institutions.

Ciro G. Corvese is Associate Professor of Business Law at the Department of Business and Law (University of Siena). He holds a PhD in Banking Law and Legislation (Siena, 1994). The main areas of his research focus on corporate law with special attention to both company law and financial intermediaries' law. He is editor in chief of the series *Profit/Non Profit* published by the Pacini Publisher (Pisa). He is a member of the board of the online review *Ianus* (Department of Business and Law—University of Siena), member of the editorial board of the review *Diritto della banca e del mercato finanziario* and member of the board of auditors of the online review *Ricerche giuridiche* (University "Ca' Foscari"—Venice).

Gabriella Gimigliano holds a PhD in Banking Law and Law of Financial Markets. She is a senior researcher in Business Law and, since September 2018, holds Jean Monnet Chair in EU Money Law, at the University of Siena, Italy.

Fatih Habib is a journalist, translator and editor at Alif edition in Kazan, Russia, holds a master's degree in journalism from the University of Kazan.

He is a translator and an editor specializing in Islamic Tatar history. His translations and publications are in the Arabic, Russian and Tatar languages.

Mohyedine Hajjar holds a PhD in Law, and two Advanced Postgraduate Degrees (DEA) in Business Law and General Private Law and an MSc in Language, Literature and Civilization of the Arab World. He is an expert in Islamic finance, and specialized in training and consulting in the field of Islamic Finance. His interventions focus on governance, ethical control (*Sharīᶜa* Boards) and the dual compatibility between Islamic finance operations and civil law to ensure the introduction of Islamic finance in civil law. His research focuses on a comparative conceptualization of fundamental theories between civil law and Islamic Law. He is Lecturer of Islamic Law at Paris III University and Catholic Institute of Paris. He is also an associated researcher in Islamic Finance at Chair of Ethics and Financial Norms (CEFN) at Paris I University (Panthéon-Sorbonne). He is the author of many articles on Islamic finance. His book on Islamic mutual funds has been published and he had submitted two books on Islamic investment norms and foundations of Islamic Law. He is also a translator and had submitted two translated books to be edited.

Sabrina Iannazzone has been committed to conducting research on Islamic banking and finance for six years. She developed a solid academic background in Islamic studies, politics and international relations at the Orientale University in Naples, Italy. Throughout her study programs, she carried out fieldwork in Istanbul, Turkey, and Paris, France, on risk management in Islamic finance and the development of Islamic financial instruments within the European market, respectively. She presented part of the related research results, in the form of a short article, on the occasion of the Sarajevo Islamic Finance and Economics Conference 2014: "Derivatives in Islamic Finance: Does Ethical Finance need them?"

She independently designed and implemented her research projects and successfully collected primary sources in several countries. She developed good connections with the *Comité Indépendant de Finance Islamique en Europe* (CIFIE), *Ecole de Management in Strasbourg*, France, Associazione per lo Sviluppo di Strumenti Alternativi e di Innovazione Finanziaria (ASSAIF) in Milan and the Bank of Italy in Rome, among others. She actively contributed to the Durham Islamic Finance Summer School, UK, and the Turin Islamic Economic Forum, Italy, in 2015.

While being a policy advisor in foreign affairs at the European Parliament in 2016, she contributed her insights on Islamic finance to the discussions

of the high-level expert groups of sustainable finance, green economy and Euro-Mediterranean partnership. Recently, she disseminated core concepts and the added values of Islamic finance in the *Galileo* online magazine (no. 234, March 2018), in Italy. She is working as a consultant in Brussels, Belgium.

Jihad Laarab is a business process expert. She holds a master's degree in Banking and Finance from Université Paris X with five years of experience in capital market and risk management at Société Générale Credit and Investment Bank.

Hafsa Lamrani is a consultant with a history of working in the financial services industry, and conducting general studies and research. Her work focuses on Islamic Finance and Corporate Finance. She holds an Executive MBA with specialization in Islamic Finance and an MSc in Corporate Finance. She is the author of many articles on Islamic finance and risk management. She is working on a project about governance in Islamic banks.

Dorsaf Matri is working as a consultant with the World Bank (IFC, IBRD) in Washington, DC, where she is advising Treasury Departments and Financial Regulation Authorities on Capital Markets financing and Anti-Money Lundering (AML)/Combating the Financing of Terrorism (CFT) issues. She is also the general counsel and head of compliance of Lutetia Capital, a Hedge Fund based in Paris and London.

Prior to this, she worked for the law firms Linklaters and Gide Loyrette Nouel. She was also a member of the Financial Law Committee of Paris Europlace created under the aegis of Christine Lagarde.

Dorsaf holds a PhD in Law with Honors from the Paris I Panthéon-Sorbonne University (Paris I) and is an attorney admitted to the Paris Bar.

A former visiting researcher at the University of Harvard Law School, she has authored several papers and books on financial law and is a Lecturer at the Sorbonne Law School.

Edana Richardson is Lecturer in Law at the University of Maynooth, Ireland, having previously worked as a solicitor in the London and Abu Dhabi offices of an international law firm. Richardson lectures in Islamic finance law and company law at undergraduate and postgraduate levels. She is a graduate of Trinity College Dublin, where she completed her undergraduate law degree (2006) and PhD (2011), and the University of Cambridge, where she completed her master's law degree (2006). Richardson's research interests include Islamic finance and capital

markets law, and her works have been published in journals and edited collections in Ireland both nationally and internationally.

Germán Rodríguez-Moreno is Associate Professor in Islamic Finance at the IE Business School. He has developed an expertise in *Takāful* (Islamic Insurance), waqf (Islamic charitable trusts) and other aspects of Islamic finance. His latest publication is "Waqf-based *Takāful* Model: A Challenge for Social Entrepreneurship" (2018). He is a member of the Observatorio de Finanzas Islámicas (Islamic Finance Observatory) in Spain. City of London trained, Germán is an English solicitor with 20 years of experience as a corporate lawyer doing M&A work all around the world. He is a former head of legal at Aviva, a large international insurance company. Prior to qualifying as a lawyer, Germán obtained a First Class BA (Honours) and an MSc in Politics at Stirling University, Scotland. He then worked as a freelance journalist, during which time he co-authored a book and published on different Latin American issues. He has lived in Madrid since July 2008.

Uğurlu Soylu As former Managing Director at Kuwait Turkish Participation Bank's Financial Services Germany, Uğurlu Soylu was the initiator and pioneer of establishing the first Islamic Bank in Germany and Eurozone.

Uğurlu Soylu has served as lecturer at various universities and is a regular speaker in international conferences. He has delivered numerous invited talks/keynote speeches and has authored several articles and papers.

He holds a master's degree (German Diploma) in Economics from the University of Mannheim, the "Harvard" of Germany. Prior to joining Kuwait Turkish Participation Bank, he has served as a teaching and research assistant in the Department of Economics at the School of Law & Economics, University of Mannheim.

His doctoral thesis' (not yet finished) topic is on "Socio economic change in Islamic societies".

Transliteration Signs

Transliteration signs	*Arab letters*	*Transliteration signs*	*Arab letters*
’	ء	Ẓ	ظ
b	ب	‘	ع
t	ت	Gh	غ
th	ث	F	ف
j	ج	Q	ق
ḥ	ح	K	ك
ḣ	خ	L	ل
d	د	M	م
dh	ذ	N	ن
r	ر	H	ه
z	ز	W	و
s	س	Y	ي
sh	ش	**Les longues voyelles**	
ṣ	ص	Ā	ا
ḍ	ض	Ū	و
ṭ	ط	Ī	ي

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CHAPTER 1

Introduction

Mohyedine Hajjar

Islamic finance is an ethical financial system based on Islamic Law. It has spread beyond the Muslim world, but with various theoretical and practical implications. It has potential for high growth, especially in Europe. Beyond its intrinsically religious character, this sector of activity is open to every client, without religious discrimination.

According to the International Monetary Fund (IMF), the assets involved in this specific finance rose from $200 billion in 2003 to $1.8 trillion in 2013.[1] The IMF 2013 report reveals that 80% of Islamic financial assets were bank assets, while *ṣukūk* accounted for 15% of the total amount.[2] The Islamic Financial Services Board (IFSB) Stability Report 2017 indicated that the global issuance of *ṣukūk* has increased significantly over the last decade: the value of *ṣukūk* in circulation was $270 billion at the end of 2013, which represented less than 1% of global bond markets, and has grown to $318.5

[1] International Monetary Fund, *Islamic finance: Opportunities, Challenges, and Policy Options*, April 2015, pp. 13–14, online on: https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf

[2] *Ibidem*.

M. Hajjar (✉)
Pantheon-Sorbonne University, Paris, France

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billion at the end of 2016.[3] The latest estimates are also optimistic: the 2016 Islamic Research and Training Institute (IRTI) report mentions that Islamic banking assets have exceeded $1.9 trillion.[4]

Islamic finance is obviously marginal on the scale of the world economy. However, its continued growth and "relative" resilience in the face of the 2008 crisis[5] have attracted significant attention. The characterization of this industry and its viability in legal and economic regimes therefore become a necessity.

Islamic finance can be defined as the practical application of legal and economic principles flowing from the *Sharīᶜa* which means "the way to go". This way must begin with one's submission to the will of God. It encompasses three main disciplines: Islamic Law (*Fiqh*), Islamic belief (*ᶜAqīda*) and the spiritual science of soul purification (*Tazkiya*).[6]

Thus, the *Fiqh* is the set of rules of conduct governing all facets of human life, in the form of a hierarchical body of law. The *Fiqh* regulates several legal disciplines: worship, commercial transaction law, family law, criminal law, administrative and constitutional law as well as international relations law. The originality of this legislation lies in its intimate and inseparable relationship with the purification of the soul, which gives it its moral and spiritual depth. Thus, Muslim law, in addition to its legal nature, constitutes a moral code of conduct for private and social life.

As for Islamic finance, it draws its legal rules in the section entitled "*Fiqh al-Muᶜāmalāt*", which can be translated by the law of commercial transactions. *Fiqh al-Muᶜāmalāt*, in its classical form, essentially regulates the legal relationship between individuals who enter into a particular type of contract while relying on legal theories of Islamic Law, such as the theory of *ribā*[7] and that of *gharar*.[8]

[3] IFSB, *Islamic Financial Services Industry Stability Report 2017*, May 2017, p. 3, online on: https://www.ifsb.org/docs/IFSB%20IFSI%20Stability%20Report%202017.pdf

[4] IRTI, *Global Report on Islamic Finance 2016, Islamic Finance A Catalyst for Shared Prosperity?*, p. 3, online on: http://www.irti.org/English/News/Documents/438.pdf

[5] IMF Working Paper, *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study*, September, 2010, online on: http://www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf

[6] Kuwait Ministry of Awqaf and Religious Affairs, *The Kuwaiti legal encyclopaedia*, vol. 1, pp. 16–17.

[7] Literally, increase, addition or growth. Legally, a surplus granted to a contractor but having no legal counterpart. Cf. Al-Jurjānī, *The definitions*, Beyrouth: Dār al-kutub al-ʿilmiyya, p. 109.

[8] What has an unknown fate, without anyone knowing if it exists or not. *Ibidem*, p. 161.

Thus, any action of introducing Islamic financial operations into another legal environment leads to an interconnection of Islamic Law with the positive law governing the territory in which the said operations will take place. Implementation of Islamic finance into a pre-existing legal framework surely is a matter of comparative law. It may seem then that legal challenges are the main challenge to be dealt with in implementing Islamic finance. Such view would be overly simplistic, as Islamic finance is a comprehensive approach, encompassing both Islamic Law and positive law, as well as community development, local customs and traditions.

The study of this interconnection between the different legal, economic and financial systems is extremely complex in terms of its comparative aspect and its transversal and interdisciplinary nature. This complexity appears in the practice of Islamic finance at the level of Muslim and non-Muslim countries. However, introducing Islamic finance in Europe implies an additional difficulty, particularly at the societal and even political level.

In the course of history, Europe and the Arab-Muslim world have fostered several types of exchange and mutual influences that have been reflected in the legal, economic or social disciplines. The appearance of Islamic finance in its current form during the twentieth century and its entry into the practice of business mark a new form of cultural exchange between the two shores of the Mediterranean.

The challenges that banking and Islamic finance pose in Europe have been much in the news. Through this work, we aspire to find ways of a serene integration of Islamic finance in European countries, whose practice will be put at the service of the citizen and society as a whole. European societies are losing steam in a neoliberal capitalism aimed solely at maximizing profits at the expense of a non-negligible number of ethical values in terms of investment. The world needs a new lease of life that is offered by the ethical finance of Islamic finance.

In fact, Islamic banking and financial practice has become widespread in Europe. It began with the creation of the first Islamic retail bank—the Islamic Bank of Britain—in 2004 in the United Kingdom, which confirmed its position as the Western leader in Islamic finance by becoming the first non-Muslim country to issue a *ṣukūk* sovereign. Similarly, Luxembourg has benefited from its reputation as a mutual funds management center in Europe to attract Islamic asset management expertise and gain experience. More broadly, every European country has approached Islamic finance in an idiosyncratic way, reflecting its own socio-cultural, political, economic and regulatory constraints and comparative advantages.

After the global financial crisis in 2008, new sources of funding were necessary to restore growth. Many additional reasons have driven European countries to seek a growth driver in Islamic finance, such as targeting potential growth with clientele of more than 20 million Muslims living in the European Union, as well as completing their supply with a new range of financial products available on the global market, not to mention the societal interconnections between Islam and the West.

Furthermore, Islamic finance is characterized by a few specificities that mark the minds, as it stimulates and affects the real economy, promotes individual initiative and enhances cooperation between economic actors, especially actors which were set aside by the conventional financial system. Taking into account the essence and ethical dimension of Islamic finance, these characteristics find their counterparts in European legislation, particularly in microcredit, crowdfunding, social and cooperative banks and socially responsible investments. Despite the similarities between, on the one hand, ethical, solidarity and social investments and, on the other hand, Islamic financing, there are several differences that could be described as "serious". They are at the level of philosophical, legal and economic values, which are accentuated by the difficulties arising from the governance of Islamic financial institutions in the positive legal framework.

These serious reasons deserve a careful study and an overview of Islamic finance in Europe, trying to take into account its social dimension in aspirations of the public, as well as practical implementation by stakeholders. The actual practice of Islamic finance is at the heart of this work. Integrating aspirations and practice makes a difference in comparison to classic studies and statistical reports published by famous organizations such as EY, Thomson Reuters, Zawaya and others.

This collective work is based on a comprehensive and interdisciplinary vision of Islamic finance. Thus, we will focus on presenting the state of Islamic finance in European countries by focusing the presentation and analysis on four main axes.

1.1 Interconnection Between Society and Islam

Knowledge of the customer base of Islamic finance is different from one European country to another: for instance, France prohibits religious and "ethnical" statistics. We thus need to establish consistently the place of Islam in European countries. This will allow us to assess the perspective of sustainable development of Islamic finance in these countries. It is there-

fore a question of presenting the sociological and demographic aspects that reflect the perspectives of the development of Islamic finance in each country.

1.2 Legal Framework of Islamic Activity

The practice of Islamic finance is generally limited by legal constraints that arise from the incompatibility between the principles of Islamic finance and certain national legal rules. Thus, in order to accommodate Islamic finance operations, the legal framework may be tuned by the legislator or by the regulatory authorities, if the practitioners themselves did not find appropriate applicable material provisions. Indeed, the freedom to contract is sufficient to structure a banking and financial transaction in accordance with the principles of Islamic finance as long as it is not contrary to public order.

These legal arrangements are the center of our inquiry in this axis. To carry it on consistently, we will study legal texts which have undergone modifications to allow exemptions from the common legal framework. Similarly, the analysis of a given national legal framework for certain transactions may lead to the formulation of proposals to amend this framework in order to accommodate optimally the particular characteristics of Islamic financial transactions.

1.3 Current Situation of Islamic Finance

In every chapter, this section puts the current situation of the Islamic financial sector in perspective with the history of Islamic finance for every country considered. This will help to understand the strengths and weaknesses of an industry in the making by presenting the state of the market. This axis of research differentiates developments affecting each sector of activity such as Islamic banking, Islamic insurance (*Takāful*), other Islamic financial institutions or the market for the issuance of Islamic financial securities called *ṣukūk*.

1.4 Academic Situation

The study of the academic situation of Islamic finance in each country will allow to know more precisely the ideas that are conveyed about this new industry. Indeed, it will provide sharp criteria for the evaluation of its

social and moral anchoring in each country. It will also discuss the specialized courses in Islamic finance and academic studies.

This book will not be limited to a study of countries belonging to the European Union or the Council of Europe. We decided to review *significant* countries, from the point of view of either supply or demand. On the demand side, it is easy to figure out that we are interested in countries with a significant Muslim population (e.g. Turkey,[9] Germany, France, Russia, the United Kingdom). On the supply side, some countries have expressed their benevolence to accommodate Islamic financial operations or demonstrated a remarkable expertise in some products: to these categories belong, for instance, the Republic of Ireland and Luxembourg.

However, since the majority of the countries studied are part of the European Union, an introductory chapter will analyze the degree of compliance of the rules governing Islamic finance with European Union legislations. It will then follow various contributions, that is, an article—or two articles depending on the importance of the subject—for each country studied.

[9] One may argue Turkey is only marginally in Europe, but the Turkish financial sector is mostly headquartered in Istanbul, that is, in Europe, geographically, as is the large Muslim community in Russia, which demonstrated a definite interest in Islamic finance since more than a century; cf. Zaripov I. 2013. “ИКЪТИСАД” – ПЕРВЫЙ РОССИЙСКИЙ ЖУРНАЛ ПО ИСЛАМСКОЙ ЭКОНОМИКЕ; Iktisad, the first Russian magazine on Islamic economics, *Philology and Culture*, 31.

PART I

Legal Framework of Islamic Finance in EU Legislation

CHAPTER 2

Financial Undertakings, *Sharīᶜa* Rules, and the Internal Market Framework: Challenges and Opportunities

Gabriella Gimigliano

2.1 Introduction

Islamic finance refers to the "application of classical 'Islamic law' in the management of money"[1] and covers economic activities performing an intermediary and risk transformation function like conventional finance but operating as interest-free (*ribā*), real asset-based, and equity-backed businesses, refraining both from taking risks amounting to gambling (*maysir*) and from exhibiting an excessive degree of uncertainty (*gharar*).

Generally speaking, Islam is considered to be a social system given to humanity by Allah to cover all aspects of human life.[2] Accordingly, Islamic finance is based on Divine Law, or *Sharīᶜa*, as revealed in the *Qur'ān* and the

[1] Valentino Cattelan (2010), Islamic finance and ethical investment: some points of reconsideration, in Mohammad Fahim Khan, Mario Porzio (eds), Islamic banking and finance in the European Union. A challenge, Edward Elgar publishing: Cheltenham, Glos, UK, p. 78.

[2] More in-depth analysis in: Gohar Bilal (1999), Islamic Finance: Alternatives to the Western Model, 23 Fletcher Forum World Affairs 145, pp. 109–118.

G. Gimigliano (✉)
Business and Law Department, University of Siena, Siena, Italy

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Sunna. These are, respectively, the Muslim sacred text and the collection of the Prophet Muḥammad's real-life examples. However, Islamic finance is also based upon the interpretation of the sacred texts, or *fiqh*, according to the premise that "the clarity of the Truth does not mean that it is manifest, and *fiqh* is the discipline which aims specifically at 'making manifest' God's Will as 'clearly' revealed in the *Qur'ān* and exemplified by the Prophet".[3]

This chapter takes a normative approach to examining Islamic finance within a non-Islamic setting, namely, the European Union (EU). It is, however, far from being an overview of Islamic financial principles or *Sharīᶜa*-compliant products and activities, nor is it an in-depth analysis of community-based regulation for banking and financial undertakings. What it aims to do is to take the community-based framework as a more workable legal setting than national ones, and by analysing how the accommodation process is carried out, this study challenges the mainstream approach that subsumes Islamic financial undertakings within conventional banking and financial regulation as if Islamic financial undertakings were directly comparable with other socially responsible enterprises or ethical businesses. The main focus is to argue for the normative autonomy of Islamic finance, that is, of Islamic rules applied to the management of money within the EU legal order, analysing the consequent regulatory challenges and opportunities for the European lawmaker.

The whole analysis is constructed on the premise that the Rome I regulation[4] on contractual obligations in civil and commercial transactions is based on connections or conflicts between the laws of different States and may not be applied to *Sharīᶜa* rules on the management of money because they represent the law of communities rather than of States.

To be precise, the preamble (13) to Rome I establishes that "*[t]his Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention*". However, scholars have convincingly argued that "incorporation by reference into the contract strongly indicates that such non-state principles only become part of the contract replacing the non-mandatory provisions of the otherwise applicable law, but do not exclusively govern the contract".[5]

[3] Cattelan (2010), pp. 76–87.

[4] Precisely. Regulation EC/593/2008, of 17 June 2008, published in OJEU, L 177/6, of 4.7.2008 (Rome I).

[5] Behr Volker (2011), Rome I regulation. A—mostly—unified private international law of contractual relationship within—most—of the European Union, Journal of Law and Commerce, vol. 29, p. 241.

This chapter has a further five sections laid out as follows. Section 2.2 argues for allocating the process of accommodating Islamic finance within the EU regulatory framework. Sections 2.3, 2.4, and 2.5 examine the normative approaches to the regulatory accommodation process, combining the "business-based" and the "cultural-based" approaches; the former concern *Sharīʿa*-compliant financial undertakings from the point of view of the economic activity performed, while the latter consider Islamic finance as a cultural experience, where the adjective "cultural" implies that Islamic finance should be conceived at least as a set of thinking and behaviours that every Muslim gradually comes to endorse through a socio-educational process of induction. More specifically, Sect. 2.3 investigates the mainstream normative approach to the regulatory accommodation process, Sect. 2.4 makes some critical remarks regarding the prevalent interpretative solution, and Sect. 2.5 argues that the Islamic Law of finance is an autonomous regulative model and examines the consequences of this reasoning for the business- and cultural-based analyses. Section 2.6 draws some conclusions emerging from the analysis.

2.2 The European Union as an Eligible Regulatory Framework of Accommodation

The first question to pose concerns the choice of legal system for the accommodation process of Islamic finance. Although there have only been State-based policy actions so far, this study argues that the EU may be regarded as a workable regulatory framework as a whole. There are at last three arguments to support this regulatory option: (i) a matter of fact: the geographical spread of Islamic finance; (ii) a matter of policy: the shared ground between the features of Islamic finance and the policy strategy and tools of the Capital Market Union (CMU) with a view to building up a more inclusive "internal market" and channelling further capital; and lastly, (iii) a matter of law: the "internal market" is not only an *area without frontiers* for persons, capital, workers, and services, but also an EU-based legal order set up to achieve the above-mentioned policy objective.

2.2.1 A Matter of Fact: Geographical Spread

Islamic finance is, firstly, something more than a local experience: it has spread throughout the European area and Member States. Steady and firm support from some national governments has boosted the growth of

Islamic finance, particularly in the United Kingdom, Luxembourg, Ireland, and France.[6] The United Kingdom may be regarded as an Islamic financial hub within Europe and, until the end of the Brexit procedure, within the European Union.[7] Thanks to the role of the City of London as an international financial centre, the sharp rise in oil prices in 2003 resulting in liquidity surpluses, and its long-standing ties with Middle Eastern countries, the UK Islamic financial experience dates from the 1980s and covers a wide range of activities. In fact, during the 1980s and 1990s, London transitioned from being a site of wholesale business operated by subsidiaries of Middle Eastern Islamic banks to become the home of the first retail operations performed by the Jeddah-based Al Baraka Investment Company, which bought Hargrave Securities, a licensed deposit taker, and transformed it into an Islamic bank. As such, Al Baraka provided *ribā*[8]-compliant current accounts and payment services, as well as *murābaḥa*[9] housing finance, and *muḍāraba*[10]-based investment deposits. Once

[6] The list of policy actions and countries is by no means exhaustive. For an overview of the state of the art, see: Filippo di Mauro et al (2013), Islamic finance in Europe, Occasional Paper, n. 146, European Central Bank (ECB): Frankfurt, p. 25ff.

[7] More details on the development of Islamic finance business: Michael Ainley et al. (2007), Islamic finance in the UK: regulation and challenges, Financial Service Authority (FSA) November 2007, https://www.isfin.net/sites/isfin.com/files/islamic_finance_in_the_uk.pdf; Rodney Wilson, (2010), Islamic banking in the United Kingdom, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, pp. 212–221; Jonathan Ercanbrak, (2013), Regulating Islamic financial institutions in the UK, in Cattelan (ed), Islamic finance in Europe. Towards a plural financial system, Edward Elgar publishing: Cheltenham, Glos, UK, pp. 157–175.

[8] *Ribā* is often translated as "usury", referring to the prohibition on paying out interest on credit. However, this is only a part of the story: according to *Sharīʿa* sources, *ribā* principally regards sales contracts, covering any unjustified increase in the exchange of contract considerations. More details in: Frank Vogel (2010), Islamic finance: personal and enterprise banking, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, p. 46.

[9] *Murābaḥa* is a sale-based transaction: a client who wants funding to purchase goods asks the bank to purchase the goods and then resell them to him. The bank calculates the price of the second sale taking into account the price of purchase and the pre-agreed mark-up above its own costs. More details in Vogel (2010), p. 54ff.

[10] *Muḍāraba* is a profit-and-loss sharing business operation. Under this system, a capital provider (silent partner) and an entrepreneur (active partner) contribute either their own capital or their own time and work to the venture. Both of them are entitled to share in the business profits on a pro-rata basis, but only the capital provider takes on any business losses, except in the event of mismanagement by the active partner. More details in: Vogel (2010), pp. 40–60.

Al Baraka closed its banking business down, the United Bank of Kuwait established the first "Islamic window" in London, operating as a separate unit within a conventional bank based in the United Kingdom. This served as an example for other conventional banks, such as HSBC and Lloyds TSB, which set up new "Islamic windows" in the years to follow.

Since 2004, the Financial Service Authority (FSA) has authorised five stand-alone Islamic banks (retail banks, i.e., the Islamic Bank of Britain, and wholesale banks, i.e., the European Islamic Investment Bank and the Bank of London and the Middle East)[11] as well as over 20 further banks that have opened Islamic windows, as well as an Islamic hedge fund manager and the issuance of *ṣukūk*[12] listed on the London Stock Exchange.[13]

In the United Kingdom, the main driving force behind the growth of Islamic finance is government commitment.[14] In 2001, a high-level working group chaired by the Governor of the Bank of England was established, comprising representatives from the city, the government, the Muslim community, and the FSA, officially tasked with addressing regulatory barriers to the growth of Islamic finance in the United Kingdom. In subsequent years, close cooperation between the British supervisory authorities and Muslim industry could ease management of the authorisation process in order to bring Islamic and conventional banking and financial activities under a single regulatory framework.

Within the Eurozone, Luxembourg has had a particularly interesting business experience in this area. In 1978, it hosted the first Islamic financial institution established in a non-Islamic country; 1983 saw the foundation of the first Islamic insurance company in Europe, and in 2002, the Luxembourg Stock Exchange became the first in Europe to list *ṣukūk*. It

[11] It is noteworthy that the Bank of London and the Middle East is the first Islamic bank to have the European passport for cross-border services within the EU. See: Ainley et al. (2007), p. 28.

[12] *Ṣukūk* may be considered as *Sharī*ᶜ*a*-compliant bonds. They are equivalent to share certificates. See: Gian Maria Piccinelli (2010), The provision and management of savings: the client-partner model, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, pp. 23–39, especially pp. 32–35.

[13] Bank of England (2016), Consultation paper. Establishing *Sharī*ᶜ*a*-compliant central bank liquidity facility, February, 4.

[14] In 2013, Dr. Ercanbrak wrote that "[d]espite the Islamic finance industry's international growth, UK domestic demand for Islamic financial products and services may be limited". See: Ercanbrak (2013), p. 160.

is still the main centre for *Sharīʿa*-compliant investment funds.[15] It is also worth mentioning that the government set up a cross-sector task force in 2008 to address any obstacles to the development of Islamic financial institutions and find ways to support them.[16]

Ireland follows the same approach as Luxembourg. In 2003, Oasis Global Management Company (Ireland) plc was authorised to launch the Oasis Crescent Global Investment Fund, that is, an investment fund operating in compliance with the EU legal framework for Undertakings for Collective Investment in Transferable Securities (UCITS), which provides for *Sharīʿa*-compliant equity-based investment products.[17] A year later, the Bank of Ireland signed an agreement with the Arab Banking Corporation to launch the first *Sharīʿa*-compliant home-financing scheme. In 2005, the first *ṣukūk* was listed on the Irish Stock Exchange. Since then, the Irish supervisory authorities have been gradually getting more involved in supporting the development of Islamic finance. More recently, the Irish government has set up subcommittees entrusted with working with the Islamic Finance Council of Ireland (IFCI)—a non-for-profit entity, set up in 2015, to promote the development of Islamic finance in the country and spread information on the principles and working methods of Islamic finance.[18]

In France, the authority for market supervision authorised five Islamic funds, and in 2010, the General Direction of the Treasury framed a tax regime tailor-made for a number of *Sharīʿa*-compliant operations, such as *murābaḥa* or *ṣukūk*-like bonds. The year 2011 saw the establishment of the first Islamic deposit scheme operating through an Islamic window at an existing conventional bank. After this success, an Islamic home finance product was introduced.[19]

Germany remains a few steps behind despite the efforts of BaFin (Germany's Federal Financial Supervisory Authority). A licence to run

[15] In the following sections (namely, Sect. 2.4), this study draws a comparison between UCITS funds as regulated in the community-based law and the basics of *Sharīʿa*-compliant investment funds.

[16] Eleanor de Rosmorduc, Florence Stainer (2013), Luxembourg: a leading domicile for *Sharīʿa* compliant investments, in Cattelan, (ed), Islamic finance in Europe, pp. 179–191.

[17] http://www.oasiscrescent.ie/default/content.aspx?initial=true&moveto=155

[18] See: Martin Moloney, (2015), Address by IFLC Head of Markets Policy at the UCD School of Law, at https://www.centralbank.ie/news/article/martin-moloney-at-iflc-at-the-ucd-school-of-law; Simon O'Neill (2015), The Islamic finance industry in Ireland, Country Report Ireland, Islamic Finance News, December, at http://www.aicc.ie/content/publications-0

[19] More details in: Ibrahim-Zeyyad Cekici (2013), Managing Islamic finance vis-à-vis laïcité: the case of France, in Cattelan, V. (ed), Islamic finance in Europe, pp. 192–202.

banking operations was granted to Kuveyt Türk Bank AG, a German subsidiary of the Turkish Kuveyt Türk Katilim Bankasi A.S. bank in 2009.[20] An addition to the German market is a new *Sharīᶜa*-compliant investment product, benchmarketed to the WestLB Deutschland Index, covering shares in ten German firms.[21]

Italy has taken no regulatory initiative as yet. However, according to the leading financial journal *Il Sole 24 Ore*, the Italian Parliament is working on a legislative proposal to remove any legal obstacles to the development of Islamic finance in Italy.[22] Surprisingly, over the last ten years, Islamic banking and finance have raised a certain degree of interest among the supervisory authorities, as well as in legal and economic studies, both arguing that no formal regulatory obstacle bars *Sharīᶜa*-compliant financial institutions from entering the Italian market.[23]

2.2.2 A Matter of Policy: Common Ground Between Islamic Finance and the "Capital Market Union"

Turning to the next argument in favour of accommodating Islamic finance within the EU regulatory framework, our attention shifts to the Capital Market Union (CMU)[24] an action plan aiming to remove any regulatory

[20] Azadeh *Farhoush* and Michael *Mahlknecht* (2013), A critical view on Islamic finance in Germany, in Cattelan (ed), Islamic finance in Europe, pp. 203–212, critically analyse the development of Islamic finance in Germany after the 1990s fraud scandal. On the regulatory aspects of Islamic finance accommodation within the German legal system, see: Johannes Engels (2010), German banking supervision and its relationship to Islamic banks, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, pp. 174–188.

[21] di Mauro et al. (2013), p. 26f.

[22] This is confirmed by: Riccardo Ferrazza (2017), Arriva in Parlamento la proposta per portare la finanza islamica in Italia, Il Sole 24 Ore, 18th May.

[23] More details in: Gabriella Gimigliano (2016), Investigating Islamic banking in Italy. Business-based and cultural-based analyses as complementary approaches, International Journal of Islamic and Middle Eastern Finance and Management, vol. 9 (3), pp. 364–387; Simone Alvaro (2014), La finanza islamica nel contesto giuridico ed. economico italiano, Quaderni di ricerca giuridica Consob, n. 6, pp. 1–68; Giorgio Gomel et al. (2010), Finanza islamica e sistemi finanziari convenzionali, Questioni di Economia e Finanza: Banca d'Italia, Quaderno n. 73, pp. 1–77, https://www.bancaditalia.it/pubblicazioni/qef/2010-0073/QEF_73.pdf; Luigi Donato, Maria Alessandra Freni (2010), Islamic banking and prudential supervision in Italy, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, pp. 189–206; Pietro Abbadessa, (2010), Islamic banking: impression of an Italian jurist, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, pp. 207–211.

[24] COM (2015) 268 final.

barriers to cross-border investment. This may be conducive to the development of Islamic finance in the EU framework and, in turn, growing Islamic finance may end up underpinning CMU strategy. Indeed, within the CMU, EU policymakers attempt to strengthen the link between savings and economic growth, providing more funding choices for European businesses and small- and medium-sized enterprises (SMEs), increasing investment alternatives for retail and institutional investors, and, among other things, improving the stability of the financial market.[25]

The CMU strategy framework envisages a variety of regulatory tools, varyingly consistent with the rationale of Islamic finance. Of these, crowdfunding could bridge the regulatory gap between conventional and Islamic finance: for example, the CMU action plan treats crowdfunding as an innovative form of business financing suitable for supporting SMEs and start-ups, but crowdfunding has also been considered as a non-banking funding channel consistent with the Islamic approach to property rights and risk allocation mechanisms.[26]

Moreover, important synergies between the CMU and Islamic finance may be developed in terms of equity-based financing for SMEs and start-ups. Indeed, the CMU action plan envisages a comprehensive package of regulatory measures to support venture capital and risk capital financing in the EU, and consistently, *Sharīʿa*-compliant lending operations are typically partnership initiatives based on *muḍāraba* and *mushāraka*.[27]

2.2.3 A Matter of Law: The "Internal Market" as an EU-Based Legal Framework

Ultimately, allocating the accommodation process of Islamic finance at community level sounds like a sensible choice, first and foremost for the EU legal framework, established to back the construction of the internal

[25] For example, thanks to the CMU, European businesses should be able to raise funding as easily as large companies; the cost of investing and access to investment products should be levelled out, or there should be fewer obstacles to seeking financing in another Member State.

[26] Valentino Cattelan (2016), "Equal for equal, hand to hand": comparing Islamic and Western money, in Gabriella Gimigliano (ed), Money, Payment Systems and the European Union, Cambridge Scholars Publishing: Newcastle Upon Tyne, pp. 77–101.

[27] *Mushāraka* is, like *muḍāraba*, a profit-and-loss sharing business transaction. In *mushāraka*, two or more partners pool their financial resources to operate a business; they have a share in the returns and losses on a pro-rata basis. For more details, see: Vogel (2010), pp. 40–60.

market.[28] This means that, thanks to the negative and positive integration process, any Islamic financial undertaking may enjoy the advantages of a single market dealing with a harmonised set of rules and regulations. But there is a trade-off between the regulatory advantages of the "internal market" and the dialectical relationship between the EU and Member States in the law-making activity as well as Home[29]-Host[30] State regulation.

Indeed, in the area of financial markets, the community-based integration process does not always encompass the same matters of law, but at least covers the authorisation requirements, capital adequacy conditions, and the conduct-of-business rules. Sometimes, the EU issues norms regarding contract law, for example, in the relationship between payment service providers and users; EU law addresses some others such as insolvency and the pre-insolvency state of undertakings, as in banking law and so forth.[31]

Regulatory content aside, the community-based legal framework for finance has not fully pre-empted national regulations. After the failure of the project to establish a uniform law at community level, the European Commission successfully promoted a harmonisation process mainly dealing with cross-border financial transactions. Over time, moving from an approach based on minimum harmonisation towards maximum or full harmonisation and establishing the European Supervisory Authorities to provide technical regulatory standards and coordinate the national authorities, community law has gradually reduced regulatory arbitrage among the Member States to a large extent.[32]

[28] According to Art. 26 of the Treaty on the Functioning of the European Union (hereafter, TFEU), the "internal market" covers "*an area without frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties*".

[29] The "Home State" is the Member State where the head office and registered office of the financial entity are placed.

[30] The "Host State" is the Member State where such an entity, once formed in an EU country, provides services or sets up branches.

[31] Generally speaking, a broader and stricter harmonisation process has developed in the Eurozone.

[32] Regarding the main legislation on the authorisation and supervision of banks, payment institutions, electronic money institutions, UCITS, and investment firms, see: directive 2013/36/EU on access to the activity and the prudential supervision of credit institutions (CRD IV directive); regulation n. 575/2013/EU on prudential requirements for credit institutions and investment firms; directive 2015/2366/EU on payment services in the internal market (PSD2); directive 2009/110/EC on the electronic money institutions (IMEL2); directive 2009/65/EC on UCITS (UCITS V directive) directive 2014/65/EU on markets in financial instruments (MIFID2).

The above explains the dialectical relationship between community- and State-based law. This relationship *may* raise legal uncertainties and further costs to any *Sharīʿa*-compliant financial undertakings accessing the internal market.

For example, concerning the professional provision of payment services, *Member States may exempt or allow their competent authorities to exempt natural or legal persons providing payment services (…) from the application of all or part of the procedure and conditions set out (…) where: (a) the monthly average of the preceding 12 months' total value of payment transactions executed by the person concerned, including any agent for which it assumes full responsibility, does not exceed a limit set by the Member State but that, in any event, amounts to no more than EUR 3 million. That requirement shall be assessed on the projected total amount of payment transactions in its business plan (…) and (b) none of the natural persons responsible for the management or operation of the business has been convicted of offences relating to money laundering or terrorist financing or other financial crimes.*[33]

Whenever the EU directives allow a Member State to grant a waiver to the harmonised legal framework, any applicants for a banking or financial licence bear a cost. There are two sets of norms to deal with: Union-based and State-based. However, the legal costs do not seem too high because any financial institutions benefiting from the waiver can operate their business only within the national territory.[34]

If the matter of law falls outside the directive field of harmonisation, the law of the Home State is applicable according to the international private law rules and regulations. For example, a *Sharīʿa*-compliant undertaking authorised as a payment institution in Italy and branching in France will abide by the concepts of money and monetary obligation provided for

[33] Art. 32, directive 2015/2366/EU. It is true that some Member States may have decided to grant the waiver in compliance with Art. 32, para. 1, PSD2, but some others may not ("*may exempt or allow … to exempt*"). Furthermore, two or more Member States all granting the above-mentioned waiver may have exempted payment institutions from different procedure rules and licensing conditions ("*all or part*"). The same type of waiver is expressly provided also for electronic money institutions and investment firms, respectively, under Art. 9, IMEL 2 directive and Art. 3, MIFID2 directive.

[34] Nevertheless, no higher regulative costs arise because any *Sharīʿa*-compliant institution meeting the waiver conditions has already made its business choice, opting to provide its services on a national market in order to enjoy lighter licensing and supervisory requirements. If such an entity plans to establish a branch or provide its services in/to another Member State, it must apply for new authorisation in the host country.

under French civil law, as the PSD2 directive does not harmonise this aspect. However, no discrimination due to nationality is allowed under Art. 18, TFEU (Treaty on the Functioning of the European Union).

Moreover, in cross-border business operations, the EU framework makes a clear-cut choice regarding the functioning of the internal market, and to avoid the duplication of competences, it gives priority to Home State law over Host State law. To this end, any financial undertaking set up in a Member State may obtain a European single passport based upon the principle of the mutual recognition of licences and supervisory systems. The "passport" only covers the provision of services and activities listed in the annexes of associated directives and regulations when those activities and services are covered by the authorisation released.[35]

So, a *Sharīʿa*-compliant financial entity based in a Member State is entitled to operate across the internal market, establishing either branches or providing services, but exclusively under Home State law. No further authorisation may be required by the Host State, and prudential supervision is exercised by the competent authority that issues the licence (Home State authority).[36]

However, the legal prevalence of the law of the Home State over the Host State law be subject to some exceptions, establishing a new legal and dialectical relationship: indeed, a "Host State" regulator may apply the "general good" clause, raising an exception to the principle of mutual recognition. Not only is this clause of strict interpretation, being an exception to the internal market principle, but the Host State is entitled not to

[35] Both are applied to credit institutions, investment firms, collective investment undertakings, payment institutions, and electronic money institutions.

[36] It should be recalled that the single passport is not applied to branches of financial undertakings with their head office and registered office in a non-EU country. It may be applied to subsidiaries from non-EU countries when they meet community-based requirements. However, accessing the internal market as non-EU financial entities does not seem to increase the gap between the community- and State-based frameworks. It is true that no harmonised set of rules has been provided for third-country branches, but the EU banking regulations have established, since the Second Banking Directive, that "*Member States shall not apply to branches of credit institutions having their head office in a third country, when commencing or continuing to carry out their business, provisions which result in more favourable treatment than that accorded to branches of credit institutions having their head office in the Union*" (Art. 47, para. 1, 2013 Consolidated Banking directive). In addition, the Union is entrusted with entering agreements with third countries with a view to applying non-EU branches with identical treatment throughout the territory of the Union (Art. 47, para. 3, 2013 Consolidated Banking directive).

recognise the Home State's law only when the following conditions are met: (i) absence of community-wide regulation, (ii) the concern is not already covered by the laws of the State of origin, (iii) the regulatory measures taken by the Host State are appropriate and proportionate, and (iv) the concern cannot be resolved by a lesser measure. These conditions can be found in European case law since *Cassis de Dijon* on the freedom of goods and has successively been applied also to the freedom of services.[37]

2.3 The Mainstream Normative Approach to Islamic Financial Undertakings

As to *how* to accommodate Islamic financial business within a non-Muslim setting, namely the European Union, it is the supervisory authorities that, analysing the application of Islamic finance in the United Kingdom, France, Luxembourg, Ireland, and Germany, have de facto adopted the mainstream regulatory approach. Indeed, whenever an application for authorisation is submitted, the supervisory authorities are entrusted with assessing whether the applicant can enter the "internal market". To this end, they are in charge of drawing a comparison between the activities and business transactions to be performed by the applicant and those forming the core business of credit institutions, investment firms, investment fund managers, or payment institutions.

In as far as they can be subsumed under the conventional legal paradigm, Islamic financial undertakings are entitled to access the relevant market and, in turn, actual and potential clients may enjoy the same degree of legal protection enjoyed by "conventional" customers. For example, investors may benefit from the service providers' duty of disclosure, care, and loyalty, while deposit holders may enjoy the deposit insurance scheme in the event of a bank becoming insolvent and so on. Conversely, anything falling outside the conventional legal paradigm becomes less convenient, or more expensive, for potential Muslim customers or investors. The mainstream approach seems to be characterised by the neutrality principle and attention to the "economic substance" of the activities and business operations with a view to "facilitating"[38] the operation of Islamic financial undertakings within non-Muslim countries.

[37] *Cassis de Dijon*, case 120/78, Judgement of 20.2.1979.

[38] See: Ercanbrak (2013), p. 165.

As for the neutrality principle, the British supervisory authorities have simplified its contents, establishing that all financial institutions authorised by the FSA and operating in the United Kingdom, or seeking to do so, are subject to the same standards. This is true regardless of their country of origin, the sectors in which they wish to specialise, or their religious principles. (…) The FSA is happy to see Islamic finance develop in the United Kingdom, but it would not be appropriate, nor would it be legally possible, to vary its standards for one particular type of institution.[39]

It is argued that the neutrality principle is applied to economic activities and contractual relationships to overcome the regulatory differences between Islamic and conventional approaches, paying attention both to the economic substance of Islamic financial operations on the one hand and the structural features of conventional ones on the other. Within such a framework, national policymakers end up applying a single regulatory framework and make only the slight adjustments needed for public policy reasons.[40]

Indeed, this was the case for tax law mechanisms and the double stamp duty on Islamic mortgages: double stamp duty is incurred whenever there is a double transfer of ownership, namely in *murābaḥa*-based transactions,[41] where the bank buys the assets on behalf of the customer and resells them to him with a mark-up. It is also incurred in *ijāra*-based transactions,[42] whereby the lessee pays a rent for an asset and gradually buys a share in the leased property (gradually reducing the rent).

The lobbying activity of the Muslim Council of Britain and the investigations of an ad hoc committee[43] led to the UK government amending tax regulations and removing the double stamp duty, arguing that the tax mechanism in real estate transactions was tailor-made for conventional mortgages and could, therefore, alter the level playing field. Actually, the legislative acts refer to "alternative" mortgage models (including Islamic ones) performing the same function with different structures.[44] It might reasonably be supposed that virtually the same line of reasoning was fol-

[39] Ainley et al. (2007), p. 11ff.

[40] More details in: Ainley et al. (2007), p. 8f.

[41] With regard to *murābaḥa*-based business transactions, please see footnote n. 9.

[42] Concerning *ijāra*-based or lease operations, see: Vogel (2010), p. 53.

[43] Wilson (2010), p. 215.

[44] Ercanbrak (2013), p. 165. Dr. Ercanbrak underlines how the UK lawmakers do not refer expressly to Islamic mortgages, preferring more general expressions, such as "alternative" financial returns, financial instruments, investment bonds, and so forth (pp. 164–165).

lowed by the other national regulators who had already removed double stamp duty, such as Luxembourg, France, and Ireland.[45]

At the European Union level, there is neither relevant experience nor any official position as yet. However, it may be sensibly assumed that a neutral approach would be followed and a single regulatory framework would be applied accordingly. This conclusion may be drawn from the 2013 European Central Bank (ECB) Occasional Paper on Islamic Finance in Europe. Here, the ECB associates Islamic financial undertakings with ethical or socially responsible investment business.[46]

Ethical or socially responsible investment refers to an approach that integrates social and environmental concerns into the investment decision-making process, whereby companies that meet certain standards of corporate social responsibility are identified and selected for investment. As such, in addition to financial performance, SRI also takes into account non-financial factors when analysing firms from an investment perspective. (…) All of this is fundamentally in line with the values behind Islamic finance, which seeks to promote activities that are beneficial to the planet and to remove those that may prove harmful.

If Islamic finance is comparable to ethical banking or socially responsible investment activities,[47] it should be subsumed within the "regular"

[45] de Rosmourduc and Stainer (2013), p. 187; Cekici (2013), p. 193; Edana Richardson (2011), Accommodation of Islamic finance in Ireland's financial regulation: a comparative study of wholesale financial products, 34 Dublin University Law Journal, pp. 127–154.

Although there is no concrete experience of Islamic banking and financial business in Italy, the supervisory authority may tend to prefer a neutral approach. Indeed, Donato and Freni (2010), p. 189, wrote: "In any event, the entry of Islamic finance cannot be dealt with by imagining the creation of a special regulatory regime (adoption of ad hoc rules) either for or against".

[46] di Mauro et al. (2013), p. 36. The decision to treat *Sharīʿa*-compliant financial undertakings as ethical businesses is easily inferred from the sources of *Sharīʿa* law. By contrast, the comparison between Islamic finance and socially responsible enterprises may be explained by referring to *Sharīʿa* as the law of the Muslim community. However, going further in depth, one might also consider the idea of distributive justice as established by Islam, whereby every Muslim is supposed to donate 2.5 per cent of their yearly savings or income to charity as *zakāt*. The idea that the right to private property is less important than the duty of ensuring social justice. See: Samiul Hasan (2007), The Islamic concept of social justice: its possible contribution to ensuring harmony and peaceful coexistence in a globalised world, Macquarie Law Journal, vol. 7, pp. 167–183.

[47] According to the 2007 FSA report, the success of Islamic finance will depend on the "ability to demonstrate how the products are underpinned by generally-accepted ethical principles. If *Sharīʿa*-compliant products are no longer seen as 'exotic' or niche products, the industry could benefit from economies of scale which would help to sustain it over the longer-term". FSA, Islamic finance in the UK: regulation and challenges, p. 29.

legal framework for banking and financial undertakings[48]: this conventional framework is "rectified" in ethical terms by the application of *Sharīᶜa*-inspired contracts and operating rules.[49] At the moment, there is no ad hoc legal framework for ethical or socially responsible undertakings at EU law level with regard to capital ratios, licensing requirements, directors' duties, stakeholders' rights, and so on.[50] This normative approach finds scholarly support among, and outside, the group of academic experts on *Sharīᶜa*.

From the inside,[51] for example, Dr. Asutay found the "ethicality" of Islamic financial undertaking to be its distinctive feature compared with conventional financial business, as the economic relationships of Muslim communities centre on the so-called Islamic Moral Economy (IME) model. This economic model works as a holistic approach to financing and recognises self-interest as an essential motivation factor for individuals. However, IME suggests a moral filter through which the economic and financial choices can be made. (…) Thus, an IME suggests that not only self-interest but also social interest is to be served as well. Such an understanding and filter mechanism aims to remove the conflict between self-interest and social interest.

Mandatory financial and economic obligations, based on the sacred texts, serve to overcome any conflicts between individuals and society that are not overcome on a voluntary basis.[52]

[48] This construction is also confirmed in the assumed neutrality of commercial law towards "national ethos": see, Ercanbrak (2013), p. 163.

[49] Valentino Cattelan (2013), Sharīᶜa economics as autonomous paradigm: theoretical approach and operative outcomes, Journal of Islamic Perspective on Science, Technology and Society, vol. 1 (1), pp. 3–11.

[50] It goes without saying that any ethical financial intermediaries will have an ethical expert or an advisory committee. However, each Member State makes its own policy choices on the role of such a committee within the regular corporate governance structure.

[51] Mehmet Asutay (2013), Islamic moral economy as the foundation of Islamic finance, in Valentino Cattelan (ed), Islamic finance in Europe. Towards a plural financial system, Edward Elgar publishing: Cheltenham, Glos, UK, pp. 55–68. In addition, drawing a comparison between conventional and Islamic finance, Jean Francois Seznec (1999), Ethics, Islamic banking and the global financial market, 23 Fletcher Forum World Affairs 161, p. 120, argued: "As a religion based upon justice, Islam can serve as an ethical framework for regulating monetary transactions between people and, in this way, influence the global financial marketplace".

[52] According to Dr. Asutay, IME pursues "social welfare" and is based upon three main assumptions, namely that individuals are (i) all equidistant from the Creator, (ii) on an equal footing with each other, and (iii) God's vice regent on Earth, to fulfil His will on Earth. Therefore, the growth of individuals may not be considered counter to environmental and social growth; any asset managed either by a private or by a public entity is to be driven by social responsibility. Within this framework, the individuals enjoy "free will", but the freedom must be interpreted in such a way as to meet individuals' functional responsibility towards society.

From the outside, Dr. de Anca contends that Islamic and ethical financial businesses are two forms of "investing with values".[53] Indeed, apart from a common religious background,[54] both investment schemes try to channel the savings of individuals who wish their money to be invested according to their principles and values. Both investment systems operate in a similar manner, with negative criteria to exclude activities perceived as harmful for the [*sic.*] society, and with positive criteria to foster activities and attitudes perceived as positive for society. The movement in both cultures illustrates a similar trend that consists of a growing awareness of individuals with more responsible business behaviour, investing following the values of the investor.[55]

From the point of view of legal accommodation, *Sharīʿa* is treated as a cultural phenomenon, and its rules are considered to be ethical or social prescriptions. A regulatory process aiming to "facilitate" Islamic financing activities may therefore give a minority community—that is, the Muslim community—the feeling of social and economic inclusion. Indeed, Muslims would not then be forced to make a choice between their own values and principles on the one hand, and financial investment opportunities and legal protection on the other.[56]

The mainstream normative approach thus easily seems to match the business-based normative perspective with the culture-based approach in the process of regulatory accommodation.[57] Is this simple picture wholly convincing though?

2.4 The Mainstream Normative Approach: Some Doubts and Critical Remarks

Taking a few steps further, the *way* of accommodating Islamic finance at community level may raise many more issues of a legal nature than the choice of a framework suitable for accommodation does. Generally speaking, at the crossroads between the business- and cultural-based approaches,

[53] Celia De Anca (2010), Investing with values: ethical investment versus Islamic investment, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, Edward Elgar publishing: Cheltenham, Glos, UK, pp. 128–147.

[54] In fact, ethical investing business is rooted in the Quaker and Methodist religious movements of the last century. The first ethical investment initiatives in Europe can be found in the United Kingdom and are linked to the Anglican Church. De Anca (2010), p. 128f.

[55] De Anca (2010), p. 143.

[56] See: Ercanbrak (2013), p. 160.

[57] On the definition of business-based and cultural-based normative approaches, please see, in this chapter, Sect. 2.1.

the mainstream normative model features prominently *Sharī*ᶜ*a*-compliant undertakings on account of their "ethicality" and, consequently, may be regulated as ethical or socially responsible enterprises. Such a conclusion refers to the "inner ethicality" of *Sharī*ᶜ*a* rules and implies that Islamic financial undertakings, based upon *Sharī*ᶜ*a* norms, can always achieve ethical performance because they are based upon a moral screening process, unless—as Dr. Asutay argues—efficiency-based assessment compromises the aspirations of the IME paradigm.[58]

However, the IME normative paradigm has been interestingly and critically analysed. Some authors have (i) challenged the assumptions on which the IME seems to be based; that is, that the ideals of social justice belong only to the Islamic economics model, addressing Sen's studies on social justice, Weber's research on religious elements of Western capitalism, and the historical analysis of the concept of risk in financial business relationships by Bernstein within the conventional economic literature;[59] and (ii) emphasised that despite the undeniable religious and moral foundations of Islamic Law of finance based upon the sacred texts,[60] *Sharī*ᶜ*a* is something other than *fiqh*: while *Sharī*ᶜ*a*, as enshrined in the *Qur'ān* and *Sunna*, is "divine, fixed and perfect", *fiqh*, as a hermeneutical activity, is a process of understanding and is per se "human and improvable". More precisely, it is argued that *Sharī*ᶜ*a*—the Way—has been revealed through the Book (*Qur'ān*) and by sending the Prophet to the earth (whose teachings are collected in the *Sunna*). However (…) the clarity of the Truth does not mean that it is manifest, and *fiqh* (literally "comprehension", "understanding") is the discipline which aims specifically at "making manifest" God's Will as "clearly" revealed in the *Qur'ān* and exemplified by the Prophet. *Fiqh* implies an effort, an endeavour (*ijtihād*) of interpretation that does not aim at acquiring any firm knowledge or at constructing

[58] Asutay (2013), p. 56.

[59] According to Dr. Cattelan, "[I]n IME, *Sharī*ᶜ*a* economics is conceptualized as a value-oriented proposition, frequently referring to *homo-Islamicus* as an ethical antithesis to *homo-economicus* (…) by identifying the rational/secular homo-economicus as acting in denial of any social justice, as reduction of human being to greedy economic actor, outside Islam, is apoticticaIly proclaimed. The anthropological nihilism represents an unfortunate oversimplification, that not only obscures the effort of conventional economics to promote social justice but also forgets deep religious elements that Western capitalism embodies". Cattelan (2013b), p. 5.

[60] Cattelan (2013b), p. 5.

a systematisation of God's Will, but at achieving a better understanding for the goodness of the whole Muslim community.[61]

Setting aside such doubts for now, it would be advisable to reflect on the main outcomes of the mainstream approach from a purely business-based perspective. What is at issue is the application of a single legal framework—the conventional one—to every financial undertaking. The analysis presented here will focus on some regulatory inconsistencies, both in the way *Sharīᶜa* finance operates and in the enforcement of conventional community rules and regulations.

First, the EU framework is applied to *Sharīᶜa*-compliant businesses deemed to be ethical or socially responsible enterprises, looking at structural rather than functional similarity. Indeed, the "economic substance" of Islamic financial undertakings and operations seems to be relevant only to any regulatory adjustments needed for public policy purposes, such as double stamp duty. In all other cases, the structure seems to prevail over the function. For instance, in the 2007 FSA report, the regulatory definition of *Sharīᶜa*-compliant financial products was seen to be one of the three main areas of potential difficulty: it is argued that their economic effects are comparable to those of conventional products, but their basic structure may be significantly different.[62] This normative approach may create a certain number of normative inconsistencies in the application of both the conventional framework for banking and finance and the *Sharīᶜa* law of finance, frustrating the goal of true social and financial inclusion.

The Islamic Bank of Britain seems to be an emblematic case because the FSA's investigation examines the concepts of *money* and *deposit* as well as the scope and organisation of the deposit-guarantee scheme. Indeed, when the Islamic Bank of Britain applied for a banking licence, the FSA required it to join a recognised deposit-guarantee scheme.[63] The concept of "deposit" covers "*credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal*

[61] Cattelan (2010), p. 78.

[62] See: Ainley et al. (2007), p. 12f. This, in turn, may influence their legal construction and, accordingly, the conclusion as to whether such operations are permissible and, if so, which legal discipline would be applicable.

[63] Directive 2014/49/EU of 16 April 2014, O.J.E.U. 12.6.2014, L173/149.

and contractual conditions applicable, including a fixed-term deposit and a savings deposit".[64]

By contrast, from the Islamic finance standpoint, money is potential capital and represents a "monetized claim of its owner to property rights created by assets"[65]: these assets may be obtained either from a combination of labour and natural resources or from exchange. When such an approach is applied to financial undertakings, the concept of banking deposits covers not only sight and savings deposits, but also investment ones.[66]

Investment deposits or profit-sharing investment accounts (PSIAs) raise issues of insurability: indeed, in the European deposit-guarantee scheme framework, a credit balance may not be regarded as a deposit when (i) its principal is not payable at par, (ii) its principal is only repayable at par under a particular guarantee or agreement provided by the credit institution or a third party, or (iii) its existence may be proven only by a financial instrument, such as transferable securities or units in collective investment undertakings.[67] Therefore, PSIAs are comparable to investment products rather than deposits and, therefore, seem not to be covered by the deposit-guarantee scheme.

Can such a regulatory issue be overcome? In the case of the Islamic Bank of Britain, the FSA achieved the following solution: the Muslim "depositors", holders of *muḍāraba*-based accounts, were legally entitled to full repayment of their deposits in the event of the bank's insolvency, thus ensuring compliance with FSA regulations, but they had the right to refuse deposit protection on religious grounds in order to be repaid according to the loss-sharing approach in compliance with *Sharīᶜa* precepts. In this case, the Muslim depositor accepted reimbursement with a view to making a donation to a preferred charity.[68]

[64] Art. 2, directive 2014/49/EU.

[65] Zamir Iqbal, Abbas Mirakhor (1987), Islamic banking, International Monetary Fund. Washington, p. 2f. Accordingly, sale-based contracts such as *ijāra* or *murābaḥa* and partnership contracts like *muḍāraba* and *mushāraka* have been established.

[66] When partnership contracts, such as *muḍāraba* and *mushāraka*, are applied to banking, on the liability side, the bank performs the role of the entrepreneur and the depositor is the capital provider, whereas on the asset side, the bank and the depositor swap places.

[67] Art. 2, directive 2014/49/EU.

[68] If the deposit holders accept, they are advised that their behaviour will not be in compliance with *Sharīᶜa* rules. See: Ainley, p. 14f. Ercanbrak (2013), p. 168.

As in the British case, one should hope that the depositor acts as a devout Muslim. Indeed, if an Islamic bank failed and Muslim depositors took their reimbursements, they would be acting against *Sharīʿa* (according to a large number of *Sharīʿa* scholars) and, in addition, the deposit-guarantee scheme would de facto not comply with the conventional rules and regulations.[69]

A couple of further critical remarks may be added. Firstly, this normative construction seems to treat the deposit-guarantee scheme as a regulatory mechanism aiming to protect subjective interest only. On the other hand, any deposit-guarantee scheme, whether conventional or Islamic, also aims to cover the general interest in the stability of the financial market as a whole by minimising the risk run by the depositors' bank and keeping overall confidence in the stability of the financial system high.[70] Secondly, an Islamic-like deposit-guarantee scheme, covering both stand-alone Islamic banks and Islamic windows, depends on a series of further features, such as the premium structure paid out from PSIA holders' funds and the reimbursement mechanism that prioritises unrestricted PSIAs,[71] according to the type of *Sharīʿa*-compliant commercial contract it is based on (such as the mutual guarantee/*Takāful*[72]

[69] Concerning the case of the Islamic British Bank (IBB), in the business plan submitted, it proposed retail banking services and, among them, unrestricted PSIAs as substitutes for conventional deposits. The banking licence was issued on the condition that any unrestricted PSIAs would be "capital certain" and returns would be based on a profit-sharing approach. However, to reconcile the conventional UK statutory rules with *Sharīʿa* principles, the FSA and the IBB agreed that PSIA holders were not required to accept a share of the losses provided the bank remained solvent, but could (if they so choose, for religious reasons) volunteer to accept them. As Dr. Archer emphasised, "This arrangement allowed the bank's customers (or those who so wished) to be *Sharīʿa* compliant, but the bank's unrestricted investment accounts (being contractually 'capital certain') were not themselves *Sharīʿa* compliant, and hence neither was the bank, even though it was permitted to call itself 'Islamic Bank of Britain'". See: Simon Archer (2009), Profit-sharing investment accounts in Islamic banks: regulatory problems and possible solutions, Journal of Banking Regulation, pp. 300–306.

[70] Jennifer Payne (2015), The reform of deposit guarantee schemes in Europe, European Company and Financial Law Review (4), pp. 539–561.

[71] Unrestricted and restricted investment deposits are both *muḍāraba*-based transactions, but while the former allow *Sharīʿa*-compliant financial institutions to take title to the placed funds and invest them at their discretion, in the latter the depositor is entitled to give instructions concerning the type, timing, and use of the investments.

[72] *Takāful* schemes represent the alternative to insurance contracts within the Islamic financial framework. This contractual scheme is based on the concept of donation or voluntary individual contribution to a risk pool (the *Takāful* fund) on condition that they receive a compensation from the pool for a specific type of loss they may incur. Amplius: Simon

or guarantee with fee or *kafāla bi-Ajr*), whereas restricted PSIAs are liquidated separately.[73]

Turning now to corporate governance issues, the mainstream approach treats Islamic financial undertakings as socially responsible or ethical businesses, conferring on *Sharīᶜa* scholars a *Sharīᶜa* compliance role. *Sharīᶜa* scholars—sometimes forming the so-called *Sharīᶜa* Supervisory Board (SSB)—are advisors entrusted with monitoring the correct interpretation of *Sharīᶜa* rules and principles in the financial products provided and in the economic activity performed. What raises more doubts of a legal nature is the fact that *Sharīᶜa* scholars end up falling outside the corporate governance structure and, accordingly, they are in no way accountable towards shareholders, creditors, and the market.

One should take into account that *Sharīᶜa*-compliant activity can deeply and continuously influence overall business strategy as long as the enforcement of *Sharīᶜa* rules (and the IME model) can influence the structure of financial services and the allocation of risks in the user-service provider contract relationship, in addition to the liquidity risk of financial or banking businesses, as the specialised and conventional scholarship emphasise.[74]

Therefore, one might imagine either of the following scenarios:

– *Sharīᶜa*-compliant activity and management activity seem to be two sides of the same coin, so strictly intertwined that, together, they can influence the degree of risk a financial business can transfer to the "internal market" as such. Agreeing on this normative perspective, MIFID2 norms on management bodies' duties and the organisation of management activity may include *Sharīᶜa* scholars in the business organisation, raising doubts about the proper enforcement of conflict of interest[75] rules whenever, as often happens, they sit in more than one board.[76]

Archer, Rifaat Karim Abdel Ahmed, Volker Nienhaus (eds) (2009), *Takāful* Islamic insurance. Concepts and regulatory issues, Wiley and Sons: Singapore.

[73] Md Khairuddin Hj Arshad (2011), Implementation of an Islamic Deposit Insurance System for the Islamic Financial Services Industry, Fourth Islamic Financial Stability Forum, Kuala Lumpur, 17 November 2011, p. 4: http://www.ifsb.org

[74] See, above all: Elisabetta Montanaro (2010), Islamic banking: a challenge for the Basel Capital Accord, in Fahim Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, Edward Elgar publishing: Cheltenham, Glos, UK, pp. 112–127.

[75] On conflicts of interest, MIFID2 states that financial undertakings must "*take all appropriate steps to identify and to prevent or manage conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof*".

[76] See: MIFID2, namely preambles (53) and (54), as well as Arts. 9 and 23.

- *Sharīᶜa*-compliant activity is comparable to the legality control performed by a company's auditors, where the legal order to comply with consists of *Sharīᶜa* rules and principles. This type of control prevents any financial undertaking claiming to be *Sharīᶜa* -compliant and de facto operating like a conventional bank, carrying out misleading and deceptive practices and enjoying unfair competitive advantages against its competitors. At issue is the principle of correctness and fair trading upon which any entrepreneur may operate as long as no market distortion is brought about, as well as preserving the integrity of the internal market.

Furthermore, *Sharīᶜa*-compliant activity highlights the so-called *Sharīᶜa* risk, defined as "the chance that an Islamic financing transaction is challenged on the grounds that it does not comply with Islamic law",[77] because the enforcement and interpretation of *Sharīᶜa* is characterised by a natural pluralism of opinions.[78] In fact, there is no hierarchical structure and, unlike the Catholic Church, there is no reference to an official doctrine for the authorised construction of precepts and norms, despite the growing process of regulatory standardisation.[79]

A "waiver of *Sharīᶜa* defence" is often used to mitigate *Sharīᶜa* risk, namely a contractual clause whereupon the borrower (e.g.) waives the right to bring any defence based on non-compliance of the financial operations and products with *Sharīᶜa* principles. Additionally, such a contract clause may often provide for an "explicit statement on *Sharīᶜa* compliance, pursuant to which the parties agree to follow the interpretation of the bank's own *Sharīᶜa* board as far as the transaction is concerned".[80]

[77] See: Kilian Bälz (2008), *Sharīᶜa* risk? How Islamic finance has transformed Islamic contract law, Harvard Law School: Occasional Paper, n. 9, p. 23. Mr. Bälz referred to *Sharīᶜa* risk, adding that "[l]aw provides transaction security. In Islamic finance, the role of *Sharīᶜa* is reversed. *Sharīᶜa* is a risk, which allows the transaction to be attacked on the basis that it did not conform to Islamic legal principles".

[78] Mathias Rohe (2004), Application of *Sharīᶜa* rules in Europe: scope and limits, Die Welt des Islams, New Series, vol. 44 (3), pp. 323–350 (in particular, p. 345f.); Hasan (2007), p. 183.

[79] The regulatory standardisation process is carried out by international organisations or non-profit entities, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), or the International Islamic Financial Market (IIFM). For an interesting analysis of this process, see: Nicholas H. Foster (2007), Islamic finance law as an emergent legal system, Arab Law Quarterly 21, pp. 170–188.

[80] Bälz (2008), p. 23f.

The incorporation of this type of clause implies that "Islamic financing transactions are no longer governed by Islamic Law, but only by a conviction of the parties (not necessarily a shared one)[81] that the transaction is compliant with Islamic business ethics".[82]

On this premise, to meet the level of information required by potential and actual clients, the United Kingdom put forward the idea of incorporating for reference all relevant *Sharīᶜa* rules in the master agreement.[83] From the duty of disclosure standpoint, it appears difficult to reconcile this normative solution with the rationale of the MIFID regulatory package, centred, for example, on an ongoing update of investment services conditions in parallel with the change in the customer risk profile in order to comply with appropriateness and suitability principles.

In addition, the MIFID1 and MIFID2 regulatory approach, in establishing a set of business of conduct rules with a view to pursuing specific public goals (consumer protection and internal market integration), seems to set aside the idea of the terms of contract as the hub of the full autonomy of the parties. Indeed, this body of law, and public policy priorities, has fostered the development of a "contract governance perspective". According to this approach, contract-related rules stem not only from national and European lawmakers, but also from various actors, such as administrative agencies and civil courts, so attention should be given to the interplay between the different actors and the layers of contract-related rule-making established. Following such an approach, jurists working in the field of financial services should look beyond the traditional relationship between EU conduct-of-business rules and private law rules to focus on the interplay between them. Furthermore, it is argued that[84] the fact that financial service contracts between two private parties may have negative third-party effects can no longer be neglected when designing the institutional framework for contract-related rule-making. The role of civil courts in the governance of contract law, in general, and in securing the

[81] This is particularly true considering the contractual asymmetries between financial service providers and retail clients.

[82] Bälz (2008), p. 24. This sounds like a market-based approach. As Dr. de Anca suggests: "The success of the movement will lie in its diversity, not in defining what an ethical investment is, in absolute terms, but in offering the tools to allow for an individual choice according to an individual ethic within a large diversity of criteria". De Anca (2010), p. 145.

[83] See: Foster (2007), p. 175.

[84] Olha Cherednychenko (2014), Public Supervision over private relationships: towards European Supervision Private Law?, European Review of Private Law, pp. 37–68 (esp. p. 63).

public interest in the adequate functioning of financial markets, in particular, deserves special attention in this context. (…) One of the important questions that needs to be answered from the governance of contract law is whether a formal separation between supervision private law and traditional private law should be maintained or, alternatively, regulatory contract-related rules that now form part of supervisory regimes should be integrated into private law systems.

2.5 Addressing Alternative Normative Approaches: Some Starting Points

The doubts cast on the mainstream regulatory approach seem, at least, to pave the way for some alternative normative solutions. The starting point may be found in the normative hypothesis of "*internalising* Islamic values within an Islamic economic rationality as intellectual endeavour (*ijtihād*) aimed at reconciling divine omnipotence and human agency (*Sharīᶜa-based economy*)"[85] with a view to establishing the *Sharīᶜa* economics model as an autonomous scientific paradigm and the relationship between Islamic and conventional regulatory paradigms on a pluralist approach or a one/many perspective.[86]

Starting from the concept of justice and, especially distributive justice in Islamic rationality, this normative hypothesis emphasises that the 1 model enjoys (a) a theory of property rights centred on an "equal sharing of economic resources" and postulating a primacy of real economy over finance; (b) a theory of obligations where money is more than a commodity, and works as a means of exchange and investment in real activities; (c) labour and investment are the only legitimate instruments for acquiring property.[87] That is, if one agrees with the theoretical premise that *Sharīᶜa* economics works as a scientific paradigm independent of the conventional one and provides an alternative regulatory approach to property rights and money within a pluralistic normative vision, of course.[88] The next step is to establish the nature of *Sharīᶜa* rules according

[85] Cattelan (2013b), pp. 3ff.

[86] See, also, Cattelan (2010), p. 77.

[87] Cattelan (2013a), p. 7; Valentino Cattelan (2013), Introduction. Babel, Islamic finance and Europe: preliminary notes on property rights pluralism, in Cattelan (ed), Islamic finance in Europe. Towards a plural financial system, Edward Elgar publishing: Cheltenham, Glos, UK, pp. 1–12.

[88] See, Sect. 2.4, in particular, Cattelan references.

to the European system of civil law. Indeed, the legal nature of *Sharīʿa* rules may influence how Islamic finance is accommodated within the EU-based framework.

At the moment, three regulatory options may be addressed:

(a) *Sharīʿa* rules as legal precepts according to a pluralistic approach, proposed by Santi Romano, a leading Italian jurist.[89] In his construction, a legal system (or institution or legal order) is made up not only of rules of conduct, but first and foremost, of rules of organisation. He began by contending that a legal system amounted to a sum of norms and, consequently, objectivity and enforceability through sanctions were to be considered as the distinguishing features of the legal system as a whole. At the heart of Santi Romano's theory is the idea of community, regarded as an organisation embodying a social order. It means that where there is a group of persons with or without legal personality, displaying a more or less complex organisation, there is a legal system and, as a consequence, an institution. This means that the concept of legal system departs from any religious, ethical, political purposes pursued and becomes a matter of form: it needs organisational rules, namely rules addressing the authority entrusted with legislative power, the procedures to lay down and enforce the rules of conduct, and, in the end, the conditions of membership of the social organisation. At the same time, Romano's approach argues that any organised social force may be considered a legal order: "[T]here can be multiple legal orders, each corresponding to a different social force (variously embodied in, and represented by, an ideal, a common purpose or an aspiration)".[90]

(b) *Sharīʿa* rules may be treated as "clausole generali". They are all juridical prescriptions to be applied through reference either to other legal precepts or to notions falling outside the general legal framework, such as cultural, technical, or social rules. This is the case for the precautionary principle, good faith, fair trading, or the concept of artistic value.[91]

[89] Santi Romano (1962), L'ordinamento giuridico, Sansoni: Firenze.

[90] Filippo Fontanelli (2011), Santi Romano and *L'Ordinamento Giuridico*: the relevance of a forgotten masterpiece for contemporary international, transnational and global legal relations, Transnational Legal Theory (2), pp. 67–117.

[91] On the concept of *clausole generali*, see: Mario Libertini (2011), Le clausole generali nel diritto commerciale ed. industriale, paper presentation, at the general meeting of "Orizzonti del diritto commerciale" association: Rome.

(c) In the end, *Sharīᶜa* rules might be deemed to be voluntary rules, comparable to the Basel standards. This normative option refers to the international voluntary standardisation process covering aspects of contractual and institutional relationships.[92] This is a growing norm-creating process, addressing a "developing transnational legal system" or an "emergent legal system" made up of "standards" and enforced, for example, via arbitration.[93]

Once a normative choice has been made, legal analysis will be transposed from the EU to the national level because it prompts legal scholars to investigate the role of such rules in corporate governance and the user-service provider contract-based relationship. However, both company law and private law rules give a certain degree of leeway to the traditions of the Member States.

Turning now to the business-based standpoint; in general, if *Sharīᶜa* economics represents an autonomous paradigm and works as a distinct regulatory model, its regulatory peculiarities should be seriously taken into account instead of forcing Islamic finance businesses to resemble conventional financial intermediaries.[94] To pursue this normative objective, it has to be admitted that Islamic financial undertakings cannot take on legal forms of structure (credit institutions, payment institutions, UCITS investment funds' manager, etc.), unless either the Islamic financial undertakings face higher competitive costs or the EU legal framework is weakened by new normative inconsistencies.[95]

To make a choice between one legal form of financial undertaking or the other, it might be advisable to reverse the mainstream approach, giving priority to functional rather than structural similarities when analysing both the contractual and institutional aspects.

The functional-based approach to the concept of "undertaking" is a long-standing outcome of the case law of the Court of Justice of the European Union.[96] As a general rule, the European courts have provided the so-called *effet utile* doctrine, which is: a corollary to the teleological method of interpretation adopted by the ECJ judges in order to apprehend

[92] See footnote n. 71.
[93] Foster (2007), p. 186f.
[94] See also Cattelan (2013b), p. 9.
[95] See Sect. 2.4.
[96] Gabriella Gimigliano (2010), Islamic banking and the duty of accommodation, in Khan, Porzio (eds), Islamic banking and finance in the European Union. A Challenge, p. 154.

the meaning of community law in light of its purpose. Accordingly, once the purpose or end of a legal provision is clearly identified, the detailed terms shall be interpreted in order to produce the desired effect.[97]

As for the definition of "business" or "undertaking", the courts have produced a functional construction focusing more on the subject matter that the entity in question is concerned with than on its legal status; for this reason the concept of undertaking/business encompasses any entity engaged in an economic activity, assuming that an activity is considered as economic "if it faces actual or potential competition by private companies".[98]

This concept has also been applied to banking and financial institutions in order to ascertain whether authorisation was needed and which legal statute should be applied. With a view to reducing legal inconsistencies both in the enforcement of *Sharī ͨa*-based and conventional finance models, some differences should be made between the regulatory alternatives provided for in the EU legal framework:

1. **The professional provision of retail payment services.** Islamic financial businesses may be entitled to provide payment facilities. When the demand deposits are assumed to be placed as safekeeping, such as in a two-window system,[99] they are considered to belong to depositors at all times. In fact, according to *Sharī ͨa* rules, the current account may fall outside the transformation function: in the two-window system, such accounts do not provide their holder with any remuneration, while the service provider has to guarantee the entire refund of the deposit on demand by a 100 per cent reserve requirement ratio and, at the same time, such funds may not be used in the service provider's business. In the end, a payment institution's business might be *ribā*-compliant: indeed, there is no provision of interest on the sums placed in the payment account, or on credit extended to the performance of a payment operation or to be paid within a short period of time. This way of performing the demand

[97] Louis Charpentier. (1998), The European Court of Justice and the rhetoric of affirmative action, European University Institute, Working Paper RSC, 98/30.

[98] For more details on the concept of "undertaking" in the EU legal framework, see: Luc Gyselen (2000), 'Case law', Common Market Law Review, 37 (2), pp. 425–48.

[99] Luca Errico, Mitra Farahbaksh (1998), Islamic banking: issues in prudential regulations and supervision, International Monetary Fund Working Paper (30), p. 9f. In the chapter, the authors refer to the demand deposits provided by Islamic banking in a two-window system and draw a comparison between the demand deposits provided in a two-tier *muḍāraba*, where the assets and liabilities of a bank's balance sheet are fully integrated.

deposits services may recall the EU-based payment institutions' way of operating. Payment institutions are a class of financial intermediary specialised in the provision of retail payment services for single operations and current account facilities *comparable* to banking facilities, where a payment account corresponds to "an account held in the name of one or more payment service users which is used for the execution of a payment transaction".[100] According to the payment account contract framework, the payment service user is entitled to withdraw or place funds, respectively from or to his payment accounts. Moreover, he can transfer the funds placed on the payment accounts through credit transfers, direct debits, and card payments. In turn, the payment institution performs the payment order received properly, but does not couple the payment function with an intermediary function. Indeed, the payment institution is not enabled to accept deposits or to use the funds placed on the payment accounts for investment as well as for lending activities. In fact, when the payment institution extends credit, this is a credit line ancillary to the provision of payment services and, what is even more important, is provided using the payment institution's own funds or other funds taken from the capital markets.[101] There are no clear rules on the provision of interest rates on the sums placed in the payment account, nor on the credit extended to the payment service user. However, on the liability side, one might assume that there is no interest rate, simply because the sums cannot be used by the payment service provider, which essentially acts as a trustee and an agent of the payment account user. On the asset side, similarly, an interest rate should not be charged since the credit lines are only ancillary to performing payment transactions and have to be returned in a very short period of time.

2. **The provision of portfolio-based investment services and the management of investment funds.** Restricted and unrestricted *Muḍāraba*-based investment deposits may be compared with the management activity of individual portfolios of investments and UCITS fund management, especially common funds managed by management companies, because both are contract based. Indeed, according to the community-based framework, the former covers

[100] Art. 4, n. 12, PSD2.
[101] Arts. 10 and 12 PSD2.

any "*managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments*",[102] while the latter deals with pooling small and large resources of natural and legal persons to invest them according to risk-spreading principles.[103] Whereas in the restricted *muḍāraba*, the holder of an investment deposit can give instructions to the management company, in the unrestricted *muḍāraba*, the holder of the investment deposit cannot withdraw at any time, is entitled to enjoy a regular flow of information on the management company, has no voting rights, and, consequently, cannot influence a company's investment policy.[104] If an Islamic financial undertaking were authorised to operate like a common funds management company in the Union, it could perform both individual-based and collective-based investment management activities. It goes without saying that a *Sharīʿa*-compliant UCITS fund should comply with its main principles, such as the prohibition of *ribā* and *gharar*. This means that it is not possible to invest in not only companies involved in prohibited activities, such as alcohol, tobacco, pork-related instruments, conventional derivative instruments, defence and weapons, and so on, but also any company where the following ratios are 33 per cent or more: "(1) total debt divided by trailing 12-months average market capitalization; (2) the sum of a company's cash and interest-bearing securities divided by the trailing 12-months average market capitalization; (3) accounts receivable 12-month average market capitalization".[105] However, Islamic mutual funds may also be based on contract operations other than *muḍāraba*, such as *ijāra* funds or *murābaḥa* funds, or they may be mixed. It needs to be ascertained whether such types of common funds can be compatible with the UCITS legal framework.

3. **Banking business operations.** Islamic and conventional banking share a definition of banking business that centres on the performance of money policy and the intermediary transformation function. Indeed, it is established that banking business covers any

[102] Art. 4 (8), MIFID2.

[103] Art. 1, UCITS directive, consolidated version.

[104] Errico, Farahbaksh (1998), p. 10f.

[105] Said M. Elfakhani, M. Kabir Hassan and Yusuf M. Sidani (2007), Islamic mutual funds, in M. Kabir Hassan, Mervyn Lewis (eds), Handbook of Islamic banking, Cheltenham: UK, p. 259.

"undertaking whose business is to receive deposits and other repayable funds from the public and grant credits for its own account". However, (i) the banking business, both from the liabilities and assets sides, is based upon a creditor-debtor relationship; (ii) no Member State can prevent banks from remunerating sight accounts after the Caiaxa Bank case; and (iii) the holders of demand (or sight) deposits are entitled to pay back their funds through the deposit-guarantee scheme should a bank default. The conditions listed above appear inconsistent with a banking business model based, like the Islamic one, on the partnership approach and the prohibition of prohibition. Apart from the condition in (ii), which may easily be overcome via an agreement between the depositor and the bank, European legislation does not preclude the entry of Islamic financial undertakings on the internal market as EU-based credit institutions because banking directives allow European credit institutions to perform not only the core banking business, but also passported activities according to the principle of mutual recognition and home country control. Two further aspects are worthy of mention: some *Sharīᶜa*-compliant operations, such as *ijāra*/leasing, may be subsumed under one or more passported services, according to a functional-based approach; the EU-based bank might devote most of its business to the passported activities instead of the core banking business, and no home country authority is entitled to withdraw its licence (Art. 18, CRD IV directive). However, any Islamic credit institution authorised according to the EU banking directive suffers from a competitive disadvantage compared with conventional ones, not least because it cannot fully enjoy the universal banking model. This competitive disadvantage may be increased because Islamic banking is based on asset management principles, while the pursuit of conventional business is based on capital adequacy requirements and the stability standards applied in the EU: this difference implies that it is "the moral hazard issue that would need to be handled by prudential rules and overseeing the investment strategies of Islamic banks rather than imposing stronger capital adequacy requirements".[106]

[106] Mohammed Fahim Khan (2010), Islamic banking in Europe: the regulatory challenge, in Khan, Porzio (eds), Islamic banking and finance in the European Union. A challenge, Cheltenham, pp. 61–75.

2.6 Concluding Remarks

The main objective of this chapter was to analyse the regulatory challenges and opportunities in accommodating Islamic financial undertakings. They perform an intermediary and risk transformation function in the management of money, but their business transactions and contracts are based on *Sharīʿa* rules, as established in the sacred texts and constructed by legal scholars. In non-Islamic settings, they operate within a broader, nation-state- or community-based regulatory framework centred on the principles for pursuing legal certainty, levelling the playing field among incumbent financial enterprises and potential competitors, protecting consumers from any misleading practice, and preserving fair trading and financial stability.

At the same time, the policymakers are required to remove any obstacles that impede any natural or legal persons from the full exercise of their freedoms, especially when national rules and regulations take on a discriminatory approach.[107] Such principles form the backbone of economic relationships, within both the European Union and the individual Member States' legal systems, and are detailed in a rich set of compulsory rules and regulations in the area of competition and consumer law, financial stability ratios, duties of disclosure and business conduct rules, corporate governance liabilities, and so on. Islamic financial undertakings may not sidestep either of them.[108]

With a view to reconciling *Sharīʿa* finance rules with the conventional regulatory framework for undertakings and financial undertakings, this chapter aims to analyse two regulatory issues: firstly, the regulatory framework for accommodating Islamic finance and, more specifically, whether the internal market framework seems eligible; secondly, how to carry out a process of accommodation from a business-based and a cultural-based standpoint.

[107] Indeed, according to Art. 18 TFEU: "*Within the scope of application of the Treaties, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited. The European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may adopt rules designed to prohibit such discrimination*".

[108] An overview: Jan Hendrik Dalhuisen (2007), Financial Services, products, risks and regulation in Europe after the EU 1998 Action Plan and Basle II, European Business Law Review, pp. 819–1091.

The first conclusion that can be drawn here treats the community-based legal system as an eligible framework. Ultimately, any Islamic financial or banking undertaking will trade the advantages of the "internal market" off against the disadvantages of the dialectal relationship between the EU and the Member States. After that, they will make their own choices to operate either as a national or as a European credit institution, investment firm, fund investment manager, or payment institution.

This analysis highlights a matter of fact, a matter of policy, and a matter of law to accommodate Islamic finance within the EU regulatory setting. The matter of fact focuses on the geographical spread of Islamic finance, which is far from being a locally based phenomenon in Europe; the matter of policy addresses the constructive synergies bridging *Sharīᶜa*-compliant operations and activities on the one side and CMU policy tools on the other; in the end, the matter of law underlines that the "internal market" is a legal order.

However, the national experiences in the process of accommodating Islamic finance highlight that the government's regulatory initiatives are crucial to carrying out such a process. As Dr. Ercanbrack wrote analysing the English experience:[109]

> *Yet the rationale in facilitating Islamic finance is not a political or legal response to incidences of Unlawful discrimination. Rather, it is a pro-active, top-down and highly centralized series of measures rooted in a growing awareness of British Muslims have not been able to avail themselves of financial activities due their Islamic beliefs. Hence, it sends a strong signal to the Muslim community that the government understands their religious needs and seeks to create an environment in which Muslims are able to practise their faith in conformity with their beliefs.*

Therefore, the EU policymaker should ponder over any accommodating or "facilitating" regulatory actions with a view to pursuing a more socially and financially sustainable internal market. This matter of policy has been a subject of serious discussion at the international level: indeed, the 2015 CPMI-World Bank Group report addressed financial inclusion as a key policy objective, but stressed how self-exclusion from the financial system may be due to inconsistencies between such a system framework and the economic agents' cultural and religious reasons.[110]

[109] See: Ercanbrak (2013), p. 160.

[110] Committee on Payments and Market Infrastructure – World Bank Group (2015), Payment aspects of financial inclusion. Consultative report, 9f., http://www.worldbank.org

The next step of this chapter was to investigate *how* to accommodate Islamic financial undertakings and economic relationships within the community-based law system. Up to now, the mainstream normative approach has been through supervisory authorities, namely directly through a number of national supervisory authorities and indirectly through the European Central Bank's own studies. The main achievement seems to be the following: the conventional regulatory framework is applied functionally and structurally to Islamic financial undertakings and operations unless legal amendments are justified for public policy reasons. This is the principle of the neutral approach, treating *Sharīᶜa* precepts as ethical rules on the one hand and the Islamic financial undertakings as ethical or socially responsible enterprises on the other.

The mainstream construction is a normative approach that can be seen as significant in its attempt to match up a business- and a cultural-based perspective, but this synergy is found by wholly subsuming it within the conventional legal system and approaching *Sharīᶜa*-compliant activity using a market-based method. As the analysis emphasises, critical inconsistencies have arisen in the application of both Islamic and conventional models of finance.

By contrast, following the idea that the distinctive character of the *Sharīᶜa* regulatory model can be found in its regulatory approach to property rights rather than in its intrinsic ethicality, this chapter argues the need to treat *Sharīᶜa* law of money and finance as an autonomous theoretical and regulatory system. What are the consequences? What is at issue is the legal nature of *Sharīᶜa* rules of money and finance: this is essential to establish how they can enter the European legal system. One might think that they are (i) conventional standards, comparable to Basel rules; (ii) legal prescriptions according to Santi Romano's institutional approach; or (iii) social or community values, comparable to "fair trading", "good faith", or "artistic value", working as *clausole generali*. However, these issues—so important for the normative analysis of the accommodation process in the EU—open up a further area of research, going far beyond the scope of this chapter. In addition, in a business-based approach, one might imagine that Islamic finance works as a business (organisation) model different from the conventional one, where community law establishes the outer limits in terms of general and compulsory principles for banking and finance.

As a second-best solution, this chapter suggests carrying out the legal accommodation process within the conventional legal framework with a view to prioritising function rather than structure. In other words, this normative approach underlines that, to comply with the characteristics of the Islamic model, the Islamic financial institutions cannot take any type of legal form and cannot provide all financial or banking services within the EU legal framework unless new juridical inconsistencies arising as the result of a "mimicking" process both in Islamic and conventional finance, as well as Islamic financial institutions based in the EU, enter the internal market with a stark competitive disadvantage. Therefore, receiving authorisation as a payment institution and a UCITS investment fund manager would be preferable to being authorised as a credit institution or an investment firm.[111]

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CHAPTER 3

Islamic Insurance and European Union Legal Framework

Ciro G. Corvese

3.1 Introduction

The serious financial crisis of 2005–2008 has created the need for greater ethics in finance. Therefore, the need to appeal to not only new organisational structures but also new products that have less aggressive forms of investment objectives has been placed in the foreground.

In this context, the institutions referring to Islamic finance fit perfectly.

As stated in a chapter about Islamic finance in Europe, "*An Islamic financial system is one that complies with Islamic religious law (i.e. the Sharīᶜa). Islamic finance has become an important part of the international financial system and was, certainly, one of its fastest growing components over the last decades. In the wake of the financial crisis, there has been a renewed debate on the role that Islamic finance can play in the stabilisation of the*

C. G. Corvese (✉)
Department of Business and Law, University of Siena, Siena, Italy
e-mail: ciro.corvese@unisi.it

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global financial system, one related to the strong ethical principles on which this type of finance is based".[1]

As regards in particular to the subject of insurance, the chapter continues, "*Islamic jurists have developed a Sharīᶜa-compliant system based on mutual cooperation and assistance (commonly known as takāful). They aim to create a structure very similar to that of conventional mutual insurance. Participants in the takāful pay a sum of money (tabarruᶜ) to a mutual cooperative fund, which is then used for compensation should this be necessary. The takāful company acts as the manager of the fund; there is an agency contract and remuneration is seen as a share in any surplus – this being the difference between the takāful fund and any payments made. Funds are usually invested on the basis of Sharīᶜa-compliant contracts, particularly those featuring muḍāraba*".[2]

[1] Filippo di Mauro et al. *Islamic Finance in Europe*, European Central Bank, 2013, p. 9, and see also Valentino Cattelan (Ed.), *Islamic Finance in Europe*, Edward Elgar, Cheltenham (UK)-Northampton (MA-USA), 2013.

There are many references about *Takāful*. Among them, see Nik Ramlah Mahmood, "*Takāful*, the Islamic System of Mutual Insurance – The Malaysian Experience", *Arab Law Quarterly*, 1991, 6, pp. 280 ss. Bhatty, Ajmal, "The Growth and Global Market for *Takāful*" in *Islamic Insurance: Trends, Opportunities, and the Future of Takāful*, London: Euromoney, 2007, 3–21; Gerd, Kloewer, "Comments to: Kenya's First *Takāful* Company Licensed" in *Financial Islam–Islamic Finance*, February 17. http://www.financialislam.com/2/post/2011/1/kenyas-first-*takāful*-company-licensed.tml, 2011; Odierno, Hassan Scott P., "The Sharing of Surplus in *Takāful*", in *Middle East Insurance Review* (December), 2008, pp. 51–52; Odierno, Hassan Scott P., "Corporate Governance in *Takāful*", in *Takāful Articles,* 2009, 19 (November); Odierno, Hassan Scott P., "*Takāful* Health Insurance in Asia", in *A Quick Guide: Health Insurance in Asia*. Singapore: Asia Insurance Review, 2009; Odierno, Hassan Scott P., "Regulating *Takāful*", in *Islamic Finance News*, 2010, April 21, pp. 19–20; Odierno, Hassan Scott P., "Health *Takāful* in a Changing Environment", in *Middle East Insurance Review*, 2011, (October), pp. 72–74; Odierno, Hassan Scott P., and Muhaimin Iqbal, "*Takāful* Windows: An Initial Stepping Stone to Bigger Islamic Insurance Market", in *Middle East Insurance Review,* 2006, (December), pp. 65–66; Pask, Adrian, "In the Midst of the Downturn, Many U.S. Mutuals Aren't as Down as Their Publicly Held Peers". Standard and Poor's, 2009, October 16; Patel, Sabbir, "The World of Cooperatives and the *Takāful* Twist", in *Middle East Insurance Review*, 2007 (September); Abdul Hamid, M., and M. Sukki Othman, "A Study on the Level of Knowledge and Understanding among Muslims Towards the Concepts, Arabic and *Sharīᶜa* Terms in Islamic Insurance (*Takāful*)", in *European Journal of Social Sciences*, 2009, 10, pp. 468–478; and more other references quoted in Serap O. Gönülal (Ed.), *Takāful and Mutual Insurance*, The World Bank, Washington D.C., 2013.

[2] Filippo Di Mauro et al., *op. cit.*, p. 15.

In this chapter we intend to shed light on the problems that exist when a *Takāful* insurance decides to provide its services within the European Union markets. Given that there are no single specific rules issued by European legislation concerning *Takāful*, this chapter intends to verify if European insurance legislation deals with organisational structures similar to *Takāful* ones, and for which that legislation offers special rules that in such a way respect the *Sharīʿa-compliant* principles applicable to *Takāful*.

To do this, the chapter will be divided into three parts.

After this introduction, the second part will be dedicated to analyse the European insurance legislation by placing the focus mainly on the long harmonisation process of Member States' insurance regulations and on new directives regarding capital requirements and distribution of insurance products.

The third part will highlight what the features of *Takāful* are. We will try to locate within the European insurance legislation an organisational structure which provides for a specific discipline that can meet the principles and architecture underpinning the *Takāful*.

The last section addresses final remarks.

3.2 Insurance Companies and Access to the European Market

3.2.1 The Creation of a Single European Insurance Market: Three Generations of Directives

To better understand the European legal framework concerning insurance undertakings, we must know that the creation of a single market for the insurance sector has been very difficult, in particular for two reasons: first, two different directives have been necessary, one for life and other for non-life insurance; second, the legislations of single Member States were very different from each other.

Therefore, a single market for insurance services has been created through three steps: (a) first-generation insurance directives (1973/1979), (b) second-generation insurance directives (1988/1990), and (c) third-generation insurance directives (1992). Each time separately for the field of life and non-life insurance, six directives have been enacted with the aim of achieving the necessary harmonisation in the insurance field.

Other directives followed, partly extending the scopes of the directives, partly concerning other fields of insurance (for instance, motor vehicle liability insurance and legal expenses insurance), and partly caring for other prior conditions—like common accounting provisions—to enable the development of a single European insurance market:

A. A series of directives has set the rules under which services can be provided in the field of *life insurance*. There have been three directives on life insurance in the past, all of which were consolidated in one legal text with Directive 2002/83/EC.

Directive 2002/83/EC provides "*the taking-up and pursuit of the self-employed activity of direct insurance carried on by undertakings which are established in a Member State or wish to become established there*".

The provision of life insurance services is subject to the grant of a single official authorisation issued by the competent authorities of the Member State in which insurance undertakings have its head office. Such authorisation is valid throughout the European Union and shall permit insurance undertakings to carry on business in all the Member States, under either the right of establishment or freedom to provide services.

In terms of prudential control, the principle of supervision by the home Member State applies. For an insurer to be authorised to provide life insurance services, certain criteria need to be met. First, the provider must adopt one of the legal forms required in the home Member State. Second, it must possess a minimum guarantee fund, and third, it should provide the information required by the competent authorities.

The directive also provides for the necessary cooperation between the competent authority in the home Member State and the competent authorities in the host Member States in which insurance undertakings do business.[3]

[3] In the case of life insurance, to reach a complete harmonisation, the second-generation directive provided an intermediate step. In fact, it used a system which distinguished between policyholders who took the initiative in entering into a commitment with an insurer of another Member State and those who did not. Those cases in which a policyholder was considered to have taken the initiative was accurately laid down in the directive. Moreover, the directive foresaw that in such cases, a statement had to be signed in which the policyholder took notice that the commitment would be subject to a legal and therefore supervisory regime other than that of its habitual residence, namely the one of the Member State where the insurance undertaking which was to cover the commitment had its establishment. The

B. Similarly to what happens in the life insurance sector, the aim of EU directives on *non-life insurance* is to introduce a single passport system, whereby an insurance company based in one Member State and allowed to provide non-life insurance services under national law may at the same time open branches or carry on business activities in other EU Member States.

Whereas the first and second generation of insurance directives only opened the European market for insurance services covering large risks (such as those associated with insurance in the field of aviation and marine insurance),[4] the third-generation directive established a single market for insuring all types of risks falling within the scope of direct non-life insurance.

The legal forms which insurance undertakings must adopt in order to be authorised to provide life and non-life insurance services are in most EU Member States the same as those foreseen by life insurance directives.

According to the recital of the third non-life insurance directive, the necessary prior conditions for the mutual recognition of authorisations and prudential control systems, thereby making it possible to grant a single authorisation valid throughout the European Union and to apply the principle of supervision by the home Member State, were finally met by this last directive.

law applicable to life insurance contracts was regulated by Art. 4 of the directive. In general, the law of the policyholder's residence and seat, respectively, was to be applied. A choice of law was only possible in two cases: (a) if the applicable law allowed it and (b) in cases in which the policyholder was not citizen of the Member State where the risk was situated. Regarding the latter, the parties could choose between the law of the policyholder's residence and the law where the risk was situated. Again, the application of so-called mandatory provisions of the forum State as well as the State where the policyholder had his/her habitual residence was foreseen.

[4] In fact, as regards to non-life insurance, it was necessary to make a distinction between large risks and mass risks in creating the European insurance single market.

Large risks mainly included big commercial and transport risks, where "*policyholders who, by virtue of their status, their size or the nature of the risk to be insured, [did] not require special protection in the State in which the risk [was] situated*". For these types of insurance complete freedom was foreseen so that the policyholders could "avail themselves of the widest possible insurance market".

Mass risks, on the other hand, still required special protection, as the policyholders in these cases normally did not have the abilities mentioned above to judge the obligations they undertook in an insurance contract in their entire complexity. If an insurance undertaking wanted to cover mass risks in another Member State, that State could still ask for formal authorisation as well as impose its provisions as to technical reserves.

In particular, the prior conditions just mentioned regarded the final harmonisation of the national provisions in relation to supervision and technical reserves. The necessary control is mainly to be exercised by the supervisory authority of the home Member State. The host Member State's authority, on the other hand, has very limited means of control, which particularly do not include the question as to whether an insurance undertaking has indeed met the conditions under which it was granted the licence in the first place by the home Member State. In case of lack of respect of authorisation requirements, a rather complicated system of cooperation has been provided.

Moreover, the third-generation directives also introduced a new requirement for controlling shareholders and members of management as regards their integrity and professional skills.

C. Regarding insurance contract law, on the other hand, no important progress had been made through these three directives except for some provisions concerning the insurer's duty of disclosure. The European Commission, which came to the conclusion that "*the harmonisation of insurance contract law [was] not a prior condition for the achievement of the internal market in insurance*" (see recital no. 18 of third non-life insurance directive), instead pursued the harmonisation of the relevant private international law.

In addition to that, the major achievement of the third non-life insurance directive was the *abolition of the ex ante control of tariffs and policy terms also for the field of mass risks.* Insurance undertakings offering compulsory insurance, on the other hand, could still be required to submit their standard policy terms.

Just like in the parallel non-life insurance directive, as far as the contract is concerned, the most important novelty in the field of life insurance was the introduction of the abolition of the *ex ante* control of tariffs and policy terms.

To compensate for the lack of control resulting from the abolition of every other prior approval, the insurer was obliged to follow certain duties of disclosure having to provide the policyholder with information both before the contract was concluded and throughout the duration of the contractual relationship.

Finally, it must be additionally noted that insurance undertakings can no longer be authorised to perform life insurance and non-life insurance activities simultaneously. Where this had been the case before the entry into

force of the new rules, Member States could allow this to continue provided that separate management was adopted by the providers concerned.

3.2.2 The Most Important Changes to the Legislative Framework: (a) Directive 2009/138/EU (Solvency II) and (b) Directive 2016/97/EU (Insurance Distribution Directive)

3.2.2.1 Introduction

The framework just described was recently amended and integrated by two directives: (a) Directive 2009/138/EU (hereafter Solvency II) and (b) Directive 97/2016/EU (Insurance Distribution Directive, hereafter IDD). Briefly, the first had a direct impact on the previous directives, and the second introduced a single passport for the distribution of insurance products; therefore, it completes the European regulatory framework for the single passport.

The first directive, amending the previous one, provides for what we are interested in here, which is more stringent capital and corporate governance requirements. On the other hand, the second directive issues new transparency and behavioural rules in the hypothesis of insurance products distribution.

3.2.2.2 Solvency II and the New Requirements for Capital of Insurance Undertakings

Solvency II is a harmonised prudential directive for insurance firms, introduced in 2009 to recast the previews directives regarding (a) life insurance, (b) non-life insurance, and (c) reinsurance.[5]

Solvency II rules have introduced prudential requirements tailored to the specific risks which each insurer bears. They promote transparency, comparability, and competitiveness in the insurance sector.

The framework consists of a directive, implementing rules, and technical standards. We will focus our attention on the directive only.[6]

[5] See, recently, Pierpaolo Marano, Michele Siri (eds), *Insurance Regulation in the European Union: Solvency II and Beyond* (London: Palgrave Macmillan, 2017).

[6] Under the Solvency II directive the European Commission can adopt delegated and implementing acts, including technical standards and information for the calculation of technical provisions and basic own funds.

Regulation (EU) 2015/35 (known as the Solvency II delegated regulation) sets out detailed requirements for applying the Solvency II framework. It is the core of the single prudential rule book for insurance and reinsurance firms. The Solvency II delegated regulation

The Solvency II directive (amended by the Omnibus II directive 2014/51/EU) became fully applicable to European insurers and reinsurers on January 1, 2016.

The system set up by Solvency II is based on three pillars. The first pillar contains two capital requirements, the solvency capital requirement (SCR) and the minimum capital requirement (MCR), which represent different levels of supervisory intervention. The second and third pillars provide for qualitative requirements (such as risk management and supervisory activities) and supervisory reporting and disclosure, respectively.

For now the European Union has only implemented the first two pillars.

For non-EU insurance undertakings, it applies the rule called "equivalence decisions": this rule recognises that the supervisory regime for insurers in force in certain non-EU countries is equivalent to the Solvency II regime.

After receiving equivalence, EU insurers can use local rules to report on their operations in these countries, while third-country insurers are able to operate in the EU without complying with all EU rules.

For our interest, attention should be focused on capital requirements, because the new rules on capital might discourage or even prevent the entry of Islamic insurance companies into the European market.

In fact, Solvency II has introduced two different types of capital requirements: the MCR and the SCR:

(a) The MCR is the minimum level of security below which the amount of financial resources should not fall.

When the amount of own basic eligible funds falls below the MCR, the authorisation of insurance and reinsurance undertakings should be withdrawn, if those undertakings are unable to re-establish the amount of own basic eligible funds at the level of the MCR within a short period of time.

covers, among other things: (a) assets and liabilities valuation, including the so-called long-term guarantee measures, (b) how to set the level of capital for asset classes an insurer may invest in, (c) the eligibility of insurers' own fund items to cover capital requirements and how insurance companies should be managed and governed, (d) assessing the equivalence of non-EU countries' solvency regimes with EU rules, (e) rules on the use of internal models to calculate requirements on solvency capital, (f) specific rules related to insurance groups, and (g) simplified methods and exemptions to make Solvency II easier to apply for smaller insurers. For the last topics, see Sec. 6 of the regulation.

The MCR must be calculated in accordance with a simple formula, on the basis of data which can be audited.[7]

(b) The SCR is the amount of funds that insurance and reinsurance undertakings are required to hold in the European Union. SCR is a formula-based figure calibrated to ensure that all quantifiable risks are taken into account, including non-life underwriting, life underwriting, health underwriting, market, credit, operational, and counterparty risks. The SCR covers existing business as well as new business expected over the course of 12 months and is required to be recalculated at least once per year.[8]

The SCR is set at a level to ensure that insurers and reinsurers can meet their obligations to policyholders and beneficiaries over the following 12 months with a 99.5% probability, which limits the chance of falling into financial ruin to less than 1 in 200 cases. The formula takes a modular approach, meaning that individual exposure to each risk category is assessed and then aggregated together.

Furthermore, we must focus our attention on own risk and solvency assessment (ORSA). First, it is important to underline that the ORSA does not create a third solvency capital requirement. The ORSA is a new regulatory reporting tool intended to foster effective enterprise risk management (ERM) and provides a group-level perspective on risk and capital. ORSA is an internal process undertaken by an insurer or insurance group to evaluate its own risk management framework and current and prospective solvency positions under normal and severe stress scenarios. It requires companies to regularly evaluate and describe their risk management strategies and to align with their overall business objectives. Lastly, ORSA will become an important additional tool for state insurance regulators to carry out risk-focused supervision as it provides additional information on the key risks insurers are exposed to, on how they manage and control them, and, ultimately, on the financial resources available to cover unexpected losses.[9]

[7] See Art. 126 of Solvency II.

[8] See Sec. 4 of Solvency II.

[9] See, among others, *Own Risk and Solvency Assessment (ORSA)* at the link http://www.naic.org/cipr_topics/topic_ own_risk_solvency_assessment.htm and, for a comparative view, Ciro G. Corvese, "Corporate Governance in Insurance Companies: a Comparison between Canadian and Italian Legal Systems", in *Banking and Finance Law Review*, 2017, 33, 3, pp. 51–67.

Therefore the ORSA also has an important impact on corporate governance and, in particular, on the duties and liability of the board of directors.

Finally, in conclusion of this section and for the specific subject of this chapter, we may anticipate some considerations regarding the possibility of Islamic insurance to operate in the European insurance markets.

The adoption of the Solvency II directive by the European Parliament and the Council of the European Union could also challenge the ability of Islamic insurers to meet solvency and risk management guidelines. The regulation's concern about "concentration risks" may require Islamic insurance providers to have a portfolio that is sufficiently diversified across and within different asset classes. This would be difficult to achieve, given the scarcity of *Sharīʿa-compliant* solutions in specific jurisdictions.

This is just a suggestion. I will cover this topic in more detail in the following sections.

3.2.2.3 The European Single Passport for Insurance Distribution: IMD and IDD

A second and final major regulatory pillar that might affect the inclusion of Islamic insurance companies into the European market is represented by the protection of the insured, especially in the case of distributing insurance policies.

Insurance distribution means to sell, propose to sell, advise on, or carry out other work to prepare an insurance contract. It includes dealing with claims after an insurance event.

The sale of insurance products in the EU was regulated by the Insurance Mediation Directive (IMD). The IMD only applied to brokers and other insurance intermediaries.[10] It obliged them to register in their home country and meet certain minimum requirements.

On January 20, 2016, the European Parliament and the Council adopted the Insurance Distribution Directive[11] (hereafter IDD). The IDD came into force 20 days after its publication in the *Official Journal of the EU* (OJ). Member States will then have two years to transpose the IDD

[10] See Pierpaolo Marano, *The international dimension of insurance mediation under the UE Directive on insurance mediation. Present and future*, in Jovan Slavnic e Slobodan Jovanovic (eds.), *Changes in the Insurance law of Serbia within the European (EU) insurance law development*. (Memoir: Belgrado, 2011).

[11] Directive 20 January 2016, n. 2016/97/UE in G.U.U.E. 2 February 2016, n. L 26.

into national laws and regulations. A review is expected to be carried out five years after IDD comes into force.

The IDD updates the 2002 IMD, which sets out the current framework for regulating EU insurance brokers, agents, and other intermediaries. The IDD was originally referred to as IMD II, but the name was changed in September 2014 to reflect its focus on regulating the distribution of insurance products, including by insurers directly where no intermediation occurs. The existing law is being updated to take into account developments in insurance markets since its implementation.

Like its predecessor, the IDD will be a "minimum harmonising" directive and Member States will be able to "gold-plate" it by adding extra requirements when implementing it. That said, the IDD is intended to significantly raise the minimum standards of the IMD. On cross-border trade in particular, the introductory wording to the IDD refers to the fact that the European insurance market remains very fragmented despite the existing single "passport" systems for insurers and intermediaries.[12]

In this section, we just want to briefly explain the main changes that will be introduced by the new regime, specifying that, as with the IMD, the IDD will apply equally to reinsurance distribution.

First of all, the new regime will require stricter and more specific professional requirements. EU Member States will have to establish and publish mechanisms to effectively control and assess the knowledge and competence of insurance and reinsurance intermediaries and employees of insurance and reinsurance undertakings and employees of insurance intermediaries (see Art. 10, IDD).

Second, the new regime will introduce two general principles, providing that insurance distributors must "*always act honestly, fairly and professionally in accordance with the best interests of customers*", and that all information must be "*fair, clear and not misleading*".

There are also detailed requirements about the information that insurance distributors must disclose to customers before the conclusion of an insurance contract including, but not limited to, identity, address, and registration detail. The requirements are different depending on whether the business is an insurer, intermediary, or ancillary insurance intermediary.

Third, provisions that required insurance distributors to provide detailed information on remuneration received have been removed and

[12] See Ciro G. Corvese, "The categories of customers to be protected under the EU insurance law", in *Reforms and new Challenges in Insurance Law*, (Belgrado 2016), pp. 339–351.

replaced by less onerous requirements (see Art. 9, IDD). Remuneration disclosure requirements for insurance intermediaries in the current version of the IDD include disclosure of

(a) the nature of remuneration received in relation to an insurance contract;
(b) the basis of the remuneration—that is, whether it is in the form of a fee paid by the customer, a commission included in the insurance premium, an economic benefit of some kind offered or given in connection with the insurance contract, or a combination of these. According to Art. 19, § 2, IDD, when the fee is payable directly by the customer, intermediaries must disclose the amount of the fee or, when this is not possible, the method for calculating it;
(c) if any payments, other than ongoing premiums and scheduled payments, are made by the customer under the insurance contract after its conclusion, the insurance intermediary will also be obliged to make the disclosures after each of these payments.

Remuneration is defined in the IDD as: "*[A]ny commission, fee, charge or other payment, including an economic benefit of any kind or any other financial or non-financial advantage or incentive offered or given in respect of insurance distribution activities*".

The remuneration disclosure requirements for insurers in the current version of the IDD include disclosure of the nature of the remuneration received by their employees in relation to the insurance contract. In addition, if any payments other than ongoing premiums and scheduled payments are made by the customer under the insurance contract after its conclusion, the insurer will also be obliged to make the disclosures after each of these payments.

Remuneration disclosure requirements for ancillary insurance intermediaries in the current version of the IDD include only the nature of the remuneration received in relation to the insurance contract. The IDD also includes new requirements where information is provided by email or via a website.

Finally, among other things, the new regime provides that when an insurance product is offered together with another service, or in a package, or as a condition for the same agreement or package, the insurance distributor must inform the customer whether it is possible to buy the different components separately. If so, it must provide an adequate description of the different components of the agreement or package as well as separate evidence of the costs and charges of each component.

3.2.3 Brief and Partial Notes

As it is clear from the preceding sections, European insurance legislation is very complex. It is characterised especially by strict discipline both in terms of organisational structure and the insurance product, with particular emphasis on financial insurance products.

The scenario that occurs to those wishing to operate in the European insurance market is very spread out, especially if we consider the inclusion of organisational structures and the distribution of products which are very different from *Sharīᶜa-compliant* insurances.

In the following sections, we will try to see if there are already organisational structures and products within the European insurance market that are somehow related to the Islamic insurance, after having shown the essential features of the latter.

3.3 Islamic Insurance and the European Insurance Industry

3.3.1 Introduction

The regulatory framework about insurance companies discussed in the previous sections is necessary to see if Islamic insurance has the opportunity to operate in the European Union.

As affirmed in *Islamic Finance in Europe*, "*The growth of Islamic finance in Europe has largely been concentrated in the Islamic banking and Islamic capital market segments. But as these segments grow, Islamic insurance could become a key complementary offering for consumers who are seeking Islamic financial solutions. Islamic mortgage insurance, for example, would fit some Islamic financial instruments, particularly Islamic retail banking products and services*".[13]

So, if it is important from an economic point of view, there are some problems if we focus attention on Islamic insurance from a legal point of view. In this case, we need to discuss the main characteristics of Islamic insurance beforehand in order to verify if there are insurance undertakings similar to Islamic ones in the European legal framework.

[13] Filippo di Mauro et al., *op. cit.*, p. 24. See also Mehdi Sadeghi, "The evolution of Islamic Insurance – *Takāful*: a literature survey", in *Insurance Markets and Actuarial Computations*, 2010, 1, 2, 2010, pp. 100–107.

3.3.2 Islamic Insurance: Takāful *and Its Main Characteristics*

Takāful is the name used to indicate Islamic insurance.[14]

Takāful has proper and distinctive features compared with conventional insurance (insurance companies).

We cannot give a detailed description here but only highlight the most important aspects; we wish to refer to important work on *Takāful* and mutual insurance edited by Serap O. Gönülal.[15]

In chapter 5, the authors (Kassim, Odierno, Patel) give emphasis to the main pillars of *Takāful*.[16]

First of all, "*Takāful companies are not purely stock insurers. The takāful operator sets up a takāful fund, which is put together for groups of participants to assist each other in times of need. The direct link between contributors and those in need is not present. There is less focus on religion and religious observance, although a religious council (Sharīʿa council) carefully reviews the practices of these firms to ensure compliance*".

As regards the *Takāful* structure, the authors state that "*structure is manifest in the main business models in takāful – namely muḍāraba, wakālā, and wakālā with muḍāraba on investment profit. In addition, there is the pure cooperative model in which all profit belongs to the participants. This type of model is not common in takāful, as it does not allow profit for the operator, but it would be an excellent choice for either a cooperative interested in making its operations compliant with Islamic concepts or for a government interested in helping segments of the population to help themselves in an Islamic manner*".

To study *Takāful*, it is necessary to understand that we have a specific model of the contract[17] and, on the other hand, specific rules related to corporate *Sharīʿa-compliant* governance.

[14] The alternative *Takāful* contract which conforms to the principles of Islamic dealings is *halaal*, being the contract of cooperative insurance, which is founded on the basis of charitable donation and *Sharīʿa*-compliant dealings.

To know the situation of *Takāful* in the world, see Ernest & Young, "The world *Takāful* Report" at the link https://uaelaws.files.wordpress.com/2012/04/the-world-takaful-report-2012.pdf

[15] For further information, as well as for articles and essays on the subject, we should mention in particular Serap O. Gönülal (Ed.), *Takāful and Mutual Insurance*, The World Bank, Washington D.C., 2013.

[16] Kassim, Odierno, Patel, *Hybrid Insurance Structure: Reciprocals, Hybrid Mutual Insurers, and Takāful*, in Serap O. Gönülal (Ed.), cit., pp. 67–81.

[17] As stated by Sadeghi: *"In conventional insurance contracts, the relationship between the insurer and the insured is that of buyer and seller. An insurance policy is sold to the policyholder,*

As far as the first pillar is concerned, the abovementioned doctrine has identified three different models of contract:

A. The *muḍāraba* model (still used in Bangladesh, Brunei, Sri Lanka, and Sudan). "*In this model, the participant pays a contribution to the takāful operator, who splits this into two portions, a savings portion (participant's account) and a risk portion (participant's special account or risk fund). The funds in the participant's account belong to the individual participant, whereas amounts in the participant's special account become a community pool of money for assistance against the covered risks—that is, a common account. Thus, the pooled account operates in a manner similar to a mutual or cooperative. The takāful operator receives a portion of investment income as well as a portion of underwriting surplus, which is used to pay expenses as well as to provide profit. There are several variations of this model, depending on the country as well as the interpretation of the Sharīᶜa council as to what is acceptable*".
B. The second and most common model is the *wakālā* model. "*In the wakālā model, the participant pays a contribution to the participant's account, and drips are taken on a monthly or yearly basis for the participant's special fund (risk fund) to cover benefits. For yearly renewable products, the contribution generally goes directly into the risk fund. All investment profit and underwriting surplus is given back to*

and insurers want to maximize their own gain by selling this service. According to Sharīᶜa law, an insurance contract (like any other contract) is permissible, if it is clear and free from: Gharar or uncertainty in the contractual obligation, Jahalah or ignorance regarding financial obligation, Ribā (usury), Ghabn (fraud) and Maisir (gambling). Furthermore, an acceptable insurance contract is expected to be based on principles of mutuality and cooperation (Ta'awun), encompassing the elements of shared responsibility, joint indemnity, common interest and solidarity. The purpose of this 'mutual endeavour' is not profits but to uphold the principle of 'bear ye one another's burden'".

"This differentiates Takāful from a conventional type of insurance, in which the policyholders, rather than the shareholders, solely benefit from the profits generated from the insurance and investment assets. In a Takāful company, the manager or agent acts as trustee of the participant's fund, and is entitled to have remuneration, which is given by the participants as a share of profit arising from the operational surplus of the Takāful fund. Any cash surplus, which may remain at the end of each financial year, is normally returned to the policyholders in the form of cash dividends or distributions. This creates a built-in mechanism to counter any overpricing policies, as whatever the premium, the surplus would normally be returned to the participants in proportion to their contributions. In the case of loss, policy holders receive their compensations from a loss absorbing reserve" (Mehdi Sadeghi, *op. cit*., p. 102).

participants. The operator receives fees, called wakālā fees, from which expenses are paid as well as profit. These fees can be defined in a variety of ways and ideally relate to work performed and expenses incurred to ensure fairness and minimize the mismatch between expenses and income. The participant's special account is again a common account operating on lines similar to cooperative or mutual principles".

C. The third model is a mixture of the others and is called "*wakālā with muḍāraba on investment*". In this model, *"profit operates very similarly to the wakālā model, but with the operator sharing in investment profits. Technically, two models operate within the overall operations, one for running the company and one for handling investment activities. Some sharia councils prefer to call this model wakālā due to a dislike for having more than one model in operation at the same time. Under both the wakālā and the wakālā with mudharaba on investment profits, some operators also share in underwriting surplus. In such a model, this sharing is considered incentive compensation for managing operations efficiently. Unfortunately, such incentives can lead to practices such as charging conservative rates to ensure a significant surplus. Whereas in the wakālā model, there tends to be a wakālā fee on the total fund value (normally just the savings fund) to cover investment expenses and allow for profit, in the wakālā with mudharaba on investment profit model, the mudharaba replaces this fee*". (Kassim et al. 2013, pp. 76–78)

Another important distinctive feature of *Takāful* is corporate governance and, in particular, the agency problem.

As affirmed by Kassim,[18] "*[c]orporate governance in takāful refers to the manner in which the board of directors, Sharīᶜa board, and senior management oversee the takāful business. The business of takāful is a hybrid that requires some modification in the structure of corporate governance found in conventional insurers*".

The Sharia Advisory Board (SAB) represents an additional layer of corporate governance in *Takāful*. It is entrusted to ensure that the operation does not contravene *Sharīᶜa* principles. The Islamic Financial Services Board (IFSB) has published IFSB-10, *Sharīᶜa* Governance System for Islamic Financial Institutions, to provide guidance in this area.

[18] Zainal Abidin Mohd Kassim, *Principal-Agent Issues in Takāful*, in Serap O. Gönülal (Ed.), cit., pp. 99–111.

The board of directors is responsible for ensuring that the business aspect of the operation is optimised, and the *Sharīᶜa* board is responsible for ensuring that the operation is run on a *Sharīᶜa*-compliant basis.

For what specifically concerns the agency problem, the author affirms, "*Who, then, is responsible for protecting the rights of policyholders? IFSB-8 is of particular interest when considering this question. This standard recommends the establishment of a separate independent body – a governance or policyholders committee – responsible for giving due consideration to the policyholders' rights and interests in the takāful operation. While the theory is sound, the practicality of resolving a conflict between the board of directors and their policyholders committee can be challenging. This structure recognizes that there are areas in the operation of a takāful company where the interests of shareholders and policyholders may diverge*".[19]

Finally, still regarding the organisational structure, it is important to note, with the abovementioned author, "*in some countries and markets, especially where Muslims are a minority, takāful operations are set up as a department within a conventional insurance operation (called a takāful window). This is useful where there is an insufficient number of Muslims or insufficient interest to justify separate takāful operations. Such an approach can be problematic. However, with regard to the segregation of funds, cannibalization of funds, and infighting between conventional and takāful operations, antiselection between conventional and takāful products where they are similar, and potential dilution of branding, such as the difficulty of convincing Muslims of the acceptability of such operations from an Islamic point of view*".[20]

3.3.3 *Is* Takāful *a Mutual? Mutual Insurance Companies: Features and Legislative Framework*

After these preliminary remarks on *Takāful* models, the problem now is to verify if the European legal system offers the possibility of exercising insurance activities within the single European market through a company that has the features of *Takāful*.

Most authors affirm that a *Takāful* company is a "mutual company" with different capital and shareholders (not necessarily the policyholders).

[19] Zainal Abidin Mohd Kassim, *op. cit.*, p. 110.

[20] Zainal Abidin Mohd Kassim, Hassan Scott Odierno, Sabbir Patel, "Hybrid Insurance Structures: Reciprocals, Hybrid Mutual Insurers, and *Takāful*", in Serap O. Gönülal (Ed.), cit., *op. cit.*, pp. 78–79.

Some scholars highlight the main qualities of *Takāful*: "*[T]akāful can be considered a mutual insurance hybrid, operating in a new segment of the universe of insurance models. Takāful is similar in structure to a mutual insurance company, which is run by a stock insurer for a fixed fee, but also to a faith-based insurance company, which needs to comply with religious principles*".[21]

To verify the similarity, we should answer the question "what is a mutual company?" and, secondly, what are the specific rules, if any, for that organisational structure.

3.3.3.1 Main Characteristics of Mutual Insurance Companies

Before looking at the main characteristics of mutual insurance companies, it must be noted that there is no common definition at a European level. Mutuals have been described by the European Commission as "*voluntary groups of persons (natural or legal) whose purpose is primarily to meet the needs of their members rather than achieve a return on investment. These kinds of enterprises operate according to the principles of solidarity between members, and their participation in the governance of the business*". The European Commission further specifies that mutual societies "are governed by private law".[22]

In those circumstances, as there is no European harmonisation legislation concerning mutual companies, it happens that each Member State has its own definition of mutual insurance company and has turned out its own specific protocol for those operating in its Member State. Nonetheless, some recent studies have succeeded in enunciating the principles that are common to most mutuals.

In a recent study, scholars indicate the following principles:[23]

Absence of shares*: mutuals are a grouping of persons (physical or legal), called members, and not a pooling of funds as in the case of corporations;*

Free membership*: that means free entry (and free exit) for everyone who fulfils the conditions laid down in the by-laws and abides by the principles of mutuality;*

[21] Zainal Abidin Mohd Kassim, Hassan Scott Odierno, Sabbir Patel, *op. cit.*, p. 76.

[22] See Douwe Grjpstra, Simon Broek, Bert-Jan Buiskool, Mirjam Plooij, *The role of mutual societies in the twenty-first century*, European Parliament, 2011; Simon Broek, Bert-Jan Buiskool, Alexandra Vennekens, Rob van der Horst, *Study on the current situation and prospects of mutual in Europe*, Zoetermeer, 2012 and, more recently, *Mutual insurance in the twenty-first century: back to the future?*, Sigma n. 4/2016.

[23] See Douwe Grjpstra, Simon Broek, Bert-Jan Buiskool, Mirjam Plooij, *op. cit.*, p. 19.

Solidarity among members*: a historical principle rooted in the 19th century worker's movement and the ideology of the solidarity movement. Today, that means joint liability and a cross subsidisation between good risks and bad risks and no discrimination among members;*

Democratic governance*: conveyed by the principle "one person, one vote" in contrast to the rule "one share, one vote" which is symbolic of corporate governance. The board's members are volunteers, in contrast to the corporations' practice paying their directors a fee;*

Independence*: mutuals are private and independent organisations, neither controlled by government representatives nor funded by public subsidies;*

Limited profit sharing*: the profit of a mutual can be shared among the owners/members, usually as discounted premiums or rebates, but the main part of the company's proceeds is re-invested in it to improve services, finance the development of the business or to increase its own funds.*

Although, as a general rule, there is an inseparable relationship between membership and being a policyholder, there are some Member States to which this principle is not applicable.

In some countries, mutual insurance companies are allowed to provide insurance to non-members as well as to member policyholders (for instance, in Italy).

Given that, the abovementioned study reaches the conclusion that "*there can be a broad interpretation throughout Europe of what mutuals are, and sometimes organisations are called mutuals although they do not share all the characteristics most commonly attributed to mutuals. What is considered to be a mutual society in one country might not be considered a mutual in another country. In addition, although organisations from different countries share a number of similar characteristics, they can differ on essentialities so that they do not in fact appear to have the same legal form*".

From this important research emerges that it is not possible to find in the European Union legislative framework a unique set of features for mutual insurance companies. Therefore, it is also very difficult to make a comparison between mutual and *Takāful*, and the eventual correspondence between these two models of exercising insurance is different state by state.

This same problem emerges if we bring our attention to the relative legislation.

3.3.3.2 European Regulatory Framework on Mutual Insurance Companies

In Sect. 3.2, we have discussed the creation of the European single market of insurance services and explained the content of the last directive, as well as the new changes provided by the Solvency II directive.

In this section, we wish to retrace that legislative framework but with regard to mutual insurance.

In general, we can say that EU internal market rules apply to mutuals as to all economic operators.[24]

As far as life insurance is concerned, "the activities carried out by some mutuals are explicitly excluded from the scope of the directive, i.e.:

1. operations of provident and mutual-benefit institutions whose benefits vary according to the resources available and which require each of their members to contribute at the appropriate flat rate (single fixed fee for a service);
2. mutual associations, where:
   - the articles of association contain provisions for calling up additional contributions or reducing their benefits or claiming assistance from other persons who have undertaken to provide it, and
   - the annual contribution income for the activities covered by this Directive does not exceed EUR 5 million for three consecutive years".

Considering non-life insurance, "*In general, very small companies operating in niche-markets are not covered by the nonlife directives. Under certain conditions, mutual associations are also excluded from the scope of application of the directives: these conditions have to do with the way additional contributions are gathered, the size of the mutuals, types of activities and arrangements concerning reinsurance*" (Grjpstra et al. 2011, p. 41).

[24] "*Mutual societies are considered as 'companies' under the definition of the TFEU. As such, they enjoy the rights associated to freedom of establishment and freedom to provide services throughout the European Union and European legislation applies to them as to all economic operators. In addition, mutual societies are active in markets which are highly regulated through sector-specific legal provisions (insurance in particular). Mutual societies also play an important role in the social and health sectors and some of the activities they perform fall under the definition of "social services of general interest" of either economic or non-economic nature and, hence, may be partially or totally excluded from the scope of EU internal market and competition rules*" (*The role of mutual societies*, cit., p. 38).

As with life insurance, operations of provident and mutual benefit institutions whose benefits vary according to the resources available and in which the contributions of the members are determined on a flat-rate basis are excluded from the scope of the non-life insurance directives. Also, provisions concerning the minimum fund and the related special treatment allowed for mutuals are similar to those in Directive 2002/83/EC.

With respect to Solvency II we must, with Sabbir Patel, stress, "*All insurers, as defined by the directive, are subject to Solvency II. There is no differentiation or special dispensation for mutual, cooperative, or member-owned organisations. However, it is expected that certain dispensations will be given to smaller insurers based on 'proportionality' principles. Of the more than 5,000 regulated insurers in Europe, two thirds are mutual, and mutuals represent 25 percent of the European market by premiums; therefore, the majority of smaller insurers undoubtedly will be mutuals. The current definition of small insurer, termed 'non-directive insurers,' is an insurer with premiums below a 5 million.*

The costs to implement a complex new regulatory system are far greater for smaller organisations in proportion to their total costs than they are for large organisations. It is hoped, therefore, that the proportionality principles of Solvency II will avoid the 'law of unintended consequences,' which could result in the disappearance of small mutuals and the loss of market diversification that they bring".[25]

As stated by some authors, the new solvency regime can have severe effects on mutuals. The increasing need for own funds, risk differentiation, and solvency requirements could prove to be difficult for small- and medium-sized insurance companies, and for mutuals in particular, to comply with, since they are often focused on niche markets and specialised in very select types of risks.

Coping with the new solvency regime could force smaller mutuals to raise contributions from members, or to partially reject their mutualistic values by becoming a stock holding company in order to obtain additional funds or to merge with other companies (leading to de-mutualisation, i.e. the process of a mutual transforming into a different legal form).

Applied specifically to mutual insurers and the way they acquire additional funds, it is mentioned in the directive that for mutual-type associations with variable contributions, ancillary own funds may comprise any future claims on their members by means of a call for supplementary contributions.

[25] Sabbir Patel, *Overview of Mutual Structure*, in Serap O. Gönülal (Ed.), *op. cit.*, pp. 43–44.

To facilitate the implementation of Solvency II, a five-year transition period has been negotiated to comply with the regulatory demands. If, after five years, insurance undertakings do not comply with the Solvency II rules, they will no longer be entitled to benefit from the so-called single passport authorising the insurer to sell insurance throughout the EU and European Economic Area (EEA) on the basis of authorisation in its home Member State.[26]

3.3.3.3 Main Differences Between Mutual and Takāful

We can find the definition of main differences between mutual and *Takāful* in an important essay by Kassim.[27]

In particular, the research paper sheds light on the difference between the risk allocation in a *Takāful* company and the risk allocation of a mutual.

First, the author considers the various risks inherent in insurance and how they are managed—specifically expense risk, operational risk, underwriting risk, and investment risk—and these risks emphasise some important differences between *Takāful* and mutual.

If we focus solely on the three main insurance risks, *id est*. operational risk, underwriting risk, and investment risk, the author explains the main difference between *Takāful* and conventional insurance.

With regard to operational risk, the author observes, "*As the management is employed by the stockholders and therefore responsible for the proper running of the business, operational risk is also the responsibility of the stockholders. The fees (income) received from the participants for running the business should therefore compensate the operator for carrying this risk. Here again, maintaining separate balance sheets for stockholders and participants allows this risk to be quantified and appropriate capital maintained. In a mutual, operational risk is the responsibility of all participating policyholders. Given the fragmented equity structure, effective management can be an issue in a mutual and give rise to higher operational risk*".

In the case of underwriting risk, the author states that "*Conventional stock companies are not Sharīᶜa-compliant because of the method by which they manage insurance risks. In return for a premium, the stock company pays claims as and when they occur. This clearly transfers risk from the policyholders to the insurer when the insurer undertakes a speculative venture that*

[26] Sabbir Patel¸ *op. cit.*, pp. 42–43.

[27] Zainal Abidin Mohd Kassim, *The primary Insurance Models* in Serap O. Gonulal, *op. cit.*, p. 24 ss.

will make either a profitable gain or a financial loss for its capital base. In a mutual, the insurance risks are shared among the policyholders, who manage real risks (a loss can only transpire when an insured contingent event occurs) by agreeing to indemnify each other through the premiums paid. This is also the basis for managing insured risks in takāful.

However, there is one important difference in how claims are managed in a mutual and in a takāful company, and it has to do with how deficits (when claims liabilities exceed free assets in the risk pool) are managed. In takāful, the stockholders are obliged to provide an interest-free loan to the takāful risk pool to cover such temporary deficits. This loan is subsequently repaid from future surpluses in the risk pool. Obviously, such a facility is lacking in a mutual, as there are no stockholders. In theory, a mutual could raise funds externally through appropriately structured debt instruments, but this would come at a cost and have no certainty of success.

Also, a major conflict of interest is inherent in a process where the operator manages the risk on behalf of the participants, may enjoy a share of the surplus depending on the arrangements agreed, but never shares in any deficits generated (other than an interest-free loan, qard al hasan, that is repaid to the operator). Corporate governance must be brought into play to ensure that the operator does not use this process to its advantage".

Lastly, in reference to investment risk, the author affirms that "*in a mutual, investment risks are for the account of the policyholders. In a takāful, they are for the account of participants in the takāful pools and for the account of stockholders for assets in the stockholder's fund. In this regard, a third pool needs to be created when a life or family operation is involved. The risks for this pool are borne by the participants in a unit-linked setup.*

The investments of a takāful operation (including the takāful pools) have to be Sharīʿa compliant. While some mutuals based on religious affinity do restrict where their funds can be invested, in most mutuals such restrictions do not arise".

In the abovementioned study, the author underlines two other important differences.

First, "*[t]he wave of demutualization in the years preceding the financial crisis of 2008 was driven partly by policyholders of mutuals cashing out on the value of the business of the mutual. This value consists of the orphan estate in the mutual (orphan because the surpluses were generated by previous policyholders and theoretically cannot be distributed to existing policyholders unless the operation is demutualized) and the ongoing value of the mutual as a business (so-called structural value). In takāful, participants do not own the estate (takāful is relatively new, so no estate exists in most takāful operations),*

as there is a Sharī ͨa requirement (as yet untested) to give to charity any unallocated surplus in a winding up, but no requirement to distribute surplus while the operation is ongoing. The ongoing value of takāful as a business is owned by the stockholders because they funded the infrastructure of the business and control the distribution of the products".

Second, "*[t]he other obvious difference between a mutual and a takāful operation is the need for the takāful company to maintain a Sharī ͨa advisory board, which is responsible for ensuring that the operation itself is Sharī ͨa compliant at all times. The board reviews not only the investments of the takāful operation but also the operational aspects of the business. It is not responsible for setting the level of fees that the operator charges participants (other than ensuring that these fees are made transparent to participants), for managing the business, or for selecting managers and vendors, as these are deemed purely business decisions*".

3.3.3.4 Some Summary Considerations

At the end of this section, we intend to summarise a few considerations about the possibility that *Takāful* companies can carry out their services within the single European market of insurance services.

Starting from the consideration that *Takāful* does not find specific regulation within the European Union, after having highlighted the essential characteristics of *Takāful* from both the contract and the organisational structure points of view, we wondered if insurance companies that are somehow referable to the *Takāful* operate within the European Union.

The structure of mutual insurance seems to us to be the most similar to *Takāful*'s, both for the relationship existing between the shareholder and the undertaking (which, as we know, is divided into two different kinds of relations, one corporate and the other contractual, related to the transaction), and for the structure of corporate governance. Similarity that should, however, come to terms with the consideration that it cannot be limited solely to formal aspects, but must concretely check if the principles of *Sharī ͨa* compliance are respected. In other words, not all mutuals are necessarily *Takāful***.**

We may conclude this section with the words of some scholars: "*Although takāful is not quite the same as mutual or cooperative insurance, in countries where takāful is either new or non-existent and cooperatives are popular, Muslim groups have tended to set up operations with the support and help of a cooperative or in some cases as an agency of the cooperative. This is seen in the setup of pilot takāful operations in Canada by Ansar Cooperative Housing working with the Cooperators Insurance Company and the Swedish Muslim Council working with Folksam. The ability to market takāful*

through windows and cooperatives provides opportunities to spread takāful to markets not traditionally thought of as takāful, but where significant Muslims exist and have a need for such products. (…) in European countries such as Belgium, Finland, France, Germany, Spain, and Sweden, mutual or cooperative insurance constitutes more than 20 percent of total insurance, making these companies a simple yet viable means for offering takāful. Other countries in Europe also have a significant mutual or cooperative presence".[28]

3.4 Final Remarks

At the conclusion of this chapter, we may say that *Takāful* presents a unique challenge to insurance regulators, particularly because of its "hybrid" nature.

This is considering principally two points:

First, "*[t]akāful is both a proprietary setup, driven by shareholder's desires to maximize their return on capital, and a risk-pooling policyholder's fund (policyholders are called 'participants' to recognize their 'membership' in the fund). This hybrid nature is what makes regulating takāful and ensuring proper corporate governance so challenging. Regulators need to determine the extent to which takāful should be regulated, as for any other proprietary setup, and the extent to which it should be required to incorporate specific cooperative or mutual practices, such as giving participants a say in how the operations are run. Considering the unique nature of takāful, there may be a need for a participant's advocate to ensure that the rights of participants are being met. Alternatively, the regulator may need to take on this role as part of its mandate*".[29]

Second, it is also important to note "*the need to satisfy two 'regulators': the insurance regulator and Sharīᶜa law. However, the Sharīᶜa law applicable to takāful is general in nature – that is, the same laws apply to dealings and transactions in all business matters (termed mu'amalat), while insurance regulations are specifically for the conduct of insurance and insurance-like businesses. What makes resolving this challenge all the more important is that insurance is one of the few businesses where contributions (premiums) are paid before services (claims) are rendered; regulations are required to ensure that insurers will honor their obligations*".[30]

[28] Zainal Abidin Mohd Kassim, Hassan Scott Odierno, Sabbir Patel, *op. cit.*, p. 79.

[29] Serap O. Gönülal, "Regulatory framework", in Serap O. Gönülal (Eds), *Takāful and Mutual Insurance*, cit., pp. 191–192.

[30] Serap O. Gönülal, *op. loc. ultt. Citt.*

With respect to these last two points, *Takāful* could meet relevant difficulties in entering the European insurance markets because of the new rules concerning corporate governance and transparency of products.

For the first pillar, in addition to capital requirements,[31] the Solvency II directive has introduced a specific set of rules regarding the system of governance. Pursuant to Art. 41 of that directive,

1. that system shall at least include an adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information.
2. The system of governance shall be proportionate to the nature, scale, and complexity of the operations of the insurance or reinsurance undertaking.
3. Insurance and reinsurance undertakings shall have written policies in relation to at least risk management, internal control, internal audit, and, where relevant, outsourcing. They shall ensure that those policies are implemented. Those written policies shall be reviewed at least annually. They shall be subject to prior approval by the administrative, management, or supervisory body and be adapted in view of any significant change in the system or area concerned.
4. Insurance and reinsurance undertakings shall take reasonable steps to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. To that end, the undertaking shall employ appropriate and proportionate systems, resources, and procedures.
5. The supervisory authorities shall have appropriate means, methods, and powers for verifying the system of governance of the insurance and reinsurance undertakings and for evaluating emerging risks identified by those undertakings which may affect their financial soundness. The Member States shall ensure that the supervisory authorities have the powers necessary to require that the system of governance be improved and strengthened to ensure compliance with specific and strict requirements.

Among these requirements we may remember fit and proper requirements for persons who effectively run the undertaking or have other key

[31] See *supra* par. 2.

functions and the internal control system with particular interest for risk management function.[32]

For the second pillar, the need of disclosure for insurance products, the IDD should specify the minimum obligations of insurance distributors in providing information to customers.

A Member State should be able to maintain or adopt more stringent provisions in the area of information provision, which may be imposed on insurance distributors independently of the provisions of their home Member State, where such distributors are pursuing insurance distribution activities on that Member State's territory, provided that those more stringent provisions comply with Union law, including Directive 2000/31/EC of the European Parliament and of the Council.

A Member State which proposes to apply and applies provisions regulating insurance distributors and the sale of insurance products in addition to those set out in this Directive should ensure that the administrative burden stemming from those provisions is proportionate with regard to consumer protection and remains limited (recital no. 52).

The IDD affirms that in order to ensure that insurance products meet the needs of the *target market*,[33] insurance undertakings and, in the Member States where insurance intermediaries manufacture insurance products for sale to customers, insurance intermediaries should maintain, operate, and review a process for the approval of each insurance product. Where an insurance distributor advises on, or proposes, insurance products which it does not manufacture, it should, in any case, be able to understand the characteristics and identified target market of those products. This directive should not limit the variety and flexibility of the approaches which undertakings use to develop new products (recital no. 55).

Article 25 (Product oversight and governance requirements) establishes that

1. insurance undertakings, as well as intermediaries which manufacture any insurance product for sale to customers, shall maintain, operate, and review a process for the approval of each insurance product, or significant adaptations of an existing insurance product, before it is marketed or distributed to customers.

[32] See Arts. 42–49 of Solvency II.

[33] As regards *Takāful* and target market, see M Iqbal Asaria, "*Takāful* Potential in the UK and Europe (Analysis of the Target Market)" at the link www.assaif.org/index.php/content/.../file/1015_1_Asaria.pdf

2. The product approval process shall be proportionate and appropriate to the nature of the insurance product. The product approval process shall specify an identified target market for each product, ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market, and take reasonable steps to ensure that the insurance product is distributed to the identified target market.
3. The insurance undertaking shall understand and regularly review the insurance products it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the product remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate. Insurance undertakings, as well as intermediaries which manufacture insurance products, shall make available to distributors all appropriate information on the insurance product and the product approval process, including the identified target market of the insurance product.
4. Where an insurance distributor advises on, or proposes, insurance products which it does not manufacture, it shall have in place adequate arrangements to obtain the information referred to in the fifth subparagraph and to understand the characteristics and identified target market of each insurance product.
5. The Commission shall be empowered to adopt delegated acts to further specify the principles set out in Art. 25, taking into account, in a proportionate way, the activities performed, the nature of the insurance products sold, and the nature of the distributor.

The observations made do not intend to diminish the importance of the spread of *Takāful* within the single European insurance market, but only serve to highlight the important regulatory obstacles that *Takāful* could encounter should it plan to set up a subsidiary or offer its services in a European Member State.

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PART II

Status of Islamic Finance in Some European Countries 2019

CHAPTER 4

Status of Islamic Finance in Austria in 2019

Hafsa Lamrani

Abbreviations

ABNIC	Al Buhaira National Insurance Co
AG	Aktiengesellschaft
BASF	Badische Anilin- & Soda-Fabrik
BAWAG PSK	Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse
BMF	Bundesministerium für Finanzen
BMUKK	Bundesministerium für Unterricht, Kunst und Kultur
BWG	Bankwesengesetz
CEE	Central and Eastern European
EAU	Emirates Arabes Unies
EMRK	Europäischen Menschenrechtskonvention
FMA	Finanzmarktaufsicht
FMI	Finanzmarktaufsicht
GRC	Charta der Grundrechte
IGGiÖ	Islamische Glaubensgemeinschaft in Österreich
IIDZ	Islamisches Informations- und Dokumentationszentrum

H. Lamrani (✉)
Ludwigshafen, Germany

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OeNB	Oesterreichische Nationalbank
OeKB	Österreichische Kontrollbank
OMC	Organisation Mondiale du Commerce
ON	Österreichischen Normierungsinstitut
RBI	Raiffeisen Bank International
RZB	Raiffeisen Zentralbank Österreich
SRI	Social Responsible Investment
TKG	Türkische Kulturgemeinde
UE	Union Européenne
WKO	Wirtschaftskammer Österreich

4.1 Introduction

Austria seems to be an exemplary model for the countries of Europe, in terms of the coexistence of confessions. At a time when some states seem to want to antagonize an entire religious community, Austria has chosen tolerance and openness to its Muslim citizens. By looking at the question of the place of Islam and its followers, it turns out that the Austrian state is in a way a European "peculiarity". Indeed, Austria was the first country in Europe to officially recognize the Muslim community. Even more, Austria regulates the life of Muslims with the help of associations and organizations. For example, in public schools, children have the right to Islamic education classes taught by state-paid teachers.

With all these illustrations, one would think that Muslim citizens have access to a flourishing Islamic financial system in Austria. But it is far from being the case. Compared to Britain, which has several *Sharīʿa*-compliant banks and more than a dozen universities or business schools offering Islamic finance courses, Austria is still very late. In fact, apart from the few initiatives of the Muslim community, it seems that the state makes no effort in this direction in the financial, legal or academic context. That said, the country is experiencing steady growth in ethical finance, with the social responsible investment (SRI) fund industry, for example. In addition, several financial institutions and banks offer ethical financial products.

The purpose of this chapter is to present an overview of Islamic finance in Austria. The first part will review the history of Islamic finance in Austria. A brief history of Islam and Muslims will also be included. The second part will underline the current situation of the Islamic financial

sector. All sectors will be considered in this part, namely, the Islamic financial companies' sector. The legal framework governing Islamic activity will be discussed in the third part. Finally, the fourth part will deal with the current academic position and the different degrees in relation.

4.2 History of Islamic Finance in Austria

4.2.1 Islam and Muslims in Austria

Islam has a long and remarkable history in Europe, especially in Austria. Its particularity lies above all in its legal recognition in 1912 in the federal state. The basis of this law on Islam was determined by the law of the recognition of the religious communities in 1874. This took place during the years 1960–1970 before the immigration of the foreign labor force.

Austria, which at that time constituted an Empire, annexed in 1908 Bosnia-Herzegovina, which held a large Muslim community. Thousands of Muslims have been Austrians for decades. Thus, Austria officially recognized Islam by a law dated 15 July 1912. It was thus the first country in Europe to officially recognize the Muslim community (Heine et al. 2012).[1] This guarantee allowed for Muslims the following rights:

- practice of Islam as a common public religion (e.g., the right to receive a religion class at school),
- equality with citizens of Catholic faith or other recognized religious communities,
- administrative autonomy of internal affairs and
- the creation of religious organizations (such as foundations and associations and schools) (Schmied 2005).

Later, in the early 1960s, Austria experienced waves of immigration, mainly from Turkey, the Balkan countries (including many refugees from the former Yugoslavia) and from countries with which it had maintained in the past a long shared history. At the end of the Second World War, several Muslim associations emerged, whose functions were essentially religious and social charitable activities, for example, the Association of Muslims in Austria (*Verein der Muslime Österreichs*) and the Muslim Social Service (*Moslemische Sozialdienst*) (Heine et al. 2012).[2]

[1] See article Heine et al. (2012), p. 47.
[2] Ibid., p. 53.

In 1971, Bosnian Smail Balić filed an application with the Federal Ministry of Education, Arts and Culture (*Bundesministerium für Unterricht, Kunst und Kultur* (*BMUKK*)) to create the foundations of an Islamic religious community. Based on the Islamic Law of 1912 and the Recognition Law 1874, the establishment of the Islamic Community in Austria (*Islamischen Glaubensgemeinschaft in Österreich* (*IGGiÖ*)) was granted on 2 May 1979 (Wolf 2015).[3] The latter will play an important role in the promotion of Islamic finance in Austria.

This is what we will see later. As of 2016, Austria, a country of 8.4 million inhabitants, had some 700,000 Muslims (Statista 2017).[4]

Second religion after Catholicism, Islam is currently practiced by nearly 8% of the population mainly settled in the capital—mostly Turks and Bosnians, but also Afghans, Kurds, Chechens, Iranians, Arabs and Pakistanis.[5] Between 2014 and 2016, many migrants and refugees arrived in Austria, many of them Muslim.[6] Table 4.1 shows the distribution of Muslims in Austria across the nine federal states in 2012 (Statista 2017).[7]

Table 4.1 Distribution of Muslims in Austria according to federal states

Federal state	*Number of Muslims*
Vienna (Wien)	12.5%
Vorarlberg	11.5%
Upper Austria (Oberösterreich)	6.9%
Salzburg (Salzburg)	6.5%
Tyrol (Tirol)	5.8%
Lower Austria (Niederösterreich)	4.7%
Styria (Steiermark)	5.4%
Carinthia (Kärnten)	5.1%
Burgenland	2.4%

[3] See dissertation Wolf (2015), p. 18.

[4] See website Statista: Statistik Portal 2017. Available at: https://de.statista.com/statistik/daten/studie/312152/umfrage/anzahl-der-muslime-in-oesterreich/ (08.2018).

[5] See for an in-depth analysis Kolb et al. (2013), p. 17.

[6] See website *L'Observatoire de la liberté religieuse: Autriche*. Available at: http://www.liberte-religieuse.org/autriche/ (08.2018).

[7] See website Statista: Statistik Portal. 2017. Available at: https://de.statista.com/statistik/daten/studie/306821/umfrage/anteil-der-muslimischen-bevoelkerung-in-oesterreich-nach-bundeslaendern/ (08.2018).

It should also be mentioned, in relation to the total population of Austria, that the Muslim population has a much higher proportion of young people, especially in the 0–14 and 15–29 age groups (about 30% and 27% of the total population of Muslims living in Austria).

With the official recognition of Islam, Austria regulates the life of Muslims with the help of associations and organizations.[8] Thus, in public schools, children are entitled to Islamic education courses, taught by teachers paid by the state. In addition, girls can wear the hijab without fear of being fired. Nor is the call to prayer forbidden in Austria. Finally, Muslim cemeteries are at their disposal. The government has granted more legal protection for the observance of Islamic religious holidays, but it has demanded more academic training, as well as German language skills for imams, and it has enforced a ban on foreign funding for mosques and imams.[9]

A study by Ulram and Tributsch (Ulram and Tributsch 2012) that was conducted on behalf of the Austrian Secretary of State in 2012 shows that the majority of Muslims (60%) living in the country rank as “fairly religious” while 30% are classified as “very religious”. A total of 8% of Muslims consider themselves “rather not very religious” and 1% are classified as “not at all religious”. Belief intensity increases with age, and those of Turkish origin have a stronger belief percentage than those of Bosnian origin (39% vs. 20%).[10]

On the other hand, Muslims have different perspectives on the role of Islam in everyday life, for example:

- 61% believe religion is something private that affects only the person himself
- 45% believe that Islam should play an important role in the family
- 50% believe that Islam, like other religions, must be lived publicly
- 25% believe that Islam should play a leading role in society
- Only 5% think Islam should dominate the legal system and the state.

About *Sharīʿa* Islamic Law, about 9% want the law to be enforced in all areas of the legal system. Only 3% of the Muslim population explicitly emphasizes their wish to apply Islamic business law and its foundations.[11]

[8] See for an in-depth analysis Özer (2016), p. 56.

[9] See website *L’Observatoire de la Liberté Religieuse: Autriche*. Available at: http://www.liberte-religieuse.org/autriche/ (08.2018).

[10] See Ulram and Tributsch (2012), p. 9. “*Muslime in Österreich: Feldarbeit und Tabellierung*”. Available at: http://kurier.at/Muslime+in+Österreich.pdf/10.053.909 (08.2018).

[11] Ibid., p. 34.

To go into the heart of our theme, it must be said that the subject of ethical investment has appeared in Austria since 1980 (Eurosif 2003). The first Austrian SRI[12] fund, the "Hypo-Rent-A", was created in November 1985. This fund was the starting point for continued growth of the SRI fund industry in Austria, which accelerated in the 2000s. Eurosif reports that 11 Austrian SRI funds existed in 2003 (Eurosif 2003). *Vigeo*, a European rating agency Corporate social responsibility (CSR), shows that 24 SRI funds were created in June 2008 and other 10 in June 2011 (Vigeo 2010, 2011).[13]

The SRI fund industry has not only increased by the number of funds, but also by the volume. Table 4.2 shows a steady growth in the volume of SRI funds (despite a decrease in 2008 due to the financial crisis).

What is interesting to consider is that SRI funds were more strongly affected by the financial crisis in 2008 than conventional funds but recovered disproportionately rapidly in 2009 with a volume increase of more than 140%.[14] According to the Second International Forum of

Table 4.2 Volume of the SRI fund market in Austria between 2005 and 2011

Year	*Volume of Austrian SRI funds*	*Volume of Austrian funds*	*Growth of SRI funds (%)*	*Growth of Austrian funds (%)*	*SRI fund market share (%)*
2005	0.96	155.62			0.62
2006	1.06	167.35	10.42	7.54	0.63
2007	1.12	163.76	5.66	−2.15	0.68
2008	0.67	125.98	−40.18	−23.07	0.53
2009	1.63	136.66	143.28	8.48	1.19
2010	1.88	145.25	15.34	6.29	1.29
2011	2.11	134.58	12.23	−7.33	1.57

Rathner (2013, p. 6)

[12] According to the Social Investment Forum, SRI can be defined as an investment strategy that takes into account a company's ethical, social and environmental performance as well as its financial performance when choosing the management of investment portfolios (Social Investment Forum 2006). Social investment initiatives are found in a variety of financial instruments, including mutual funds, pension funds and various private and institutional savings plans.

[13] See working paper for more analysis, Rathner (2013), p. 6.

[14] Ibid.

Islamic Banks and Financial Institutions, the volume of SRI funds in Austria reached €3.3 million in 2013 (Flaunet 2014).[15]

There is also an organization in Austria responsible for assessing the ethical degree of business activity entitled *Institut für market Umwelt Gesellschaft* (IMUG).

As for Islamic finance, despite the very old position of Islam and Muslims in Austria, it must be said that it does not really date long. It was especially after the 2008 financial crisis that few initiatives were launched. But not all have been able to hold to the end.

Indeed, at a time when few *Sharīʿa*-compliant products were provided, Muslim religious communities showed more initiative than conventional financial institutions in German-speaking countries. In Austria, the Islamic Religious Community (IGGiÖ) has provided for the accreditation of at least one "*Sharīʿa* Board" which will issue legal opinions according to the precept of Islam "*fatwa*".

Another personal initiative of the IGGiÖ president's assistant, Mouddar Khouja, was born in 2008. The latter established in the capital Vienna and in association with a financial expert of the conventional sector a company called "*Baraka*" (the Arabic word of blessing), which acted in the distribution of Islamic financial products launched by the European institutions. First, the focus was on Islamic funds, for which associations were the best channels of communication within the framework of a structural distribution. The success of the test phase confirmed the interest of Muslims in Austria, and to ensure the reliability of sales, comprehensive training was provided as part of a certification for sales staff.[16]

This company targeted three main target groups: first, Muslim citizens in Austria and Europe who literally keep their money "under the pillow" or via property acquired in their home country; second, entrepreneurs who have business and need support or those who want to get started for the first time, and third, Islamic associations that want to build a cultural center and need funding.

With his company, Mouddar Khouja created an Islamic fund called "Islamic Fund – Equity Optimiser". It was planned that the fund would be both distributed by the Austrian subsidiary BNP Paribas and used as a basis for the financing of life insurance at Helvetia Bank. It was also possible to invest directly or spare aside for retirement. The fund included shares of the

[15] See Deloitte report, Flaunet (2014), p. 6.
[16] Mahlknecht (2008), pp. 84–86.

pharmaceutical company Sanofi-Aventis as well as those of the British energy group BP. In addition, there were those of BASF and China Mobile. "The fund is compatible with the Islamic Dow Jones and we are audited by a *Sharīᶜa* board", added Khouja. The latter was considered a good future for this fund, which was also intended for non-Muslims. This was not the case unfortunately because Khouja revealed to us that it is no longer active in the company since June 2009. It was managed by the other partner alone until the year 2016 when it was closed.

4.2.2 The Current Situation of Islamic Finance in Austria

Before discussing the existing Islamic financial products in Austria, it is important to start by talking about the financial system.

4.2.2.1 The Financial Market in Austria

In recent years, the capital market has experienced significant growth in Austrian corporate finance, and banks remain the main intermediary between supply and demand for capital. Banks and insurance companies are among the largest investors, employers and taxpayers in Austria. The latter have been engaged for years in the countries of central and Eastern Europe and in Southeastern Europe. Austria's financial center is therefore seen as a bridgehead between new markets in the East and traditional target groups.[17]

The Austrian financial system is strongly influenced by the banking sector. It is a universal banking system. The universal banking model offers significant potential for synergies and a high degree of risk mitigation, as well as flexible adaptation to changes in the financial environment.[18] Credit institutions can offer all forms of financial and credit transactions. Austria has one of the strongest banking networks in Europe. In 2009, nearly 850 lending institutions managed a total of more than 4000 wickets (windows). In the aftermath of the financial crisis in the financial markets, Austrian banks committed themselves to stabilize their own subsidiaries and the entire region.[19]

[17] See article "*Vue d'Ensemble*". Available at: http://www.advantageaustria.org/international/zentral/business-guide-oesterreich/importieren-aus-oesterreich/branchen/banken-und-versicherungen/Ueberblick.fr.html (08.2018).

[18] See BMF. 2017. Available at: https://www.bmf.gv.at/finanzmarkt/finanzmarktaufsicht/finanzmarktaufsicht.html (08.2018).

[19] See article "*Vue d'Ensemble*". Available at: http://www.advantageaustria.org/international/zentral/business-guide-oesterreich/importieren-aus-oesterreich/branchen/banken-und-versicherungen/Ueberblick.fr.html (08.2018).

Credit institutions in Austria are mainly divided into five sectors, depending on their legal form and their concentration on specific customer segments:

- commercial banks (*Aktienbanken*)
- savings banks (*Sparkassen*)
- banks of agricultural credit (*Raiffeisenbanken*)
- banks' credit unions (*Volksbanken*)
- mortgage banks (*Landes Hypothekenbanken*)[20]

The main Austrian credit institutions are[21] as follows:

- *Erste Group Bank AG*
- *UniCredit Bank Austria AG*
- *Raiffeisen Zentralbank Österreich AG*
- *Österreichische Volksbanken-AG*
- *Hypo-Alpe-Adria-Bank – International AG*
- *Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft (BAWAG PSK)*
- *Raiffeisenlandesbank Oberösterreich Aktiengesellschaft*
- *Österreichische Kontrollbank AG*
- *Raiffeisen Holding Niederösterreich-Wien*
- *Oberbank AG*

As for the insurance sector, it is one of the strongest pillars of the Austrian economy. In addition to protecting customers, insurance companies also have a decisive influence on society and the stability of the country.

Security bonds, bond funds, real estate and shares are considered among the major capital investments in the sector. In addition, insurance companies are very vigilant and strict regarding the investment of their clients' capital. They are important financial players in the housing construction sector and invest heavily in government bonds and bank bonds.

The following list represents the leading insurance companies in market share in 2009[22]:

[20] Ibid.
[21] Ibid.
[22] Ibid.

- *VIENNA INSURANCE GROUP Wiener Städtische Versicherung AG*
- *Generali Versicherung AG*
- *UNIQA Personenversicherung AG*
- *UNIQA Sachversicherung AG*
- *Allianz Elementar Versicherungs-AG*
- *Sparkassen Versicherung AG Vienna Insurance Group*
- *FINANCE LIFE Lebensversicherung AG*
- *DONAU Versicherung AG Vienna Insurance Group*
- *Bank Austria Creditanstalt Versicherung AG*
- *Raiffeisen Versicherung AG*

4.2.2.2 The Regulation System of the Austrian Financial Market

Austria's regulatory system is characterized by a dual supervisory system with shared responsibilities between the Financial Market Authority (FMA) and the Austrian Central Bank (*Oesterreichische Nationalbank* (*OeNB*)) for the banking sector. The FMA is solely responsible for overseeing the insurance markets and the securities industry.[23]

4.2.2.3 The Austrian Financial Market Authority (FMA)

The Austrian Financial Market Authority (FMA) is an independent and autonomous supervisory authority. The function of the FMA lies in the licensing of banking services, the supervision of the owner's control and the control of standards and penalties imposed.

The FMA is a public law institution with its own legal personality. It is the statutory single supervisory body directly responsible for banking, insurance and pension funds, securities and stock market supervision. The internal structure and organization of the FMA is governed by the FMA Act, which has been in force since 2002. The FMA is overseen by the Parliament and the Austrian Ministry of Finance.[24]

*4.2.2.4 Austrian National Bank (*OeNB*)*

The Austrian National Bank (*OeNB*) is the central bank of the Republic of Austria, which is an integral part of the Euro system. The *OeNB* fulfills a wide range of tasks and responsibilities, which also involves participation in inter-

[23] Ibid.

[24] See website of FMA. 2018. "Finanzmarktaufsicht in Österreich". Available at: https://www.fma.gv.at/finanzmarktaufsicht-in-oesterreich/ (08.2018).

national organizations and the provision of extended information services to the public. For the public interest, the *OeNB* contributes to political, monetary and economic decision making in Austria and the Euro region.

The *OeNB* is a joint stock company. Given its status of a central bank, however, it is governed by a number of special rules as set out in the National Bank Act. Despite the creation of the FMA as a single statutory supervisory body, there is extensive operational involvement of the *OeNB* in the supervision of the banking system. According to the law, the *OeNB* must be responsible for on-site inspections and the examination of bank credit and market risks.[25]

*4.2.2.5 Austrian Law on Banks (*Bankwesengesetz *(*BWG*))*

The Austrian Bank Act (*BWG*), which entered into force on 1 January 1994, contains the main regulations governing banking supervision in Austria. It defines the legal framework for banking activity in Austria and regulates activities that trigger the requirements to apply for and obtain a banking license.

The Bank Act mainly contains general regulations, laying down the conditions for the performance of a credit institution and the basic rules of the supervisory regime, as well as regulations for the protection of consumers and depositors. In addition, the Bank Act gives the FMA and the Ministry of Finance broad regulatory powers. The objectives of the Austrian banking law lie in the good functioning of the financial sector in Austria and the protection of creditors and customers. In addition to the various regulations at the European level, this law contains many standards that consider the specific components of the Austrian banking system.

4.3 The Islamic Banking Sector in Austria

Despite the strength of Austrian banks, they remain very skeptical and reluctant when it comes to *Sharīᶜa*-compliant banking instruments. As a result, little progress has been made and supply remains very timid or even absent in the Austrian national market. Following are the current offers in the Austrian banking sector.

[25] See website of OeNB. 2018. "Über uns". Available at: https://www.oenb.at/Ueber-Uns.html (08.2018).

4.3.1 BAWAG PSK

In the midst of the ongoing migrant crisis in Europe, the Austrian banking sector finally has a *Sharīᶜa*-compliant current account for the growing Muslim population of Austria. This was announced in January 2016 by the Austrian bank BAWAG PSK, one of the largest retail banks in Austria, in the statement of Claudia Lemlihi, marketing manager, becoming the first Austrian bank to do so. Being prohibited, interest is replaced by fixed costs. The manager added that this account, named "*Amana*" (confidence in Arabic) during the testing phase, is specifically tailored to the needs of Muslims living in Austria. Under this new product, BAWAG PSK offers three different types of Islamic accounts that do not pay and pay no interest. However, customers will pay fixed fees of €4.90, €11.90 or €34.90 per month. Obviously, separate allocation circle, which is controlled by an Islamic committee, is created inside the bank.

This good news for Muslims in Austria has unfortunately found great resistance from many others. Thus, several Internet users have expressed their radical rejection of the project in social media, namely, on Twitter or on the Facebook page of the bank BAWAG PSK. For example, some saw this decision of the bank as "a step forward in the future of the Islamization of Europe".[26]

Many also threatened to close all their accounts with BAWAG and compared the damage that will affect its image with that of the scandalous "Caribbean transactions" of the bank, which led to resignations from the BAWAG management and have had years of legal consequences. It has even been created a page titled "Boycott BAWAG PSK" on Facebook. Many have mentioned this Thursday in which the BAWAG announced its plans as "probably one of the saddest days in the history of the bank".[27]

To remedy this storm of anger and massive criticism, BAWAG tried to relativize the fact and argue its plans by posting a statement on its Facebook page, ensuring three essential points:

[26] See article of Wolfgang Fercher. 2016. "*Bawag hält an umstrittenen Islam-Konten fest*". Available at: http://www.kleinezeitung.at/wirtschaft/4904740/Ab-Februar_Bawag-haelt-an-umstrittenen-IslamKonten-fest (08.2018).

[27] See Kronen Zeitung. 2016. "*Islamic Banking: Wütender Protest gegen die BAWAG*". Available at: http://www.krone.at/oesterreich/islamic-banking-wuetender-protest-gegen-die-bawag-muslime-bevorteilt-story-491185 (08.2018).

- These accounts compatible with the principles of *Sharīʿa* will not be privileged and therefore, not free, but will cost the customer between €4.90, €11.90 or €34.90 per month. The main difference in product design compared to other conventional accounts is that no interest items will be included or paid, and the fixed account fees will be charged instead of the interest rate. The total cost to the customer will be comparable to that of the conventional account.
- These planned accounts will not be funded by conventional accounts.
- Finally, these accounts can be opened by any interested party Muslim or not.

Indeed, according to an article in an Austrian newspaper *Klein Zeitung* on 15 January 2016, a BAWAG spokesman assured: "we are not doing Islamic banking, we are testing a new interest-free current account model where we will be responsible for fixed costs". "Of course, this new product meets the requirements of the Austrian banking law, so the special needs of Muslims living in Austria are considered", added the spokesman of the bank.[28]

Finally, the bank said in its statement that a large part of its target group included nearly 700,000 Muslims living in Austria. Islam being the second recognized religion in Austria, it was therefore important to "respond to the needs of different groups in society".[29]

BAWAG PSK's press and media manager, Mrs Schütz Spörl, assured us again that this account is not an Islamic account. She added that it is currently known as the "budget account" (*Budget Konto*). The name "*Amana*" was used as a working title in the pilot phase. As mentioned before, like all current models of BAWAG PSK, the budget account is of course based on Austrian law and is intended to target all consumers in Austria.

The manager affirmed that till this date, the demand related to this offer exists and many customers have chosen it, without being able to provide statistics or the volume of its turnover.

The bank has been showing since the launch of the project so far that the account is not a specific offer for a single target but for any interested party in Austria. The bank avoids any contradiction with Austrian banking law which prohibits any discrimination. This is what we will analyze in the third legal part.

[28] *Loc. cit.*

[29] See the statement of the BAWAG PSK published on its Facebook page on 15 January 2016 after the storm of criticism from the Austrians during the announcement of the Sharīʿa compliant current account project.

There are other examples of banks that are active in the area of social responsibility and ethical investment both in the products offered and in their internal management. It would be useful to quote them (RFU 2017)[30].

4.3.2 Erste Group Bank

A well-known example in Austria in the area of ethical investment is the Erste Group Bank AG. “Erste Sparinvest” and “Erste Asset Management”, two subsidiaries of the group, have taken into account the desire of investors to invest in areas with environmental, social and ethical aspects. “Erste Sparinvest” has developed the largest variety of ethical funds in Austria over the last decade. In 2011, it was decided that companies which act in the field of weapons, such as nuclear weapons or cluster munitions, should be excluded from the investment portfolio. Since 2012, all asset management units of “Erste Group” have been committed to the United Nations Principles of Responsible Investment (PRI).[31] In addition, by signing the Bangladesh Protocol in 2013, Erste Asset Management has committed not to invest in countries where there are human rights violations in the textile industry. In addition, the ban on food speculation also applied to all funds in the group.[32]

4.3.3 UniCredit Bank Austria

Belonging to the Italian UniCredit Bank, UniCredit Austria offers ethical products and sustainable development to its clients such as “NGO-Bonus”. In addition, for economically or socially vulnerable customers, there are basic bank accounts with more favorable and cheaper conditions. The bank has an environmental management system according to ISO 14001 and uses 100% ecological electricity. An ethics report *Nachhaltigkeitsbericht* is published at the level of the parent company.

[30] See the report of RFU: sustainability · research · consulting. 2017. “*Wie nachhaltig sind Österreichs Banken?*”. Available at: https://www.rfu.at/wp-content/uploads/2017/03/Bankenvergleich_rfu-3-2017_1.pdf (08.2018).

[31] Entner and Püspök (2012), p. 76.

[32] See the activity report of Erste Bank. 2015. “*Nachhaltige Kapitalanlage*, Geschäftsbericht”. Available at: http://www.erste-bank.at/20160422_GB15_Online/20160422_GB15_Online/DE/GB2015_DE_Lage_60.html (08.2018).

4.3.4 Raiffeisen Zentralbank Österreich (RZB)/Raiffeisen Bank International (RBI)

RZB is the central institute of the Austrian banking group Raiffeisen. In recent years, the bank has been very interested in ethical management; the Raiffeisen Capital Management Group is one of the leading suppliers of ethical investment products in Austria. Through the Climate Protection Initiative, Raiffeisen has increased interest in the theme of climate change. The RZB group regularly publishes annual ethics reports.

4.3.5 Raiffeisenlandesbank Oberösterreich

Since 2013, *Raiffeisenlandesbank* Upper Austria has put in place an ethical management. In the field of financing, the bank has particular expertise in renewable energy projects. *Raiffeisenlandesbank* also owns a fund company *Kepler-Fonds KAG* which offers a range of ethical investment opportunities. She is socially involved in arts, health and wellness.

4.3.6 Raiffeisenlandesbank Niederösterreich-Wien

Raiffeisenlandesbank Lower Austria-Vienna is active as a regional bank in eastern Austria. Schools and kindergartens, water supply and sanitation, health facilities and employment-friendly investments by SMEs are among its areas of ethical, ecological and social funding. The bank's annual report contains a whole chapter on social responsibility.

4.3.7 Oberbank

Oberbank is mainly interested in social and environmental aspects. At the product level, the institution offers SRI funds. Internally, the bank provides CSR programs to its staff, ranging from continuing training to health promotion.

4.3.8 Hypo NOE Gruppe

Located mainly in Lower Austria and Vienna, *Hypo NOE Gruppe* considers the theme of responsible ethical bank as a central theme. This bank has maintained projects in areas such as health, education, housing and

infrastructure. Particular attention is paid to renewable energies. In the area of investment, funds focused on sustainable development are available. *Hypo NOE Gruppe* published its first ethics report in 2015.

4.4 *Takāful* Sector in Austria

According to our research, an offer for the Austrian market in Islamic insurance "*Takāful*" is absent. However, the only ones that exist for the moment are mainly intended for international Islamic markets. These are "Forward U (FWU)" and "UNIQA *Versicherung*", two companies specializing in insurance solutions. The first is of German origin with an open branch in the capital Vienna, and the second is an Austrian company. The latter has declared its interest in also targeting the national market, but no information has indicated to us that UNIQA's *Takāful* offer is currently accessible to Austrian citizens. This is what we will see in detail in the second subpart.

4.4.1 UNIQA **Versicherung**[33] *Group AG*

The UNIQA Group is one of the leading insurance groups in Austria. These are approximately 40 companies in 18 countries and locally have approximately 9.6 million customers. UNIQA has one of the largest shares of the insurance market in Austria and is well positioned in the Central and Eastern European (CEE) markets.[34]

Premiums earned (excluding discontinued operations and intra-group eliminations) by activity are distributed as follows:

- non-life insurance (53.1%);
- life insurance (24.4%);
- health insurance (22.5%).[35]

In 2008, the group founded, through a joint venture in the emirate of Sharjah, with the group specializing in *Sharīʿa*-compliant health and life

[33] *Versicherung* is the German word for insurance.

[34] See website of UNIQA Group. 2018. "Unternehmensportrait". Available at: http://www.uniqagroup.com/gruppe/versicherung/uniqa-group/ueber-das-unternehmen/unternehmensportrait/Unternehmensportrait.de.html (08.2018).

[35] See website of Boursorama. 2017. Available at: http://www.boursorama.com/bourse/profil/profil.phtml?symbole=1kHUN9 (08.2018).

insurance; Al Buhaira National Insurance Co (ABNIC), an "Islamic" health and life insurance called "*Takāful* Al-Emarat". The founding treaties of the "*Takāful* Al-Emarat" insurance were signed by the representatives of Al Buhaira National Insurance Co and UNIQA Group Austria in March 2008. Being based in Dubai, the capital shares of the created company are divided between 20%, owned by Al Buhaira, 10%, by other founding members, and 15%, by the UNIQA group. The remaining 55% of the capital, of approximately €30.8 million, was successfully placed in an IPO in early April 2009.

With the inclusion of operating activities, "*Takāful Al-Emarat*" intends to first consolidate its presence in the United Arab Emirates and open branches in Dubai, Abu Dhabi and Sharjah. Long-term sustainable positioning in the region of the Gulf countries, in North Africa and in other Islamic countries is also planned.

According to spokesman Norbert Heller, the group anticipates huge potential for the long-term growth of "Islamic" insurance products in the Arab world. He added that the group is also interested in distributing such a product sooner or later in Austria. But when and how this will happen is still unknown.[36]

4.4.2 FWU

FWU is a company specializing in life insurance solutions and financial services. It was founded in 1983 by its founder and CEO Dr. Manfred Dirrheimer under the name "*Forschungsgesellschaft für Wettbewerb und Unternehmensorganisation*". Originally a Munich-based consulting firm, FWU started to create innovative products in the German life insurance market. Today, FWU has 12 offices in Europe, including Austria and Asia, and has become a global player in the life insurance industry.[37]

FWU owes its success to innovative investment offers in Germany and Austria. Since 2000, FWU has become one of the pioneers of *Takāful* insurance. Based in Vienna under the name FWU Life Insurance Austria AG, its "Family *Takāful*" products have been specifically developed for the

[36] See website of UNIQA. 2008. "*Neue Wachstumsmärkte für UNIQA: Islamische Produkte und Krankenversicherung als zusätzliche Wachstumstreiber*". Available at: http://www.uniqagroup.com/gruppe/versicherung/press/press_release/archive/2008/pa_cannes_wachstumsmaerkte.de.html (08.2018).

[37] See website of FWU forward. 2018. "About FWU". Available at: https://www.forwardyou.com/fr/qui-nous-sommes/propos-de-fwu.html (08.2018).

Middle East and Far East markets. These products specifically designed for its Muslim customers are different from the traditional products it offers in Europe on at least three points: the limitation of the investment universe, the risk of death and the degree of transparency.

The products sold under the name "*Takāful*"[38] conform to Muslim dogma. They allow its subscribers to take full advantage of all the possibilities offered by life insurance while prohibiting trade and investment operations on weapons, gambling, pork and so on. The European insurance practice of assessing customer mortality is also outlawed because betting is prohibited. To evaluate the mortality would be to make a bet on the life of others. To that extent, FWU had to develop a completely innovative risk management system, which it incorporated into the product.

As stated in the rules, customers should be entitled to maximum product transparency. It also entails the need to present in detail the cost structure. FWU is also a pioneer in the field, since it has been able to implement these structures in the framework of a model "*Wakālā*"[39] which allows better control by the company, so that it is manageable for the company while offering customers attractive products.[40]

4.5 Islamic Financial Companies in Austria

Only two companies offer Islamic financial services: "My Islamic Finance Österreich", which for economic reasons has recently closed, and "INAIA Finance", which also offers its products to the Austrian market from Germany.

[38] *Takāful* is a type of Islamic insurance based on Islamic Law, where members contribute money into a pool system in order to guarantee each other against loss or damage. For more details, refer to the website of Investopedia. 2018. *Takāful*. Available at: https://www.investopedia.com/terms/t/*Takāful*.asp (08.2018).

[39] *Wakālā* is a contract of agency in Islamic finance in which one person (a principal or muwakkel) appoints another (an agent or *wakeel*) so that the latter performs on behalf of the former a certain task in accordance with specific stipulations, usually against a predetermined fee. For more details, see the website of Financial Encyclopedia. 2013. What Are the Types of *Wakālā*? Available at: https://www.financialencyclopedia.net/islamic-finance/questions/what-are-the-types-of-*wakālah*.html (08.2018).

[40] See website of FWU Forward. 2018. "about FWU". Available at: https://www.forwardyou.com/fr/ce-que-nous-faisons/produits.html (08.2018).

4.5.1 My Islamic Finance Österreich

My Islamic Finance Österreich is the first *ḥalāl* start-up operating in the field of Islamic finance consulting created by M. Ahmad Lamprecht[41] who was encouraged by the idea that Islamic finance has ravaged almost the whole world and that Austria is always late. The Carinthian Ahmad Lamprecht wanted to be in direct contact with Muslims and opened "My Islamic Finance Österreich" as a subsidiary of the parent company "My Islamic Finance" in Germany.

In the heart of the Turkish district of Vienna, Lamprecht occupied a sterile premise without visual indication of Islam, no Arabic characters. Only a sheet in the door reveals the company's activity: "savings plans for children, savings plans for parents, savings for pilgrimage, be happy without interest".[42]

Lamprecht was a computer technician. When he wanted to save money for his family, came the financial crisis in 2008. He tried to find solutions to the financial system and found it in the Islamic bank. He established contacts with the German network of Islamic finance consultants: "My Islamic Finance". He worked with them since the beginning of November 2014.

Lamprecht advised its customers under the name of the German brand on the means of savings and *ḥalāl* investment. For this, he earned as turnover between 5% and 6% commission on the amount saved. His range of products was a bit limited: gold and Islamic funds. The fund was distributed by an Austrian partner for whom Lamprecht was the intermediary. Of course, the fund respects *Sharīʿa* law. Customers who invested in gold were supplied by a German supplier.[43]

Due to the lack of profitability, Lamprecht assured us that he has closed his office in Vienna. He still advises on savings products and Islamic investments but from Germany and always in collaboration with "My Islamic Finance".

[41] In some articles in the past, Mr Lamprecht was called Harald. According to our correspondence via email made with him during the month of July 2017, he changed his name to Ahmad.

[42] The original sentence was "Kindersparpläne, Elternsparpläne, Hadsch-Sparen. Zinslos glücklich".

[43] See article by Clemens Neuhold. 2014. "*Ein Kärntner will Muslime "zinslos glücklich" machen*". Available at: http://www.wienerzeitung.at/nachrichten/wirtschaft/oesterreich/704401_Ein-Kaerntner-will-Muslime-zinslos-gluecklich-machen.html (08.2018).

4.5.2 INAIA Finance

Called in the past Islamic Finance Investment Solutions (IFIS), INAIA Finance is the first company in Germany (2007) that operates strictly within the framework of German law, while complying with the rules of *Sharīᶜa* as underlined by its manager Mr Emre Akyel. Having opened representative offices in several German cities as well as Egypt, INAIA Finance intends to expand its activity in other countries such as Austria and Switzerland. INAIA Finance can already advise clients living in Austria from Germany and offer a range of *Sharīᶜa*-compliant financial products to private clients and businesses, ranging from savings plans to gold, *ḥalāl* funds, asset management and more.

4.6 Legal Framework of Islamic Finance in Austria

Before the year 2010, the existing legal framework in Austria could not allow the realization of operations in Islamic finance and the development of Islamic banks. It was only after the month of May 2010, and by the initiative of the Islamic Information and Documentation Center of Austria (IIDZ Österreich),[44] that the Austrian Standards Institute[45] developed, with the help of a committee of experts in Islamic finance and Islamic Law, the first normative document of Europe for Islamic financial instruments. The standard is entitled "ON-Regel 142001-1". This standard ensures that the certified product meets all the rules of *Sharīᶜa*. This normative document was published on 1 May 2010 and a press release was issued on 6 May 2010 in the Concordia Press Club.[46]

In the same year, the "ON-Regel 142001-2" standard for *Sharīᶜa*-compliant insurance products and insurance services was published. This standard was also initiated by IIDZ-Austria in collaboration with the financial institute "Mashura Finance Consultations" in Qatar.

Günther Ahmed Rusznak, President of IIDZ and Head of the Development Committee of both standards, ensures that with them, the principles and requirements of financial products and services have been defined and are both in force with the law and the Islamic legal system.

[44] See website of IIDC. 2017. "about us". Available at: http://iidc.eu/iidc.php (08.2018).

[45] See website of Austrian Standards. Available at: www.as-institute.at (08.2018).

[46] See website of APA OTS. 2010. "*Einladung zur Pressekonferenz Erste ON-Regel für Islamic Banking*". Available at: https://www.ots.at/presseaussendung/OTS_20100503_OTS0141/einladung-zur-pressekonferenz-erste-on-regel-fuer-islamic-banking (08.2018).

Dr. Karl Grün, Development Director of the Austrian Standards Institute, also states that "In the development phase, not only experts from Austria were involved, but also well-known international experts". He added that "the purpose of these standards is mainly the desire to create an atmosphere of acceptance, security and trust in Islamic financial products between the various market partners (customers, financial institutions, government agencies)".[47]

An inconvenience to consider is that the introduction of these standards has not found a positive reception from the Turkish cultural community in Austria (TKG). In early 2017, the TKG proclaimed that it is not against Islam but against Islamic finance in Austria and against the establishment of a legal system derived from Islamic Law *Sharīᶜa*. It reinforced its refusal by arguing that the implementation of the *Sharīᶜa* law alongside the Austrian legal system as well as the offer of a product targeting a specific clientele (Muslims) are prohibited in Austria. Similarly, it referred to the decision of the European Court of Human Rights on 13 February 2003 which recognizes that the establishment of two different legal systems and discrimination is prohibited in Europe.

In 2017, a statement was written by TKG President Birol Kilic on the Internet explaining why the latter does not support Islamic financial products or advise them to its members by citing 31 theses. We will summarize some of them below[48].

1. Islamic finance (banks, insurances, etc.) is opposed to the right of all 28 EU countries, the free market economy, WTO rules, the law of unfair competition and the national laws of 170 countries in the world.
2. A total of 96 articles of the consolidated version of the "Treaty on the Functioning of the European Union", valid from 30 March 2010 (Official Journal of the European Union C 83/47), 15 articles of the "EU Treaty" (C 83/13) and Article 16 of the "Charter of Fundamental Rights of the EU" (C 83/02) are violated by the admission of "*ḥalāl*" and "Islamic Finance".

[47] See website of Islam.de. 2010. "*Österreich: Verbindliche Regeln für Finanzdienstleistungen*". Available at: http://islam.de/15842_print.php? (08.2018).

[48] See the article by Birol Kilic. 2017. "*Islamic Banking verstößt gegen das EU Recht? 31 Thesen!*". Available at: http://www.turkischegemeinde.at/index.php?id=2011&tx_ttnews%5Btt_news%5D=14121&cHash=e971c7c7bd43405b8ab4133fcf55ce74 (08.2018).

3. The European Court of Human Rights has recognized in its decision of 13 February 2003 that discrimination and the introduction of different legal systems are not compatible with Article 14 of the European Convention on Human Rights. Moreover, *Sharīᶜa* is incompatible with the fundamental principles of democracy set out in the Convention. Freedom of worship is primarily a matter of conscience of each individual. The sphere of individual consciousness is fundamentally different from that of private law which concerns the organization and functioning of society as a whole (Source: European Court Decision 13.2.2003, Bsw41340/98 Bsw41342/98 Bsw41343/98 Bsw41344/98).
4. The existing legal and social system will be shaken as a whole if *Sharīᶜa* is introduced in Austria and Europe.
5. In case of disputes, the courts, the administrative authorities, the Supreme Court, the Administrative Court and the Constitutional Court must decide on the basis of *Sharīᶜa* and differentiate between the products "*ḥalāl*" (authorized) and "*haram*" (prohibited), businesses, consumers and workers.
6. "What does religion have to do with the bank?" *Ḥalāl* certification is a commercial (economic) activity that requires a business license, not a religious activity. Compliance exams should not be monopolized by religious committees.
7. There is no separation between the state and religion.
8. *Sharīᶜa* is the basis of Islamic financial contracts between the bank and the client and must include all areas of life and activities of a person.
9. *Sharīᶜa* is the law of Islam. It is a divine law that interprets the Qur'ān and Sunnah and therefore is subjective. It is not a fixed code of laws such as the Austrian legal texts in the Civil Code or the Criminal Code. In addition, conservative fundamentalist Muslims say that this law as a value system is valid for all times and places. Moreover, it exceeds any other state law.
10. The religious rules and the *Sharīᶜa*-based legal system are beyond the laws of the national state and European law, which violates European law.

Here are some of the theses cited by the TKG to support their views on these developed standards and on Islamic finance in general in Austria. Other reasons are given on their website. However, analyzing the situa-

tion in Austria, it turns out that these two arguments—discrimination and prohibition—of two different legal systems in Europe represent an obstacle to the development of Islamic financial instruments and make the current legal regime full of uncertainties, thus, slowing the rise of Islamic finance in Austria.

4.7 Academic Situation of Islamic Finance in Austria

The growing popularity of Islamic finance is increasingly visible in the growing range of *Sharīᶜa*-compliant products and services. The Asia-Pacific and Middle East regions as well as the United Kingdom and the United States have seen several banks and Islamic banking units open in recent years. Nevertheless, this global evolution of finance and modern Islamic institutions indicates a gap in the promotion of Islamic finance in Austria as well as in the proper education of financial sector specialists in Austria.

Indeed, just like the Austrian financial market and its legal system, little progress has been made in the academic setting to encourage Islamic finance in Austria. To fill this gap, the Vienna University of Applied Sciences (International Management Center (IMC) Krems) offered, for the first time in Austria, short-term training for all interested parties entitled "Islamic Banking and Finance". This course took place at the Krems Campus, G Wing, and lasted for five days, from 29 January to 2 February 2013.[49]

The training was provided by academicians as well as international experts in the field, namely:

- Director Naser Al Ziyadat, Al Mashora & Al Rayah for Islamic Financial Consulting, Kuwait;
- Professor Dr. Sami Al Swailem, Islamic Development Bank (IDB), Saudi Arabia;
- Mag. Wilhelm Kerschbaum, European Institute for Islamic Finance, Austria
- Professor Christopher Schwand, IMC Krems.

[49] See website of IMC: FH KREMS. Last updated in 2018. "*First in Austria: Islamic Banking and Finance Course*". Available at: https://www.fh-krems.ac.at/de/aktuelles/artikel/first-in-austria-islamic-banking-and-finance-course/#.WSLMM-zKXCQ (08.2018).

The main objectives of this course were to:

- explain the most important origins and concepts of Islamic finance;
- develop an appropriate level of understanding of the main principles of Islamic banking and finance;
- expose participants to a wider range of Islamic banking and financial instruments available to industry stakeholders
- present countries where Islamic finance is practiced and widely used and share diverse business experiences;
- be able to assess the nature and scope of the Islamic financial industry relative to its conventional counterpart;
- define the different financing methods and contracts in Islamic finance;
- be familiar with Islamic financial infrastructure, international financial institutions and regulators and
- finally, help developing Islamic finance.

We contacted one of the managers, Professor Christopher Schwand, to know if this formation knows a success and an important demand. The latter revealed that the course "Islamic banking and finance" was a pilot project maintained three years ago for which demand has unfortunately remained below expectations. He added that he decided with the other leaders to adjust their efforts in this direction and concentrate on other subjects. Thus, the training was interrupted in 2014 and is no longer available.

On the other hand, there are some doctoral dissertations and master's theses which have treated Islamic finance in Austria as a subject under the supervision of professors from the University of Vienna, more precisely from the faculty of Economics and the Faculty of Philology and Cultural Studies, or the University of Applied Sciences BFI Vienna. The number of these studies is really very limited to count on the fingers of one hand.

4.8 Conclusion

This study aims to examine the current situation of Islamic finance in Austria. It was first necessary to recall the history of this sector in the country. The results of our research have shown that the subject of ethical investment has appeared in Austria since the 1980s. The SRI fund industry has experienced continuous growth in Austria, which accelerated in

the 2000s. SRIs have not only increased by the number of funds, but also by their volume. As for Islamic finance, despite the very old position of Islam and Muslims in the country, it must be said that it does not really date long. It was especially after the 2008 financial crisis that few initiatives were launched. But not all were able to hold to the end as the example of the *Baraka* who did not find a great success and had to close in 2016.

The second part studied the current situation of the various offers in *Sharīʿa*-compliant financial instruments, namely, in the banking sector, Islamic insurance (*Takāful*) and Islamic finance companies. In the banking sector, a number of Austrian banks are engaged in ethical investment, either internally in their management or externally, that is, products offered to customers. These ethical investments include several areas, namely, health, sustainable development, the environment, human rights and so on.

Apart from the ethical funds (SRI) offered to the market, BAWAG PSK is the only one of these Austrian banks which has been able to design a *Sharīʿa*-compliant product. It must be said that this mission was not easy for it at all. Indeed, its attempt to reach new "Muslim" customers with an account originally called "*Amana Konto*" and classified as an "Islamic" product triggered a very negative reaction among existing customers. As a result, the bank had to change its strategy; it later changed the labeling of the product with a neutral name *Budget Konto*. The bank has also said in the press and various social media that it does not do "Islamic banking" and that the product is a simple new model of accounts for all customers.

The Islamic insurance sector (*Takāful*), meanwhile, suffers from a lack of offers for the Austrian market. The only products that exist in the moment are mainly intended for international Islamic markets. Likewise, there is an absence of Islamic finance companies, the only start-up established in Vienna "My Islamic Finance Österreich" founded by Mr. Lamprecht had to close for economic reasons.

The third part looked into the legal situation. From the year 2010, Austria can host an Islamic financial activity thanks to two standards developed by the Austrian Institute for Standardization, under the initiative of the Islamic Information and Documentation Center of Austria (IIDZ Österreich). These standards, "ON-Regel 142001-1" and "ON-Regel 142001-2", guarantee that the certified product meets all the rules of *Sharīʿa* as they define all the principles and requirements related to Islamic financial products and services. However, this initiative has found great reluctance especially from the Turkish cultural community in Austria (TKG),

which has proclaimed that it is against Islamic finance and the establishment of a legal system derived from Islamic Law *Sharīᶜa*. It reinforced its refusal by arguing that according to the decision of the European Court of Human Rights on 13 February 2003, the establishment of two different legal systems (Austrian legal system and *Sharīᶜa* law) as well as the resulting discrimination from the offer of a product targeting specific clientele is completely forbidden in Europe.

Finally, the academic situation was the subject of our fourth part. The latter is not different from its previous ones. In general, the analysis found that little progress has been made in the academic setting to encourage Islamic finance in Austria. The only training that was offered by the University of Applied Sciences in Vienna (IMC Krems) titled "Islamic Banking and Finance" and which lasted for five days from 29 January to 2 February 2013 had to be interrupted in 2014 and is no longer available because the demand has unfortunately remained below expectations.

Generally, the study of various sectors, including financial, legal or academic, reveals that in this current situation, the prospects for the development of Islamic finance are not promising. The results show that the main causes slowing the evolution of this sector lie primarily and mainly in the great reluctance vis-à-vis the word "Islamic". Chapra suggested that it would have been better if the name "Islamic finance" had not been used. He argues that a number of principles of Islamic finance are also part of the Western tradition and that the name, "Islamic finance", can keep many people away. He suggested that "ethical funding" could have been a better term to use, and that would have been more acceptable. Moreover, contrary to popular fundamentals, it is not only to serve the Muslim population that is wary of the interest but also to provide an alternative to the current conventional funding for Muslims and non-Muslims.

These results also show that the Austrian legal framework is another obstacle to the development of Islamic financial instruments. Indeed, the big challenge is to bring the principles of *Sharīᶜa* and Austrian banking supervision under one roof. According to a report by Ernst & Young (2010), the limits of this development depend on permanent uncertainties about the legal and tax system to be applied. These uncertainties come essentially from the principle of the prohibition of interests. Also, the query of value-added tax, the tax treatment of profit margin income and double taxation in the case of real estate purchases are constant issues. Moreover, when it comes to the *Sharīᶜa* Board's need for governance of Islamic financial institutions, for example, the question that needs to be

addressed is how to classify it in legal terms and how to guarantee its independence required by law (Ongena and Zaheer 2013).

The academic situation will also play a key role in promoting Islamic finance in Austria. Academicians, researchers and experts in the field are a necessary source of support for Islamic finance. According to Wilson (2007), the development of Islamic finance can be seen as a populist movement rather than a government initiative. On the other hand, during our research, we have seen the scarcity of works and studies that deal with the subject of Islamic finance in Austria. From this observation, we can already envisage new tracks of research in this field specifically for this country.

It remains to say that the continued growth of the Muslim population in Austria and the flow of refugees from the Arab region to Austria are two favorable points which should bring a demand and will put more emphasis on Islamic finance in Austria.

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CHAPTER 5

Status of Islamic Finance in France in 2019

Mohyedine Hajjar

5.1 Introduction

As a result of the 2008 financial crisis, Islamic finance has received renewed interest in many countries around the world, both in the East and the West. This is how the United Kingdom, the main financial center in Europe, has established itself as a European pioneer in Islamic finance. Prime Minister David Cameron has said he wants to not only make London the leading Islamic finance country outside the Muslim world but also make it one of the most important Islamic finance capitals in the world, alongside Dubai and Kuala Lumpur.[1] The United Kingdom then became the first Western country to issue a *sovereign ṣukūk* in 2014 for £200 million[2] (the German Land of Saxony-Anhalt issued a €100 million

[1] This statement took place during the 9th World Islamic Economic Forum held in London in 2013. See World Islamic Economic Forum: Prime Ministers' speech, online at: https://www.gov.uk/government/speeches/world-islamic-economic-forum-prime-ministers-speech

[2] Government issues first Islamic bond, online at: https://www.gov.uk/government/news/government-issues-first-islamic-bond

M. Hajjar (✉)
Pantheon-Sorbonne University, Paris, France

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ṣukūk as soon as 2004). This success was followed later by Luxembourg and Germany.

These developments were closely followed in France, where the authorities and industry representatives explicitly expressed their interest in Islamic finance, having noted the potential development of this market. Insofar as the French practice of Islamic finance is often compared to that of its neighbor across the Channel, France has an admiring look, although there are flagrant differences between the two states. Indeed, in France, the legislator tried to introduce some particular texts to regulate the new born Islamic finance market (Sect. 5.3). Its evolution is, for its part, very slow and unsatisfactory (Sect. 5.4). Despite weak practice, this industry has sparked many academic works (Sect. 5.5).

5.2 France and Islamic Finance: Assessing the Potential Market

The development of Islamic finance in France is motivated by the presence of "the first Muslim community in Europe" as stated in a Senate report.[3] There is no official statistics about this community, though, and we must rely on Pew Research Center for a tentative measurement of around 5 million.[4] According to the Pew Research Center, Muslims will represent 10% of the French population by 2030,[5] exceeding the current percentage of 7.5% computed by Ipsos Mori.[6] Moreover, 41% of French Muslims declare being observants, according to the survey conducted by the IFOP institute.[7] The market volume of ḥalāl products which represents around €5.5 billion in France is growing rapidly[8] and shows the economic impact of the religious choices of the Muslim community. Eventually, the demographic structure of France is a significant potential for the development and evolution of Islamic finance, as Muslims are younger than the general

[3] Commission des finance du Sénat: "Rapport d'information", n°329, online at: https://www.senat.fr/rap/r07-329/r07-3291.pdf, p. 8.

[4] Pew Research Center: "The Future of the Global Muslim Population", online at: http://www.pewforum.org/2011/01/27/the-future-of-the-global-muslim-population/

[5] Ibidem.

[6] Ipsos Mori: "Perils of perception 2016", online at: https://www.ipsos.com/sites/default/files/2016-12/Perils-of-perception-2016.pdf

[7] Hakim El Karoui: "Un islam français est possible", Institut Montaigne & IFOP, Rapport Septembre 2016.

[8] Ibidem, p. 26.

population. Taking together all these factors, the demand for Islamic finance shall be strong and sustainable in France.

In view of their origins, important cultural and religious differences exist between Muslims living in different European countries, if not inside a given country (France accommodate mainly Maliki Muslims from Maghreb and sub-Saharan African plus a definite population of Hanafi Turks and Indians, especially in Reunion). It seems thus difficult to infer from the British experience how to successfully develop the supply of Islamic financial services in France, where the Muslim mix is both different and heterogeneous.

Since interest-bearing loans are prohibited under Islamic Law, French Muslims who are faithful to the precepts of Islamic Law lack the most basic financial services and are de facto discriminated by financial exclusion. The development of Islamic financial services in France will therefore be an opportunity to meet those needs, such as the acquisition of real estate or the investment projects in economic or human capital, as is currently possible in the United Kingdom. Thus, the potential French market for this alternative finance is promising, and the development of Islamic finance is likely to have a positive impact on the real economy.

Furthermore, France is one of the countries with the most comprehensive insurance requirements. Being the fifth OECD country for insurance penetration (% of GDP), France could thus benefit from the growth of Islamic insurance, which is called *Takāful*. Among the Muslim population in France, 35% consider their insurance needs unfulfilled due to non-compliance with Islamic ethics insurance coverage proposed.[9] If "*one or more players are able to offer competitive products, the takāful can represent 1.8 billion euros in takāful general (property & casualty insurance) and 1.7 billion euros in takāful family (life & health insurance). It would be sufficient for 1.75% of the French insurance market to go takāful, so that France can become the second largest takāful world market, just behind the Kingdom of Saudi Arabia*".[10] Thus, the establishment of an operator offering services that compete with conventional insurance services could become the pioneer of the *Takāful* market in France and even Europe.

In the following, we argue that such development would not require a "disruption" of positive law. It would be enough to reduce the legal and

[9] Ezzedine Ghlamallah: "La finance islamique française en 2016", in Dossier ENASS Papers 11, *Banque & Stratégie*, n°347.

[10] Ibidem.

fiscal frictions for Islamic banking and financial transactions. Such amendments appeared early in the form of tax instructions to facilitate access of Islamic financial services in France.

5.3 How Far Is French Legal Framework Suitable for Islamic Finance Operations?

The interest of France in Islamic finance began just before the 2008 financial crisis: the French authorities ostensibly sought investment from sovereign wealth funds of the Middle East, particularly from the Gulf countries, and tried to coordinate a response to the considerable potential internal market.

French law offers a wide contractual freedom and a generous range of flexible legal principles to structure Islamic banking and financial transactions while respecting public order. The introduction of these in France does not require a disruption of the French legal system as confirmed by the Report prepared by the Finance Commission of the French Senate.[11] However, some changes are needed to remove legal and tax friction. Thus, it was deemed preferable to amend specific texts governing these operations in order to ensure better control over the operations and the actors involved. We will therefore focus on the peculiarity of the legal texts adopted by the securities market regulator and the Tax Administration, although the absence of proper legal framework eventually proved unsatisfactory.

5.3.1 Proceedings of the Senate

The Senate was quick to publish the information report n°347 of 22 June 2007,[12] prepared on behalf of the joint information task force on economic decision-making centers and their consequences on the attractiveness of the country. This report highlights the need to support the emergence of Islamic finance in France.

In October 2007, an information report was released by the Senate[13] on the "*new golden age*" *of sovereign wealth funds in the Middle East*. This

[11] Commission des finance du Sénat: "Rapport d'information n°329", p. 8.

[12] Commission des finance du Sénat: "Rapport d'information n°329", online at: https://www.senat.fr/rap/r07-329/r07-3291.pdf

[13] Commission des finance du Sénat: "Rapport d'information n°33", 17/10/2007, online at: https://www.senat.fr/rap/r07-033/r07-0331.pdf

report contained a section dedicated to Islamic finance, which contributed to accelerate the interest in this peculiar type of alternative finance.[14] In order to attract sovereign investment funds, appropriate investment products had to be developed to meet their particular ethical needs, namely Islamic financial services.

On 14 May 2008, the Senate Finance Committee organized two workshops[15] bringing together experts and professionals to assess the opportunity and modalities for France to enter the Islamic finance market.

It emerged from this event

> *that the integration of Islamic products in the regulatory, accounting and prudential framework requires, of course, a thorough examination in order to avoid any external ambiguity and ensure an adequate level of protection to customers. But at this stage, no change in the legislative and regulatory framework of banking activities appears necessary to acclimate it to products. Nonetheless, certain prudential standards may, for their correct application, give rise to interpretation, as **it** is often the case when new financial techniques are introduced.*[16]

Today this statement seems overly optimistic as Islamic banking and financial activities did not develop as intended in France! This might be the result of the "benign" neglect from the legislator, who did not set a clear and precise legal framework to secure Islamic finance operations. By comparison, thanks to legislative and regulatory reforms, the United Kingdom has attracted global Islamic finance players.

Let us now return to the second roundtable of same Senate event, which dedicated to the study of the limit of the adaptation of the French legal framework to accommodate the Islamic finance. The panel concluded that no amendment of the Monetary and Financial Code was required and that the problem resulting from the implementation of Sharīʿa compliant products are easy to solve[17] with mere "tax instructions".

[14] Ibidem, pp. 37–40.

[15] The reports of the two workshops are available online at: https://www.senat.fr/rap/r07-329/r07-329.html

[16] Report of the second round table, *Le développement de la Finance Islamique en France: Quelles adaptations du cadre législatif et/ou réglementaire?*, online at: https://www.senat.fr/rap/r07-329/r07-3294.html

[17] Ibidem.

5.3.2 AMF's Explanatory Note on UCITS[18]

In order to foster financial innovation, the French securities and exchange commission, the *Autorité des Marchés Financiers* (AMF), published on 17 July 2007 an explanatory note dedicated to Islamic finance. This note was the first French legal text specifically targeted at Islamic finance. It is entitled "*Extra-financial criteria for the selection of assets and application to UCITS claiming conformity with Islamic law*".

This note explains how to reconcile the fundamental principles of "collective investment" operation and the specific features of Islamic mutual funds. According to that note, the extra-financial criteria required by the constituents must respect the following principles: the independence of the asset manager, the asset manager must be able to appreciate the extra-financial criteria it had defined, the extra-financial criteria used must comply with all applicable laws and regulations, and in index funds, the indices must comply with the provisions of Article R. 214-22, I of the Monetary and Financial Code. Similarly, the note required, for distribution of impure income to be valid, (1) to mention this possibility in the prospectus, (2) to nominate the beneficiary in the prospectus as well and (3) the beneficiary must be "recognized to be of public utility".[19]

This note, updated on 23 July 2015, inaugurated a long legislative and political activity aimed at facilitating the integration of Islamic finance operations into French law.

*5.3.3 "***Fiducie***" Regime*

In 2007, the French legislator adopted the regime of the "*fiducie*", French version of the Anglosaxon trust. Given that the trust is responsible for the economic roles of the trust, some researchers have argued that Islamic finance operations, such as Islamic *ṣukūk*, could be based on the "*fiducie*". The Senator Philippe Marini proposes an amendment to the "*fiducie*" law to develop the French financial system and facilitate the issuance of *ṣukūk*. Thus, an amendment of the "*fiducie*" regime was proposed by the law of

[18] The French term for Undertakings for Collective Investment in Transferable Securities (UCITS) is "Organismes de placement collectif en valeurs mobilières" or OPCVM.

[19] A non-profit organization can be "recognized to be of public utility" by the Government, based on the advice of the French administrative court "Conseil d'État". This is a lengthy and difficult procedure.

19 December 2009[20] by introducing a new paragraph in article 2011 giving the grantor or beneficiary a real right over the trust patrimony.[21] This proposal was intended to facilitate *ṣukūk* issuance by granting a beneficial right of ownership to the grantor or beneficiary as is the case with *muḍāraba*. This amendment was criticized for its contradiction with the essence of the fiduciary contract. Indeed, the recourse to the fiduciary patrimony aims at protecting the beneficiary who does not enjoy any right of ownership over the fiduciary assets. If the beneficiary is granted such a right, the trust patrimony will have no legal value and no cause of existence.

The most rigorous criticism of this amendment is the contradiction of this modification with the "*fiducie-sûreté*" regime, which loses its value if the founder retains both the ownership of the property and its possession. Thus, the trustee does not benefit from any guarantee through this contract conceived as a guarantee if he is no longer regarded as owner.[22] The contradictions caused by this law pushed the French Constitutional Council to declare its unconstitutionality in its decision of 14 October 2009.[23]

5.3.4 Tax Instructions

From what we just described, the French legislator has understood the importance of the regulation of Islamic finance in France. Thus, a timid project of legal and fiscal tuning was decided and resulted in the issuance of four tax instructions by the Ministry of Economy. These notes from 2009 clarified the taxation of the operations of *Murābaḥa*, *tawarruq*, *ijāra*, *istiṣnāᶜ* and investment *ṣukūks*. Two later sets of instructions were published on *ṣukūk* and *murābaḥa* in 2009 and 2010. The four first tax instructions were amended and published in the Official Tax Bulletin of 12 September 2012 as "Common Legal Provisions of Islamic Finance in France".[24]

[20] "Adptation du régime de la fiducie afin de permettre l'émission de 'Sukuk'", JCPE 2009 Act.322, et J. Charlin: "Fiducie, sukuks et autre murabaha ou ijāra, à propos de la finance islamique", JCPE 2009.1946, n°7 à 16.

[21] This law creates a second paragraph in the article 2011 which reads as follows: "The trustee exercises the fiduciary ownership of the assets contained in the trust patrimony, for the benefit of the beneficiary or beneficiaries, according to the stipulations of the trust agreement".

[22] For further details: L. Aynès et P. Crocq: "La fiducie préservée des audaces du législateur", D.2009, 2559.

[23] Ibidem.

[24] Bulletin Officiel des Impôts du 12/09/2012, BOI-DJC-FIN-20120912.

The purpose of these tax instructions is to describe the cases, in which these contracts may be used for the financing of assets or projects and to specify the tax rules applicable to them with regard to the various taxes concerned (corporate tax, income tax, value-added tax, registration fees and other French taxes).

5.3.4.1 Murābaḥa *and* Tawarruq

The tax instruction for the *Murābaḥa* to purchase order and *Tawarruq* defined the *Murābaḥa* as:

> *a financing contract under which a Client asks a Financier to finance the purchase of a particular asset or a portfolio of specified assets, in particular by carrying out two successive transfers of ownership in the following manner: a seller sells the asset to a Financier who resells it to a Customer for a price payable on hire purchase, which is higher than the price of acquisition up to a Profit. From a tax and accounting point of view, this Profit comprises an Income covering in particular the financing costs as well as possibly a Fee covering in particular the costs of management and setting up of the Financier: price, Fee and Income are determined or determinable and known by both contractors on the day of the conclusion of the contract.*[25]

In this transaction, the financier's income can be spread across the whole duration of the contract, as would be rent or interest payments under the provisions of Article 38 (2bis) of the French General Tax Code (CGI). The various tax aspects of the transaction (VAT, added value of companies, land assessment of companies, etc.) are regulated in the tax instruction as well.

The implementation of the *Murābaḥa* in French law implies, in principle, paying twice the transfer duties, which are quite high in the case of land property. This would therefore increase the cost of the transaction compared to conventional financial services such as the interest-bearing loan, where transfer duty is paid only once. Consequently, the tax authorities agreed to neutralize the dual collection of transfer duty: transaction costs are thus equal to registration fees for a single transfer of ownership, as with conventional financing.

In the case of *Tawarruq*, the tax instruction compares it with *Murābaḥa* and introduces it as the transaction in which "*the Client buys […] an asset*

[25] General Directorate of French Public Finance: "*Murābaḥa* Tax Instruction 4FE/S1/10" of 23 July 2010, published in BOI n°78, 24 August 2010.

with the intention of reselling it and uses the time between those payments to 'build up liquidity'". This transaction is subject to the tax principles regulating the *Murābaḥa* particularly with regard to the profit perceived by the financier.

5.3.4.2 Ṣukūk

The French tax administration, influenced by the similarity of actual debt instruments, considered the *ṣukūk* in the 2009 instruction as being debt instruments.[26] This qualification aims first and foremost at facilitating the tax treatment of *ṣukūk*, since the remuneration of *ṣukūk* holders is conceived as interest.[27] Without doubt, this qualification does not entirely coincide with the *ṣukūk* and their fundamental characteristic corresponding to the ownership of the underlying assets. This interpretation of *ṣukūk* income would be rejected by many specialists of Islamic finance. This qualification prevented all attempts to issue *ṣukūk* under French law, but it helped to publish new tax instructions in 2010.

In the newer tax instruction of 2010 dedicated to *ṣukūk*[28] (4 FE/S2/10), the tax administration defines the investment *ṣukūk* as follows: "*the investment ṣukūk here are negotiable hybrid financial securities whose remuneration and, if applicable, the principal are indexed to the performance of one or more underlying assets held directly or indirectly by the issuer. Their holder benefits from a right assimilated to a direct or indirect right of co-ownership over this or these assets. The asset or assets concerned are services, goods or rights or the usufruct of these goods or rights*". This definition was included in the subsequent tax instruction published on 12 September 2012.

Obviously, through this definition, we find that the right of the holder of this financial instrument does not constitute a right of joint ownership since the definition grants him a right merely *assimilated* to a right of joint ownership.[29] In addition, the tax instruction adds that these instruments

[26] General Directorate of French Public Finance: "*Ṣukūk* tax instruction 4FE/S2/10" of 23 July 2010 published in BOI, N°78, on 24/08/2010, See the definition of *ṣukūk*, n°4.

[27] B. Gérard Godard et F. Martin, "Les financements islamiques ou éthiques", *Les nouvelles fiscales*, n° 1069, June 2011, p. 18 et s.

[28] General Directorate of French Public Finance: "*Ṣukūk* tax instruction 4FE/S2/10" of 23 July 2010, published in Bulletin Officiel des Impôts, n°78, on 24 August 2010. See the definition of *ṣukūk*, n° 4.

[29] In accordance with this point of view: F. Barrière: "Propriété fiducie et *ṣukūk*", *JCPE* 2011.1203, n°22–23.

are debt securities indexed on the performance of an underlying asset.[30] The tax authority therefore decided the legal qualification of the *ṣukūk* as debt securities and considers the investor-manager relationship as a debt relationship indexed to the performance of an underlying asset. This legal situation blocks the issuance of the *ṣukūk* under French law because no Muslim scholar would certify the *Sharīʿa* compliance of this interpretation of *ṣukūk*.

The tax instruction dedicated to the *ṣukūk* aims to find an explicit criterion for the taxation of income of the *ṣukūk* in French tax law. Thus, *ṣukūk* are assimilated to debt securities or indexed loans facilitating the taxation of *ṣukūk* income and the calculation of taxes owed.

5.3.4.3 Ijāra *Operations*

The tax instruction defines *Ijāra* as

> *a contract under which an entity makes a movable or real estate asset available to a customer for a specified period in return for the payment of a rent. The client may be the original owner of the asset. Ijāra contract may include a promise to sell or a possible purchase option at maturity or during the terms of the contract. This promise to sell or this purchase option may be separated from the lease agreement.*[31]

The tax regime applicable to *Ijāra*'s contract depends on the legal qualification that will be used for the transaction, depending on whether or not it constitutes a financial lease transaction within the meaning of art. L.313-7 of the Monetary and Financial Code, or a lease with a purchase option (also known as "lease with promise of sale" in French-speaking countries).[32]

5.3.4.4 ***Istiṣnāʿ*** *Operations*

The *istiṣnāʿ* is defined by the tax instruction as "*a construction contract under which a Client asks a third party in charge of the construction, called 'the Manufacturer', to build a movable or immovable asset for a price payable in advance, by fractionated payments, on due date or by installment. The contract provides that the ownership of the constructed property is trans-*

[30] General Directorate of French Public Finance: "*Ṣukūk* tax instruction 4FE/S2/10", n°5.

[31] General Directorate of French Public Finance: "*Ijāra* Tax instruction 4FE/S3/10" of 23 July 2010, published in BOI n°78, 24 August 2010.

[32] Ibidem.

ferred to the Client upon completion".[33] In addition, the instruction also regulates the parallel *istiṣnāᶜ* which combines two *istiṣnāᶜ* contracts in a single operation in which the Financier acts as an intermediary between the manufacturer and the customer.

According to the tax instruction, an *Istiṣnāᶜ* transaction between a client and a manufacturer or between a financier and a manufacturer is a common purchase transaction including, where applicable, a distribution of payments and/or payment terms. The common taxation rules apply[34] (as above in the *Murābaḥa* case).

As for the parallel *istiṣnāᶜ*, the income of the financier is considered to be the remuneration of a deferred payment, considered for tax purpose to the interest that would be paid under conventional financing during the period.[35]

5.3.4.5 Further Developments

Despite the promulgation of the four tax instructions, those relating to the *muḍāraba*, *wakālā*, *salam* and *mushāraka* contracts, which had been announced, have not been published: as of July 2018, they are mere projects.

Since the publication of the tax instructions in 2012, the interest of the public authorities for Islamic finance has dropped since the efforts and the legal framework has remained unchanged. The current situation of Islamic finance development in France is the result of private initiatives only, which provides a diversified supply of solutions in spite of the limited suitability of the French legal framework.

5.4 Recent Evolution of Islamic Finance Practice in France

The introduction of Islamic banks in France is still expected by French Muslims but currently no Islamic bank has yet opened. However, some French banks have Islamic subsidiaries operating internationally, such as Société Générale Calyon, Sofider and BNP Paribas.

[33] General Directorate of French Public Finance: "*'istiṣnāᶜ* Tax instruction 4FE/S4/10" of 23 July 2010, published in BOI n°78, 24 August 2010.

[34] Ibidem, II-70.

[35] Ibidem, II-70.

Despite the absence of Islamic banks in France, the supply range of Islamic financial product appears to be well diversified and covers some of the main customer needs. However, the effectiveness and reliability of these products is not always on par with their conventional counterparts, especially for Muslims residing in France, which significantly affects the credibility of these products and accounts for the very low rate of subscriptions. We will present below the various products that have been issued in France in chronological order, to clearly present a view on the evolution of the practice in France.

5.4.1 An Analysis of the SGAM "AI Sharia Liquidité" UCITS

On 29 February 2008, the French Indian Ocean Business Bank (BFCOI), a subsidiary of *Société Générale* in Réunion, issued an IPO for an Islamic UCITS (Undertakings for Collective Investment in Transferable Securities) named SGAM AI Sharia Liquidity. This fund was therefore the first Francophone financial product complying with the requirements of Islamic Law and approved by the French Financial Markets Authority (AMF) under French law. Authorizations from the AMF were obtained in February and the fund was also certified by the Fiqh Cell of the Islamic Center of Reunion (CFCI).

Barely three months after its launch, the SGAM Shariah Liquidity product already reached €15.7 million. The product was thus fairly successful with a substantial amount raised through a public offering on a very small local market. During this short period, the fund managed to generate a small profit.

However, the existence of this fund was interrupted, allegedly by the subprime crisis that occurred that year. The manager, BFCOI, announced that after few months of positive activity SHARIA LIQUIDITE product, the deterioration of commodities markets and the complexity of the general economic situation no longer allowed to make an optimistic forecast of the future of the product performance of this investment. Thus, the BFCOI and the *Fiqh* cell of the Islamic Center of Réunion (CFCI) agreed on the suspension of this project, three months after its establishment. The BFCOI, in order to preserve the interests of investors and protect the capital gain acquired, decided to repay without any charge the shares held by every investor.[36]

[36] Fiqh cell of the Islamic Center of Reunion: "Communiqué of the fiqh cell of the Islamic Center of Reunion about the reimbursement of the shares of SGAM AI Sharia Liquidity", 31 March 2009.

Despite the very short existence of this project that was terminated with the global crisis of 2008, we note that the possibility and viability of this type of project was proved in Reunion and the (other French-speaking islands) Indian Ocean. We think that this attempt deserves a more extensive implementation.

5.4.2 An Analysis of the "CAAM Islamic"/"AMUNDI Islamic" UCITS

With more than 15 years of experience in the management of funds in accordance with Islamic Law, Crédit Agricole Asset Management Group (CAAM Group) launches CAAM Islamic, its first Islamic UCITS (SICAV), on 29 September 2009. This collective investment scheme under Luxembourg law, registered in France, aims to provide individuals and institutions with sub-funds invested in different asset classes strictly complying with the rules of *Sharīᶜa* with three compartments available in France: CAAM Islamic Quant BRIC, CAAM Islamic Asian Active Equity Ex-Japan and CAAM Islamic Multimanagers Global Equities.[37]

Following the merger of the asset management activities of the Crédit Agricole and Société Générale groups on 1 January 2010, Amundi changed the name of the Islamic SICAV CAAM Islamic to Amundi Islamic. The three sub-funds were renamed to Amundi Islamic BRIC Quant, Amundi Islamic Asian Active Equity Ex-Japan and Amundi Islamic Multimanagers Global Equities. In addition to these three sub-funds, a fourth was launched: Amundi Islamic Global Resources.[38] However, the Amundi Islamic Multimanagers Global Equities sub-fund appears to be closed with three sub-funds currently available and around $45 million asset.[39]

5.4.3 Insurance of Muslim Place of Worship in France

On 8 May 2011, Cabinet LABIDI insurance broker announced that it held exclusivity with ALLIANZ for the sale of insurance contracts for Muslim places of worship in France, with a coverage extension to the asso-

[37] Emily Firth: "CAAM launches its first Shariah Sicav", 29 September 2009, online at: http://citywireselector.com/news/caam-launches-its-first-shariah-sicav/a359293

[38] Credit Agricole: "Amundi annonce le changement de nom de sa SICAV CAAM Islamic en "Amundi Islamic"", press release of 07 September 2010, online at: https://www.credit-agricole.com/finance/finance/communiques-de-presse-generaux/amundi-annonce-le-changement-de-nom-de-sa-sicav-caam-islamic-en-amundi-islamic

[39] Data on the performance of the funds are available on the manager's website: https://www.amundi.fr/

ciative activities of mosques (Islamic science courses, Arabic language, calligraphy, etc.) and, above all, a free coverage extension to the outdoor premises (gymnasium…) rented by the mosque on the occasion of the two main Muslim religious festivals.[40]

5.4.4 Analysis of Chaabi Harmonis Banking Account

Chaabi Bank, a European subsidiary of the Banques Populaires Group of Morocco, headquartered in Paris, launched on 20 June 2011 "Chaabi Harmonis", the first personal bank account in France compliant with Islamic principles.

The Chaabi bank account is associated with several ancillary services such as a personalized account monitoring, a bank card for withdrawals and payments, a personalized checkbook, Internet account management and competitive rates for management fees.

The Harmonis service is the result of the cooperation between Chaabi Bank and the Islamic Finance Advisory and Assurance Services (IFAAS) ensuring compliance with Islamic Law and the Herbert Smith law firm providing legal advice related to the implementation, for the first time in France, of a product for individuals to manage a deposit account in accordance with the principles of Islamic finance. In addition, Chaabi Bank has delegated the marketing of this product to Sopi, a community-oriented communications consultancy.[41]

Toward its customers holding a Harmonis personal account, Chaabi Bank is committed:

(a) not to pay interest on Chaabi Harmonis deposits,
(b) to use these funds only for products and financings compatible with the principles of Islamic finance,
(c) to separate Chaabi Harmonis deposits from conventional funds and
(d) to be controlled and audited by a committee of independent Muslim scholars to ensure that the current account complies with Islamic precepts.

[40] Cabinet Labidi: "Assurance spécifique des lieux de culte musulmans en France", online at: http://www.cabinetlabidi.com/

[41] See the following article: https://ribh.wordpress.com/tag/chaabi-harmonis/

5.4.5 Swisslife's "Life Insurance" Investment Product

Launched on 4 July 2012, *Salam-Epargne & Placement* is a multi-asset life insurance contract for French residents, which is compliant with the principles of Islamic Law. It is backed by the UCITS (SICAV) Salam-Pax Ethical Fund of Funds whose investment area is composed solely of "Sharīʿa compliant" UCITS. The contract allows a designation of beneficiaries and allows them to build, value or transmit capital in a religiously lawful and fiscally advantageous manner. The *Salam Epargne & Placement* contract and the Salam-Pax UCITS were certified by the French *Sharīʿa* board CIFIE (Independent Committee for Islamic Finance in Europe) (Fig. 5.1).[42]

This product is characterized by:

- free payment with an absolute minimum of €1500,
- entry threshold on a given vehicle: €75,

PERFORMANCES DU FONDS

A LA FIN DE MOIS GLISSANTES

	1er JANVIER	1 MOIS	6 MOIS	1 AN	3 ANS	5 ANS	10 ANS
FONDS	-0.72%	-1.22%	2.81%	0.61%	3.06%	9.49%	-
CATEGORIE	6.04%	0.18%	9.87%	9.89%	28.85%	52.04%	124.34%
CLASSEMENT*	100	86	100	100	100	100	0

*Rangs calculés en percentile par Morningstar sur la dernière valeur liquidative du mois précédent

Consulter les infos des autres fonds

PERFORMANCES ANNUELLES DES 5 DERNIÈRES ANNÉES

	2013	2014	2015	2016	2017
Fonds	+3.24%	+10.10%	+0.29%	-1.39%	+0.35%
Catégorie	+13.25%	+15.37%	+6.83%	+8.58%	+4.97%
Classement	89	83	83	98	79

Calcul fin de mois au 30/09/2018

Fig. 5.1 SICAV performance *Salam*-pax Ethical Fund of Funds (15 October 2018). (Source: http://www.boursorama.com/)

[42] Swisslife: "Swiss Life lance *Salam*-Epargne & Placement, le premier contrat d'assurance vie conforme aux principes de la finance islamique", online at: http://www.swisslife.fr/Le-Groupe/Swiss-Life-en-France/Communiques/Swiss-Life-lance-*Salam*-Epargne-Placement-le-premier-contrat-d-assurance-vie-conforme-aux-principes-de-la-finance-islamique

- payment charge (maximum): 4.95% and
- unit management fees: 1.10% of assets, on an annual basis.

Despite the importance and innovation of this product, it remains marginal in the market compared to the estimated potential. The number of subscriptions to *Salam-Epargne & Placement* life insurance is still low.[43] This seems to be the consequence of insufficient marketing of the product.

5.4.6 Ṣukūk *Orasis*

Moreover, in July 2012 the first French *ṣukūk Ijāra* and *Mushāraka* (*ṣukūk* Orasis) is offered to the French investors on behalf of Global Patrimoine Investissement, also known as Legendre Patrimoine. This investment product had been certified by CIFIE.[44]

The holders of these new *ṣukūk* securities will be co-owners, through this investment, of photovoltaic plants that will produce renewable energy for EDF (Electricité de France is the French leading electricity producer). They will receive either their share of the yield from the lease of the power plants (as part of the *Ṣukūk Ijāra* structure) or the dividends of the shares linked to the investment in these power stations (as part of the *Ṣukūk Mushāraka* structure).

The financial structure used is quite flexible. Each issue of *ṣukūk* is dedicated to a solar power station allowing flexibility regarding the dates and the sizes of the issuances, which depend on the price of the implementation of each power station. Investors have an option to resell the plant in the tenth year at 87% of its original cost. Taking into account the amount of the repayment and the annual revaluation of the coupon, the *ṣukūk* has an actuarial yield of 6.01%. The Sharīʿa board is critical about this option and recommends that bearers do not exercise the option in order to comply with the requirements of Sharīʿa.[45]

[43] Information given by Dr. Tarik Bengari, president of CIFIE who is certifying and auditing this product.

[44] M. Zaidman: "Searching for new partners to overcome the lack of independence of LEGENDRE PATRIMOINE", online at: http://palimpsestes.fr/IUT/pmo/pmo2014/pmo-final/E.pdf

[45] Al-Khawarizmi group: *Sukūks, A new financing alternative for Morocco,* 28 December 2012, pp. 97–98.

Fact sheet of these *ṣukūk*[46]:

- Subscription by multiple of €5000 (+ recoverable VAT).
- Totally secure investment: Guaranteed EDF contract over 20 years.
- Yearly collection of income (industrial and commercial income).
- Payment is not interest (*riba*) since it corresponds to the rent of a power station.
- The rent is revalued each year by a minimum index of 1% for an investment in a dedicated partnership (Société En Participation).
- No tax or social insurance contribution (CSG-CRDS) for 10 years.
- Eco-responsible investment.
- The subscription is open to individuals.

We wish to draw attention to the fact that the name *ṣukūk* for this financial product is only a commercial name, not a legal qualification. In reality, the product is not a "*ṣakk*" per se. It is simply a *stake* in a dedicated partnership (société en participation) under French corporate law, there is no formal issuance of securities under financial law.

Despite optimistic expectations, this experiment was a failure. On 7 June 2016, the AMF pronounced against the company Global Patrimoine Investissement (GPI), with the commercial name Legendre Patrimoine, a financial penalty of €500,000 and a disciplinary sanction, a three-year ban on advising investors. This sanction was imposed as the sale by GPI infringed investment law. Thus, this was overall a bad experience for the emerging market of Islamic finance in France.

5.4.7 Ṣukūk *Al Farooj*

Another example of structuring *ṣukūk* under French law is provided by Al Farooj. Al Farooj France Gestion is a simplified joint-stock company looking for medium-term financing in order to ensure the development of one of its projects, developed through its subsidiary AFF Alfortville, a partnership with a capital of €1000. Given these circumstances, the Issuer has targeted several investors in order to obtain financing by way of issuance of indexed bonds for an outstanding amount of €350,000, corresponding to the issuance of 3500 securities with a nominal value of €100 each. This

[46] "France: Islamic finance to finance the energy transition?" Online at: https://ribh.wordpress.com/tag/legendre-patrimoine/

issuance, dated 10 July 2012, took place under instruction 4 FE/S2/10, the bonds being treated as *investment ṣukūk*. The amount collected will be used to finance the investment required to start the activity of the Subsidiary. The payment of the remuneration is contingent on the fulfillment of the conditions contained in the prospectus.[47]

Investors are warned of the risks associated with the possible non-collection of remuneration and the partial or total non-repayment of securities.

On the issuance date, the Issuer allocates €40,000 (11.5%) to a reserve account dedicated to the bonds, called Reserve Account 1. The amount of the subscription for the Bonds and the amount of the Reserve Account 1 will be made available to the Subsidiary via a non-interest-bearing current account allocated to the financing of the Subsidiary's investments and working capital. The current account may be the subject of reimbursement requests by the Issuer to enable it to meet its payment obligations to Investors. The Issuer will establish a second reserve account and, collectively with the Reserve Account 1, the Reserve Accounts will be intended to be replenished by the profit distributions of the Subsidiary.[48]

The Issuer commits itself to[49]:

1. make all decisions so that all of the distributable profits of the Subsidiary are, each year, distributed to the Issuer, to the fullest extent permitted by the applicable provisions and
2. allocate the profit of the Subsidiary, after deduction of the amounts allocated to the legal reserve and the corporate tax owed by the Issuer, in priority to contribute to the Reserve Accounts up to the amount corresponding on the one hand to the remuneration of the securities and on the other hand to the repayment of the principal of the securities. All of the remaining profits of the Subsidiary after the deductions referred to above and after the addition of the Reserve Account 1 will be allocated to the Reserve Account 2 as follows:
    (a) 1% of the net profits of the Subsidiary will be allocated to an Issuer's sub-account and
    (b) the balance will be allocated to an Investor's sub-account.

[47] Al-Khawarizmi group: *Sukūks, A new financing alternative for Morocco,* 28 December 2012, p. 94.

[48] Ibidem.

[49] Ibidem.

5.4.8 Ṣukūk ʾistiṣnāᶜ from Medialink

On 9 May 2013, the Specialized Investment Fund MEDIALINK was approved by CIFIE for issuance of *ṣukūk 'istiṣnāᶜ* based on the "Start 2" financial package. The underlying asset was the "manufacturing" of movies complying with the rules of Islamic Law. Such issuance is said to happen "for the first time in the field of ethical cinema in accordance with the precepts of Islam".[50] This instrument is characterized by a targeted annual performance of 15%, broken down as follows[51]:

- 5% * of the net profit will be distributed in the form of Alms (with the agreement of the investor) given to a foundation, which will be created to help young Muslims wishing to train or develop projects related to the production of ethical movies. This foundation will be able to collect other funds for the same purpose. The investor can refuse this donation to alms, although the commitment of the General Partner is definitive for its part.

  * The choice of the rate of 5%, 2.5% or 0% is freely available to the investor. The General Partner commits to a minimum of 2.5%.

- The balance will be divided between the investors (80%) and the managers of the fund (20%).
- Each investor will be individually responsible for his or her annual *zakāt*.

The same remark on the legal qualification of the "*ṣukūk Legendre*" is also valid for these "*ṣukūk*". In reality, the product is not a "*ṣakk*" per se. It is simply a share of a fund (namely, a French UCITS) complying with the precepts of Islamic Law. The use of the name "*ṣakk*" is only commercial.

5.4.9 Islamic Real Estate Financing by Chaabi Bank

Chaabi Bank announced on 17 June 2013 a new Islamic real estate financing service. This financing is based on the *Murābaḥa* contract where the

[50] CIFIE: "1st *ṣukūk 'istiṣnāᶜ* for the production of ethical films", online at: http://www.cifie.fr/1ers-sukuk-istiṣnāᶜ-pour-la-construction-de-films-ethiques/

[51] Ibidem.

bank buys the seller's property, designated by the client, and sells it back to him including an agreed and known profit margin.[52]

This service is distributed by 570Easi broker. The number of real estate loans granted by 570Easi is 647 financings according to the latest announcement in April 2017.[53] On 18 October 2019, we have received an updated info from 570Easi's Facebook page manager, the real estate loans granted by the broker is 910 operations. 570Easi cooperates with other financial institutions to finance real estate operations, while the lending banks stay anonymous.

5.4.10 Amâne Exclusive Live from Vitis Life

On 7 October 2013, Vitis Life, a Luxembourg company owned by Qatari investors, launched a new high-end Islamic life insurance named Amâne, an Islamic unit-linked contract, in accordance with the principles of Islamic finance. This contract is reserved for a wealthy clientele, with a minimum subscription amount of €250,000.[54]

The contract takes the form of a *Wakālā*, where the insurer (*Wakîl*) is mandated, for a fixed fee, by the policyholder/underwriter (*Mouwakkil*) to invest their "premiums" in Sharīʿa compliant in unit-linked underlying assets (See list provided in the contract). The lessee/subscriber has the choice of investment media from the proposed Sharīʿa compliant unit-linked vehicle. This contract is characterized by[55]:

- No guarantee of capital (the value of the underlying assets is not guaranteed, but is subject to upward or downward fluctuations depending in particular on the evolution of the financial markets).
- No death or floor guarantee and no life annuity.
- No leverage: "what you see is what you get".
- Good diversification in the ḥalāl investment universe.
- No funds in Euros.

[52] Chaabi Bank: "La Murābaḥa, Un financement immobilier compatible avec la finance éthique et islamique", online at: http://www.chaabibank.fr/produit/la-Mourabaha/

[53] As announced by 570Easi: https://www.al-kanz.org/2017/04/13/financement-immobilier-riba/

[54] CIFIE: "VITIS LIFE lance Amâne Exclusive Life", en ligne sur: http://www.cifie.fr/vitis-life-lance-amane-exclusive-life/

[55] Ibidem.

- Compulsory Sharīʿa compliant buffer account (at KBL European Private Bankers which transfers the cash amount to the "call deposit" account (in the same currency) opened at QIB UK London). This buffer account does not generate any credit/debit interest and is not invested either in the general assets of the bank (neither monetary nor bond-based) but in Sharīʿa compliant products certified by their own Sharīʿa board.
- Compulsory submission to the semi-annual Sharīʿa audit of CIFIE.

5.4.11 Ethraa Family Takāful

Insurer Atlantic Lux (FWU Group), famous for having successfully developed several Islamic financial products (*Takāful*, *ṣukūk*), in the Middle East and Asia, presented a new *Takāful* product available in France. Ethraa Takāful Family was validated, on 13 November 2014, by a *fatwa* indicating its compliance with Islamic Law.

This is a *mixed* contract with both a death coverage module and a unit-linked accumulation module. A mixed contract means that the money saved serves two ends: a part is used to build capital, to provide for retirement, for paying for the children's education and so on, and the other part is used to finance the death insurance, so that on the day of the death of the subscriber the named beneficiaries recover compensation. The disadvantage is that this compensation is quite low in comparison to the amount paid.[56]

It seems quite strange to sell this type of contract since mixed contracts have been abandoned in France after the scandal of the *Afer*. According to some expert practitioners of Islamic and conventional insurance, "*it's more of a progressive life insurance, with premium in case of death, but it is inefficient for savings: it's a very bad deal for anyone looking to save for the future*".[57]

[56] "Ethra'a Takāful Famille: the wrong good idea", published on 05 March 2015, updated on 19 June 2015, en ligne sur: http://lafinanceislamique.com/infos-finance-ḥalāl/etude-ethraa-takāful-famille/

[57] Ibidem.

5.4.12 Noorassur Individual Health *Takāful*

On 5 July 2016, the *Compliance Committee with the Sharīʿa* (*Comité de Conformité avec la Charia*) has certified the *Takāful* Noorassur Individual Health, corresponding to an Islamic window in a mutual insurance company operating under French law. In this arrangement, inflows and outflows are segregated, allowing for the ring-fencing of *Takāful* funds. The relations between the *Takāful* fund (the Islamic window) and the Operator (the mutual) are governed by a *Wakālā*.[58]

In addition, Noorassur presents several savings services that are based on investment in the *Salam*-Pax SICAV via the Salam savings and investment life insurance policies and the Luxembourg-based *ṣukūk Salam*-Pax Serenity *ṣukūk*. It offers various saving plans for home, marriage, pilgrimage, education, retirement and even a so-called investment service.[59]

5.4.13 Analysis of Chaabi Damanis Banking Account

On 01 February 2017, Chaabi Bank launches the account Chaabi Damanis, an Islamic bank account enabling the owner to secure his/her savings. Chaabi Damanis is an alternative solution to basic savings products to build capital at your own pace. It is actually a "piggy bank" bank account.

This account with Chaabi Damanis is exempt from management fees and does not pay interest. Deposits are covered by the Deposit and Resolution Guarantee Fund (FGDR). It is certified by the French *Sharīʿa* Board ACERFI.

The account starts working with a minimum deposit of €100 and must operate exclusively in the creditor position, as overdrafts are not allowed. The saver does not have payment methods such as check and/or credit card. Current operations can be performed as follows:

(a) To the credit of the account:
Cash payment, Check presentation, Receipt of a SEPA transfer and/or Receipt of a non-SEPA transfer

[58] Noorassur: "Noorassur Santé Individuel" (customer information document).
[59] See all offers online at: http://www.noorassur.com/nos-produits-finance-islamique.php

(b) Account debit:
Withdrawal of cash in agencies without check issuance, Issuing a SEPA transfer and/or Issuing a non-SEPA transfer.[60]

With these features, the Chaabi Damanis Banking Account is an interest-free savings account.

Until now, the French Islamic finance market remains a gold field to mine given the absence of both Islamic banks and conventional operators in this market, since the latter fear a risk for their image. This concern of conventional operators justifies the use of brokers and intermediaries who distribute Islamic products. In addition, several compliance committees under Muslim law are founded in France: ACERFI, CIFIE and COFFIS. Several brokers and consulting firms are active in this segment such as AG Takaful, Groupe570, IFAAS, Inaya Insurance, Noorassur, SAAFI and so on. Similarly, some associations and training firms are active in public awareness of Islamic finance such as AIDIMM, IFSO and Isla-Finance which organize symposiums and conferences on the subject.

5.4.14 Concluding Remarks on French Islamic Finance Market

1. So far, "Islamic" brokers did not manage to earn the confidence of the general public. The public seems to be waiting for the mainstream banks or insurance companies to introduce mainstream products. The only experience of this nature was with the SGAM fund, which was fairly successful in attracting public demand; therefore, we can assume an Islamic product range by a major financial institution would meet market demand.
2. Some major French financial institutions supply customers with Islamic financial products but they do not want to make it public.
3. As a consequence, current marketing plans do not meet the public's expectations: even if some products such as Salam-Pax seem rather fit for demand, they only attract several hundreds of customers (around 700 in this particular case).

[60] The description of this bank account was summarized from: Chaabi Bank: "Convention Chaabi Damanis, Clientèle des particuliers, Conditions générales", in effect from 01 January 2017, The Islamic Finance Journal: "Damanis, le compte tirelire ḥalāl de Chaabi Bank".

4. In the absence of Islamic banks or Islamic windows, the market is left to brokers.
5. It is common knowledge among market initiates that projects to launch fully fledged Islamic banks around 2010 were dismissed by the regulator, which did not grant them with a banking license. No analysis of this story has ever been published, hence it is difficult to assess whether the problem comes from extreme prudence of the regulator or amateurism of the proponents. Many rumors circulate about constituting Islamic banks in France.[61]

5.5 Islamic Finance Training

Unlike the market for Islamic financial products in France, the training sector is well developed. We can list several types of Islamic finance training to meet various needs. There is a full range of training programs, from introductory courses to intensive training seminars and a full MBA.

5.5.1 Executive MBA in Islamic Finance[62]

On 21 January 2009, the Strasbourg School of Management launched the first specialized training in Islamic finance under the auspices of a French university. The Islamic Finance Executive MBA is a graduate degree (five years of studies post-secondary school).

Its objective was to provide technical skills in finance, law and management tailored to the needs of international companies, law firms or banking institutions, in order to develop critical analysis through synthetic lessons (case studies, simulations and market room), and to raise awareness about the importance of skills and knowledge specific to the development model of Islamic banking and finance in the countries where they operate (Africa, Gulf countries, South East Asia and Europe).[63]

This rich training is spread over a large numbers of hours—405 hours—spread over 11 months of courses with a three-day monthly session. The

[61] For example, al-Baraka Bank: "Al Baraka will open several agencies in France" online at: https://ribh.wordpress.com/2010/09/27/al-baraka-france/

[62] Formation website: https://sfc.unistra.fr/formations/audiovisuel_-_audiovisuel-traduction-interpretariat_-_executive-mba-finance-islamique_-_769/

[63] http://www.ifso-asso.com/emba-finance-islamique/

diversified program includes the main subjects in this discipline such as: Islamic economics, Islamic banking and finance law, Islamic banks, Islamic financial markets, the regulation of Islamic financial institutions, the management and governance of Islamic financial institutions and the Islamic insurance. Likewise, it presents several complementary subjects such as taxation and the system of imposition to Islamic operations, notation, Islamic marketing, waqf and Islamic microcredit. The student must present at the end of the course a research paper.

5.5.2 *Diploma in Islamic Economics and Finance (DEFI)*[64]

Since its creation, the International Institute of Islamic Thought (IIIT) has been interested in issues related to contemporary Islamic thought and has been presenting in France an intellectual forum for the promotion and support of research projects. IIIT had a scientific production and a publication of high-level academic works, among others, in the field of economics and Islamic finance. In the same vein, the IIIT France had set up a research group in Islamic economics and finance (GREFI), whose work was intended to be published.

In September 2009, IIIT France launched a specialized training course in Islamic economics and finance. The training is aimed at a professional audience as well as students and researchers, having at least the level of bachelor and wanting to get involved in the field of economics and finance through the acquisition of theoretical and practical knowledge.

The content of the training is designed to enable students to grasp the basic foundations of an Islamic economics, to master the analytical tools and to reflect on ethical practices and alternatives. This leads the student, at the end of their training, to acquiring a know-how in Islamic finance, allowing them to pursue a professional career in financial institutions (banks, audit firm, insurance companies, etc.).

The hourly volume was 300 hours, three sessions in the evening per week: Monday, Wednesday and Friday. Conferences and symposiums related to the training were also planned during the year.

[64] See the following article: “IIIT-France lance une formation en Finance Islamique” on the Journal of Islamic Finance, online at: https://ribh.wordpress.com/2009/09/24/iiit-france/

Unfortunately, the IIIT France is closed since 2010 having supervised students for only two years. But some graduates of this training program have become leaders of Islamic finance in France.

5.5.3 *Executive Master Principles and Practices of Islamic Finance*[65]

The diploma "Principles and Practices of Islamic Finance" is a graduate degree (five years of studies post-secondary school) launched by the Paris-Dauphine University in 2009.

The rich program covers 420 hours of teaching by presenting the theoretical and practical education of Islamic finance. Indeed, it gives the prerequisites necessary for the understanding of finance. Also, a large part of the program is dedicated to the practical and up-to-date teaching by recognized professionals in the Islamic finance industry. The program integrates all components of the industry ranging from Islamic business law, Arab economy, Islamic banking, asset management, Islamic insurance to Islamic financial structuring.

The objective of the training is to understand and master the concepts and techniques used by Islamic finance to structure products that meet the needs of investors looking for a financial performance, with is in line with their system of values and ethical principles.

This Executive Master is intended for professionals and students working in the Islamic financial industry, or working in non-Islamic financial institutions but who are looking for employees knowledgeable about the issues of Islamic banks.

Given the success of the Executive Master, Paris Dauphine University has expanded its audience and opened this training to the Moroccan public in its Casablanca campus. This initiative comes at a strategic time to meet an increased need after the start of the Islamic banking activity in Morocco.

5.5.4 *Chair of Ethics and Financial Norms (CEFN/CENF)*[66]

On 8 January 2011, the President of Paris 1 University (Panthéon-Sorbonne) signed an agreement with the Saudi Minister of Higher Education

[65] Formation website: http://www.financeislamique.dauphine.fr/
[66] Chair website: http://cenf.univ-paris1.fr/

in the framework of the creation of a joint Chair with King Abdulaziz University in the field of ethics and standards of finance. This field responds to an obvious demand and is part of the continuity of the research activities of the Paris I University, since it contributes significantly to the European Research Group (CNRS) "Monnaie-Banque-Finance" and its axis "Islamic finance", as well as the laboratory of excellence on Financial Regulation that it helped to found. On the Saudi side, the Islamic Economics Institute publishes the Journal of King Abdulaziz University–Islamic Economics (EconLit), the first scientific journal with a peer-review committee dedicated to Islamic finance, which demonstrates international expertise.

The activities of the Chair began on May 2011, with the holding of a monthly seminar by videoconference between the Center for Research on Islamic Economy in Jeddah and the University Paris 1 Panthéon-Sorbonne. The program of the various seminars recalls the multidisciplinary vocation of the Chair, at the interface of law, economics, finance and history. The monthly seminar is held every second Wednesday of each month.

In addition, the Chair contributes to the dissemination of specialized scientific writing in finance and Islamic economy. A specific series entitled Ethics and Norms of Finance was launched in the IRJS publications. This collection has published some significant PhD theses on Islamic finance.

5.5.5 Islamic Banking and Finance Certificate

The Islamic Banking and Finance Certificate is a training diploma given inside the regular curriculum at Reims Management School. It is "one of the options in the MSc in Finance and International Banking at RMS. To be awarded this full MSc degree, students must obtain the Certificate of Finance and the specialized certificate in either Islamic Banking and Finance or International Banking".[67]

This Certificate was launched in 2011–2012, aiming people who are already working or students who are interested in working in the sector of Islamic finance. They "can obtain additional specialization in the field by adding to their initial qualifications a certificate representing 180 hours of classes".[68]

[67] Ghassen Bouslama: "Islamic Finance in Reims Management School", in *Islamic Finance in Western Higher Education* by Ahmed Belouafi, Abderrazak Belabes, Cristina Trullols, Palgrave Macmillan, 2012, p. 138.

[68] Ibidem, p. 137.

> Thus, this certificate is fully taught in English and planned over a period of four months, which represents 180 hours, the equivalent of half a Master of Science. It has four courses of 45 hours each which cover Shar'iah rules in financial transactions, Islamic economics, deposit and financing operations of Islamic banks and Islamic capital markets. The certificate is intended for practitioners, bankers, financiers, and lawyers with a solid educational background; and for students with at least a Bachelor's degree or equivalent from a recognized educational institution.[69]
>
> The certificate is jointly taught with the Malaysian university INCEIF and complies with the Chartered Islamic Finance Professional (CIFP) Part 1 delivered by INCEIF.[70]

Unfortunately, this Certificate was canceled on 2013 promoting two classes only.

5.5.6 Master II Islamic Finance[71]

In 2013, the University of Strasbourg launched, in the Faculty of Law, the first national diploma dedicated to Islamic finance. This Master II in Islamic Finance is embedded in a broader and more comprehensive training. An M1 in "Islamology, Law and Management" gives access to this Master II of Islamic Finance and another Master II in "Islamology" in the Faculty of Law.[72]

The Master I in "Islamology, Law and Management" offers a rich program ensuring a good understanding of the history of Islam, foundations of Islamic Law (*uṣūl al-fiqh*) and Islamic Law (*fiqh*). This program is solidified by topics concerning the law of religions in France and the comparative approach of religions.[73]

The aforementioned Master I prepares students to enter the Master II in Islamic Finance which is well laden with deep subjects. The Master II in Islamic Finance provides all the essential subjects in this discipline by providing courses in Islamic economics, banking and financial Islamic Law,

[69] Ibidem.

[70] Ibidem, p. 138.

[71] The information presented about this Master is taken from the master's brochure we received from the secretariat of the Faculty of Law of the University of Strasbourg.

[72] Ibidem.

[73] Ibidem.

Islamic banking, Islamic financial markets, governance of Islamic financial institutions and the taxation of Islamic finance.[74]

This Master (M1 & M2) was canceled and the Islamology program is transferred to the history department at the University of Strasbourg. The last class in "M2 Islamic Finance" was at the academic year 2014–2015.

5.5.7 *Certificat en Economie et Finance Islamique (CEFI)*[75]

In September 2015, the European Institute of Human Sciences in Paris (IESH de Paris) launched an Islamic Economics and Finance Certificate.

It aimed professionals, researchers and students interested in the Islamic financial industry. The objectives of the CEFI were to understand and master the foundations and philosophy of Islamic finance and economics, to understand the concepts and techniques used by Islamic finance and to have a critical overview of the conformity of Islamic transactions, contracts and products in Islamic Law.

The training was condensed into 120 hours, spread over one academic year for a session of 4 hours per week. The program, rich and diversified, included the main subjects of this discipline as: principles and purposes of Islamic transactions, contracts for Islamic financial transactions, Islamic banks, principles and institutions of the Islamic economy, Islamic insurance and Islamic financial markets. At the end of the training, the students were required to present a research paper.

This certificate represented a compromise between extended diplomas, such as the Executive Masters in Paris-Dauphine and the Executive MBA at Strasbourg Management Business School and short certificates. Despite this peculiarity, this Diploma did not last more than two years. The European Institute replaced this certificate with a more brief testimony, in which the same materials are presented within 32 hours of study.[76]

[74] Ibidem.

[75] The information in this section is taken from the Certificate Profile as we received from the Student Affairs Section at IESH.

[76] The presentation of this short certificate can be consulted on the Institute Website: https://ieshdeparis.fr/formation-certificat-de-finance-islamique/

5.5.8 *Islamic Asset Management and Takāful Insurance Certificate*[77]

In April 2016, Paris Dauphine University launched in Marseille in partnership with Kedge Business School, an "Islamic Asset Management – Takāful Insurance Certificate".[78] The certificate corresponds to a Bac + 3 and the quality of the professional experience can be taken into account to accept professionals who do not have a diploma BAC + 2.

The training is designed for employees working in the banking sector, asset management, insurers, bank advisers and wealth management advisers. It is taught over 96 hours and presents a very concentrated program in this area.[79]

The training aims to explain Islamic finance, its functioning and its markets, while making the students understand the foundations and the specialties of Takāful insurance in order to master the main products and their modalities, to acquire technical skills related to Islamic asset management and to understand the legal and regulatory framework, and the marketing communication strategies of this type of products.[80]

5.5.9 *Certificate in Islamic and Participative Finance*

As part of its training in Islamic finance in France (Isla-Finance), the Islamic Finance Advisory and Assurance Services (IFAAS) organizes several courses in Islamic finance.[81]

In September 2015, Isla-Finance launched a professional training in Islamic finance. The program is spread over 192 hours of classes covering the various disciplines of this industry. However, this training, which spans

[77] See the training course presentation: https://formation.kedge.edu/formations-courtes/gestion-d-actifs-islamiques-assurance-takaful

[78] Nicolas Thouet: "Finance islamique: l'université Paris-Dauphine lance une formation Takaful", https://www.argusdelassurance.com/acteurs/finance-islamique-l-universite-paris-dauphine-lance-une-formation-takaful.116268

[79] Press release: "Paris-Dauphine University launches a certificate of Islamic finance at Kedge Business School", https://kedge.edu/l-ecole/communiques/l-universite-paris-dauphine-lance-un-certificat-de-finance-islamique-a-kedge-business-school

[80] See the training course presentation: https://formation.kedge.edu/formations-courtes/gestion-d-actifs-islamiques-assurance-takaful

[81] See the different courses proposed by IFAAS at: http://formation.isla-finance.com/

one academic year, has been replaced by other shorter courses: face-to-face and online trainings.[82]

Isla-Finance offers an intensive training in Islamic finance giving access to a "Certificate in Islamic and Participative Finance". Taking place in Paris 20th, the training is spread over two levels of study. The first is spread over 4 study days and consists of 28 hours of lessons with 6 modules, while the second is spread over 5 study days and includes 35 hours of lessons with 7 modules. This training requires two years of studies post-secondary school prerequisite.[83]

In addition, Isla-Finance has launched in 2017 an online training for students wishing to gain knowledge in Islamic finance but not having the opportunity to move to Paris. This lightened training offers 12 modules spread over 36 hours of lessons.[84]

The two Isla-Finance training courses (IFAAS) are designed for professionals, researchers and any other person looking for new challenges or professional reorientation.[85]

5.5.10 Islamic Finance Digital University (UNEFI)[86]

The beginning of 2015 was marked by the emergence of a specialized university for training in Islamic finance. On 29 September 2015 the Islamic Finance Digital University (L'Université Numérique en Finance Islamique UNEFI) began its activities in Paris. This initiative is characterized by its nature as e-learning training based on the MOOC system, which enables the various interested French-speaking persons living outside France to follow the courses of the Digital University.

UNEFI offers mixed certifying courses, between theory and practice, and supervised by a pedagogical committee bringing together experts of international renown. It presents trainings, evaluations, webinars and appointments with experts. The Digital University provides the first certified French-language training course in e-learning.

[82] Ibidem.

[83] Ibidem.

[84] Ibidem.

[85] Ibidem.

[86] See the University Facebook page at: https://www.facebook.com/unefi2015/ and the University trailer: https://www.youtube.com/watch?v=lZKXwvtVlEM&fbclid=IwAR1Q8Cl9tVXOrIAJ-V9W0dmJDNj0Uqks2LWkhNgqCwqEtkjR-29gLFFwDd0

UNEFI presently offers only one program; it provides training for the famous Islamic Banking Qualification professional diploma in partnership with CIFIE and Al-Maali Institute. The IBQ is a dual certificate between Al-Maali Institute and the Dubai Government's Knowledge & Human Development Authority. This training is therefore the first French-language and digital IBQ Certification comprising 10 courses and 70 modules. The very broad program covers the principles and sources of Islamic finance, its history, models of Islamic banking activity, Sharīʿa governance, international organizations of the industry, the model of Islamic banking intermediation, the products and Islamic banking. The courses broadcast by MOOC are supported by webinars, practical exercises and followed by certifications. A final exam is organized near the participant's locality.

5.6 Islamic Finance Media and Scientific Publishing

In parallel with the development of the training sector in Islamic finance, the scientific publication on Islamic finance has a remarkable prosperity. We note a diversity of productions related to Islamic finance including academic research, scientific journals and specialized media.

5.6.1 Academic Research

Academic interests in Islamic finance are reflected in the novelty of this discipline, which provides researchers with a fertile and interdisciplinary field of research. The different scientific disciplines find their interest in Islamic finance.[87] Academic production in Islamic Economics and Finance focuses on doctoral theses, which can constitute a rich bibliography for researchers in this field.

PhD theses are the most important element in these productions. Thesis project filings related to Islamic finance increased after the 2008 crisis.[88] This has therefore produced a remarkable peak in theses supported from 2012 as we note in Fig. 5.2.

[87] Abderrazak Belabes: "Doctoral research on the integration between finance and Islam: the case of France (1902–2011)", *Les cahiers de la finance islamique*, n°8, pp. 76–93, p. 82.

[88] Ibidem, p. 80.

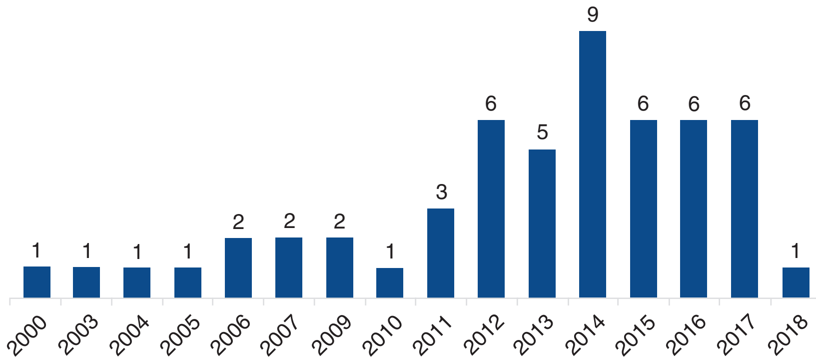

Fig. 5.2 PhD theses defended on the interaction between finance and Islam. (Author's compilation from information collected from the site: www.theses.fr)

Despite the importance of PhD thesis publications, the French research world is in short supply of specialized references on the fundamental topics related to Islamic finance. The publication of PhD theses cannot fill this gap in view of the limited scope of PhD theses that address very limited issues.

Academic research published in this sector, as well as the collection Ethics and Financial Norms published by IRJS, constitute the rare scientific production in the sector. Except for the published PhD theses, we note that the majority of publications are still limited to simplified and superficial manuals.

However, the actual writings on Islamic finance require scientific control, especially in their conformity with Islamic Law and the principles of Islamic finance before their edition.

5.6.2 Specialized Journals

Another form of scientific production is the constitution of peer-reviewed journals specialized in Islamic finance. We can mention two significant initiatives: "Les Cahiers de la Finance Islamique" and "IFSO Mag La tribune de la Finance Islamique". We also notice the emergence of specialized electronic media.

5.6.2.1 Les Cahiers de la Finance Islamique[89]

The initiative entitled "Cahiers de la Finance Islamique" is the first French-language journal dedicated to Islamic finance. It came about through the efforts of the MBA team at the School of Management of Strasbourg University. In June 2009, the first volume of the journal was issued, it was the collection of proceedings of the seminar "Ethical Finance and Islamic Finance" organized by the School of Management Strasbourg on 11 February 2009.

This Journal is characterized by its academic dimension as it is under the imprint of the University of Strasbourg. The peer-reviewers/referees are French-speaking professional and academic renowned experts from multiple countries. The published works are presented as academic research papers. Scientific participation extends to all scientific disciplines related to Islamic finance. So far, "Les Cahiers de la Finance Islamique" has produced 11 regular issues and 4 special issues.

5.6.2.2 IFSO Mag La Tribune de la Finance Islamique

IFSO is the Islamic Finance Student Organization of the Executive Islamic Finance MBA of the School of Management of Strasbourg University. The IFSO has launched its proper magazine specialized in Islamic finance in 2013.

IFSO Mag aims to (1) promote Islamic finance, (2) enhance Strasbourg research center on Islamic finance and (3) foster the networking between practitioners and academics.[90] It is characterized by short papers focused on the analysis of the Islamic finance practice, the professional interviews, the brief studies and the actuality.

Despite the importance of this initiative, its issuance is very unstable and is currently stopped. The IFSO Mag lasted for three years producing only four numbers. Further issuances may appear at any time.

5.6.2.3 Other

Academic papers on Islamic finance appear regularly in French scientific journals related to law, finance, insurance and even religions.

[89] The French Peer-review Journal "Les Cahiers de la Finance Islamique" can be found freely online on the website of the Executive MBA: http://sfc.unistra.fr/finance-islamique

[90] Ezzedine Glammallah: "Le mot du président", IFSO Mag La Tribune de la Finance Islamique, N°1, p. 1.

Furthermore, we note specialized media in Islamic finance, the most notable of which is the Journal of Islamic Finance (RIBH),[91] as well as Islamic Financial Times,[92] La Finance Islamique,[93] Finance Islamique[94] and others. Those electronic media ensure a fast and practical diffusion of the information on the sector. They also present a detailed source of information.

There are also several affinity media with a large audience in the Muslim community such as Al Kanz,[95] ḥalāl Pages,[96] Oumma,[97] Saphirnews[98] and so on, which regularly publish articles and reports on the development of the French Islamic financial sector.

5.7 Conclusion

We can say that we have tried to describe in this brief study the state of Islamic finance in France. It was first necessary to highlight the viability of Islamic finance in France. The large Muslim community in France, the largest in Europe, has a promising potential market, but remains incompetent to organize and solicit the opening of Islamic banks, although the financial crisis has brought attention to Islamic finance.

Thus, the French legislator has little contributed to the development of the legal and fiscal framework to ensure the possibility of admission of Islamic financial transactions in France. An explanatory note from the AMF provided guidance on Islamic UCITS in France. It was followed by four tax instructions ensuring the admission of the main contracts of Islamic Law into French law. Since these contracts do not conflict with the foundations of French law, state intervention has served rather to ensure fiscal neutrality. This tax arrangement aimed to reduce the costs of these transactions due to their backing of underlying assets, costs that are not present in conventional financing arrangements.

Although the legal landscape has been barely prepared to accommodate Islamic finance, there are few offers on the market. Conventional financial

[91] https://ribh.wordpress.com/
[92] http://www.islamicfinancialtimes.net/
[93] http://lafinanceislamique.com/
[94] http://www.financeislamique.com/
[95] https://www.al-kanz.org/
[96] http://www.pagesḥalāl.fr/
[97] https://oumma.com/
[98] https://www.saphirnews.com/

players have always moved away from the scene in order to preserve their image and their clientele, which has given way to the development of the profession of brokers and intermediaries who have taken charge of the distribution of these products. The young French Islamic Finance experience proved the weakness of their profitability and their very low performance. This failure is due to several causes, including (1) identification of certain financial intermediaries as dishonest people and whose image appears corrupted, (2) high costs compared to conventional services and (3) insufficient quality and unsatisfactory service.

Unlike the market that is undeveloped in France, the academic community is more alert on this subject. We notice a diversity of training in Islamic finance, where the acquisition of technical skills is well taught. The profiles of the people who follow these courses are multidisciplinary: Insurers, actuaries, managers, financiers, lawyers, private bankers, businessmen and so on. This has created a generation of legal, financial and economic specialists who are well trained in Islamic finance. Thus, the market has become mature enough to accommodate serious projects. However, theoretical writings in this area are very rare as most of the courses are professional. The majority of the published works are limited to the initiation to Islamic finance and some specialized writings appear as the result of PhD theses. The French Islamic finance bibliography seriously lacks basic references. This need can be met by specialized doctrinal writings or the translation to French from Arabic or from English.[99]

Overall, the future of Islamic finance in France seems not very promising. For several years, the context has elements to ensure a healthy and promising evolution of Islamic finance but past failures, the loss of confidence toward the intermediaries involved in Islamic operations, high fees and low publicity are important factors hampering the evolution of this sector of activity. What characterizes the situation of the Islamic finance in France is the considerable demand of the Moslem public, in no way satisfied by the offers which remain well below expectations. Pending the appearance of serious offers up to expectations, the development of Islamic finance in France is still very limited.

[99] In accordance with this recommendation, we have prepared two books that are being published: our book "Standards of Islamic Financial Investment" and "Introduction to Islamic Finance" that we have translated from English.

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CHAPTER 6

Status of Islamic Finance in Germany in 2019

Uğurlu Soylu

6.1 Introduction

As the leading economy in Europe, Germany is a crucial market for Islamic finance. Not only the approximately 5 million Muslims in Germany but also all the people disappointed with the conventional financial market in the aftermath of the recent financial crisis are a huge market potential for Islamic finance. Germany's state officials and other market actors have made several efforts in order to establish Islamic finance in Germany. There are numerous positive statements, among others from the former Minister of Finance Wolfgang Schäuble, who said in the G-20 that Islamic finance is gaining importance.[1] Also the two conferences organized by the German banking regulator *BaFin* itself in past with the participation of leading international scholars and researchers—one on Islamic banking in 2009 and another on Islamic capital markets in 2012—and the planned conference in 2019 on *Takāful* are such important attempts. In general, the German public and media are open minded, interested and quite

[1] http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/g20-treffen-in-ankara-schaeuble-islamische-finanzierungsmodelle-wichtiger-13787046.html (23.05.2018).

U. Soylu (✉)
Independent Consultant, Mannheim, Germany
e-mail: info@soyluconsulting.com

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M. Hajjar (ed.), *Islamic Finance in Europe*, Palgrave Studies in Islamic Banking, Finance, and Economics,
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benevolent to Islamic finance.[2] Despite all that, it took a pretty long time until 2015 when the first Islamic bank was granted a fully fledged banking license (more than ten years later in comparison with London). In my chapter I want to show the historical development in the German market (Sect. 6.2), the present situation with the relevant actors and main products, remaining challenges (Sects. 6.3, 6.4, 6.5 and 6.6) and finally an outlook for a likely development in the near future (Sect. 6.7).

6.2 Historical Outline of the German Market

It is quite surprising to learn that it was Germany where the foundation for the first attempts of the modern Islamic banking industry in the twentieth century was laid. Ahmad el-Nagger, the great pioneer of Islamic banking, who has finished his doctoral thesis in Cologne, has used the public saving banks (*Sparkassen*) in Germany as the blueprint for *Mit Ghamr*, a savings bank in Egypt (founded in 1963), which itself is considered as one of the first Islamic banks.[3]

But also in practice Germany is one of the leading, innovative markets in Europe. Based on real estate leasing as the underlying asset, it was the federal state of Sachsen-Anhalt which has issued successfully the first *Ṣukūk* in Europe in 2004. It has attracted strong demand with investors from the UAE (60 percent) and Europe (40 percent).[4]

Besides these positive cases, there were also some unpleasant events in the financial gray markets with superficial connections to Islamic Finance. In the 1990s a new kind of partnership was very popular in Turkey which quickly found its way to Germany: a profit and loss sharing silent partnership. The investor pays the money in exchange for an unofficial paper, granting him a share of a company claiming to be Islamic. In practice there were no losses and the profits were exorbitantly high. Actually, it was simply a pyramid scheme where the company distributed high amounts from the collected money—declared as profit—in order to attract just more money. It is assumed that an amount between EUR 5 billion and EUR 50

[2] There were about 2000 articles on granting the first fully fledge banking license to an Islamic bank and nearly all were with a positive echo.

[3] Umar Oseni and M. Kabir Hassan (2010), "The Emergence and Development of Islamic Banking" in: Islamic Finance – Instruments and Markets, p. 113.

Ahmad el-Naggar, Zinslose Sparkassen im Nildelta, Al-Kitab-Verlag.

[4] European Central Bank – Eurosystem, Occasional Paper Series, Islamic Finance in Europe, No. 146, June 2013, p. 26.

billion was embezzled.[5] Some comments suggest that this fraud is at least an indicator for an existing demand for Islamic compliant products.[6] But a more plausible explanation is that also Muslims are not immune against greed as a lot of investors even took conventional interest-bearing loans from banks in order to buy those so-called Islamic company shares. Obviously the promised (and initially disbursed) profits of 10–20 percent of the paid equity were double or triple as high as the market standards and were as such suspicious. But what is definitely true is the absence of legitimate financial investment alternatives for Muslims under state regulation and control in that time, which made it easier for dubious contractors to cheat the poorly experienced investors. Nowadays the burden of that legacy is still high as a lot of potential middle-aged investors are still very distrustful to any Islamic branded financial products.

This distrust might be the main explanation for the failure of a whole series of several types of investment funds. Commerzbank, through its daughter Cominvest, was one of the earliest actors which offered an Islamic compliant investment in 2000 (*Al-Sukoor* Fonds).[7] But after the volume of the fund decreased from the initially EUR 30 mio to less than EUR 4 mio (end of 2004), Cominvest took away the *Al-Sukoor* fund from the market (in 2005).[8]

A similar fate faced several other Islamic compliant investment funds in Germany: Meridio (mixed fund, closed 2011), Allianz Global Investors (equity fund, closed 2012), *Landesbank* Berlin (global investment certificate, closed 2013), West LB (certificate on the ten largest German Islamic compliant companies, closed 2013) and Deutsche Bank's DWS (mutual fund, closed 2016). There are still some funds from non-German banks available, but their success is modest and they are generally unknown.[9]

[5] A. Farhoush, M. Mahlknecht (2010), A critical view on Islamic Finance in Germany, p. 204 in: pp. 203–212.

[6] Chahboune, Jallale/El-Mogaddedi, Zaid (2008), Islamic Banking – das Marktpotenzial in Deutschland, in: Zeitschrift für das gesamte Kreditwesen, 15, 01.08.2008, p. 34.

[7] Commerzbank, Geschäftsbericht 2000, p. 19.

[8] Alharbi, Ahmad (2016), "Development of Islamic Finance in Europe and North America: Opportunities and Challenges", p. 116 in: International Journal of Islamic Economics and Finance Studies, Nov 2016, Vol. 2, Issue 3, p. 109–136.

[9] A. Farhoush, M. Mahlknecht (2010), p. 206.

Besides this there are some smaller sale companies, which operate in a niche and promote Islamic compliant products,[10] mainly gold-saving products, *Takāful* and some other investment products.

6.3 Present Situation

Despite the flop in the investment segment, there is one quite successful investment company, Arabesque Asset Management, based in Frankfurt am Main and London, which has still Islamic compliant funds. But with regard to the failure of the other market actors, it is not really surprising that it does not promote this feature. Being rather a sustainable and socially responsible fund which is coincidentally Islamic compliant, Arabesque offers its products mainly to clients interested in socially responsible investments and is hardly known in the German Muslim community.[11]

Another important player is FWU, an insurance company in Munich, which offers *Takāful* products in Europe and Asia. FWU promotes its products to Muslims and non-Muslims. Even in a Muslim country like Malaysia there are more non-Muslim clients than Muslim one.[12] For the Muslim clients in Germany they have used the existing sales company (see above), but recently stopped cooperation and active marketing.[13]

Quite recently a very interesting approach appeared in the German market: the Turkey-based *Al Baraka* Turkish Bank's subsidiary *insha GmbH* entered the German market as a fintech company. As a fintech company *insha* doesn't need a banking license. It cooperates with the *solarisbank* AG, which in turn is also a start-up, founded some years ago.[14] It is a fully fledged bank which has no end-user business and offers its service only to non-banks in order to enable them to realize the business models requiring a banking license.

Al Baraka Turkish Bank is one of the pioneers both in Islamic banking and in the new fintech industry in Turkey. Starting with payment products, *insha* wants to offer all classical banking products via a smart phone

[10] Presently (2018), there are the following companies: *inaia GmbH* (formerly *ifis Capital Gmbh*), My Islamic Finance and *ZinsFrei* (formerly *fmf*).

[11] For more information, see: https://arabesque.com/

[12] According to public statements of M. Dirrheimer, owner and CEO of FWU.

[13] Due to a call with Mr. Ansari from FWU on 17.7.2018.

[14] For more information, see: https://www.solarisbank.com/en/

application in the long run for retail as well as for corporate clients.[15] The start of the business was August 2018.

6.3.1 First Islamic Bank: KT Bank

The most important progress in the Islamic finance market in Germany was the granting of a fully fledged banking license for the 100 percent subsidiary of the Kuwait Turkish Participation Bank, the KT Bank, in March 2015. Besides Bosnia-Herzegovina and the Islamic banking hub of London, the KT Bank's activity is the first one within the Eurozone. Kuwait Turkish Bank spent a long time in intensive preparation and performed crucial pioneering work. They first began in 2004 with a representative office for market observation. Then they applied and granted licenses for third-country brokerage and money transfer in 2009. Based on these experiences they finally applied in October 2012 for the banking license.

Within that time period they not only gathered market information, but also informed the public, the banking authority, the media and the politicians about their company and their objective, the essence of Islamic banking and the benefits of this approach for the German market.

With two and a half years, the licensing process took a quite long time, double as in other cases. But it was not due to any resentments but due to the fact that it was a precedent-setting case within the Euro area. Although there is no "Islamic banking license" but just a banking license, there were some Islamic banking-related issues, mainly the question of whether there is a sufficient large market potential for Islamic banking,[16] independence of the management from the *Sharīʿa* board[17] and the compatibility of the profit and loss sharing accounts (pls accounts) with the deposit definition according to the German banking law (*Kreditwesengesetz*, KWG). The latter one requires no interest payment for deposits but the categorical repayment of the clients' money,[18] which seems to be apparently a contradiction to the pls account. But a sophisticated analysis on part of *Bafin* and the responsible institution for the

[15] For more information, see: https://www.getinsha.com/en

[16] The absence of a stable, sustainable business model is reason to refuse the license.

[17] Even though there were explicit written rules of order of the bank, declaring the independence of the management, the banking supervisory authority *Bafin* doubted that fact as in their view the factual influence due to the knowledge of the scholars would be harmful.

[18] According to §1 (1) of German banking law (*Kreditwesengesetz*, KWG).

deposit protection scheme (*Prüfungsverband Deutscher Banken*) came to the conclusion that in the end the preventive measures of an Islamic bank lead to the same result. Recognized preventive measures as such were the profit and loss stabilization reserves, shareholders' profit relinquishment and equity buffer.

6.3.2 Product Range of KT Bank

KT Bank is a universal bank offering all classical banking products for retail and corporate clients. Customers can deposit their money in current accounts or save money via pls accounts, make payments and take loans for moveable goods or real estate. It offers banking and credit cards where the client could make payments and draw out money globally.[19]

Besides the products for the end users, KT Bank also has instruments for the inter-banking market, where it makes business with conventional banks due to liquidity reasons. Within this context it deploys the instrument of *tawarruk* based on precious metal exchange.

6.4 Legal Issues and Solutions for Islamic Compliant Products

Germany has no special regulation or legal adaption for Islamic finance. Thus, one of the most important achievements of the KT Bank was to having found tax and legal solutions and paved the way for Islamic compliant products. Besides the integration of the pls accounts in the deposit guarantee scheme, one of the most important hurdles for Islamic compliant financial products within a non-Islamic regulatory framework is the additional cost burden in *murābaḥa* transactions, namely, the double stamp duty in real estate finance and the extra VAT for the profit margin. As interest income for conventional banks is free of VAT, this extra burden of 19 percent would constitute an important competitive disadvantage for Islamic banks. But in a precedent case the local tax authority in Frankfurt am Main has ascertained in 2014 that the *murābaḥa*-based profit margin has to be treated like an interest income and thus be free of VAT.

Another challenging issue for the establishment of Islamic banking was to find tax solutions for the real estate finance which ensures tax costs in line with the market prices for the clients. Thus, a simple *murābaḥa*

[19] For more information, see https://www.kt-bank.de/

transaction with the consequence of a double stamp duty, which is up to 6.5 percent of the purchasing price in some states,[20] did not come into consideration. The KT Bank developed a special form of a diminishing *mushāraka*, whereby the shares of ownership change not at the time of payment (in general monthly) but in advance on a *murābaḥa* basis with deferred payment. First of all, the bank and two customers establish a firm under civil law (*Gesellschaft bürgerlichen Rechts*, GbR), which itself buys the real estate. The bank then sells its share at once (a one-period sale) or in several time intervals (a several-period sale). As the sale of the shares does not constitute a new ownership—the GbR still owns the object—there is no second stamp duty.

But this product is not only highly innovative in terms of tax avoidance, but also as a long-term real estate finance tool: on the one hand, the several-period sale guarantees the client a fixed profit rate for the current time period, and on the other hand, it offers the bank enough price flexibility to structure the duration of this financing instrument according to market standards, that is, for 20–30 years. At the end of each tranche of finance, the bank makes a new price offer for the next one. The customer could accept it or opt out by paying the remaining shares, which are fixed at the very beginning of the transaction. He could pay out by own means or by a third financier.

6.5 Performance and Evaluation

The investing mother bank Kuwait Turkish Bank has made great efforts to make the engagement in Germany a success. It took a long time for market research, to inform all stakeholders, for intensive preparation and has invested huge sums. The performance of KT Bank is not only of relevance for the mother company but for the whole market as other potential investors know the enormous efforts and observe KT Bank's performance as an indicator for the market potential and decide their market entrance depending on that evaluation.

Without a doubt, KT Bank has performed exceptional pioneering work for the Islamic banking industry in Germany and was very successful forming the public opinion positively for the Islamic banking industry and

[20] The real estate transfer tax (*Grunderwerbsteuer*) is a state-based tax and differs accordingly. It ranges between 3.5 and 6.5 percent of the purchasing price.

engineering innovative products which enabled Islamic compliance under level playing fields. However, at the end of the day the financial numbers matter.

KT Bank's strategy was to act as the first mover within the Islamic banking niche. Soon after the start, the bank focused mainly on Muslim clients.

Based on the annual financial statements from 2015 to 2017,[21] the following results become apparent. Also in the third year of business, there was a loss of EUR. 7.6 mio (after 11.4 and 9.3 mio in 2016 and 2015, respectively), cumulative: EUR 28.4 mio. At the end of 2017, the KT Bank had 5435 retail and 1229 corporate customers in comparison to the declared goal of 20,000, according to public statements.[22] The balance sheet increased to EUR 193 mio (after 108 and 54 mio). The loans granted to non-banks—the basis of the bank's earnings—were only 125 mio (after 60 mio) and the client deposits 89 mio (after 38 mio). Approximately two-thirds of the deposits are current accounts, and only 33 mio are pls accounts, of which 17 mio have a maturity under one year. The latter amount shows the main problem for KT Bank: finding maturity-adequate sources for refinancing. This is the reason for the small share of loans to non-banks (more than a quarter of the balance sheet, 48 mio, is either held at the central bank (18.6 mio) or at other banks (28 mio), both with marginal or even negative returns).[23] KT Bank did not succeed in really tapping the potential and reaching retail customers. The officially declared number of 20,000 clients was not a very ambitious goal, but the number of 6000 customers in three years is disappointing.

Probably due to this, KT Bank has made a shift of paradigm and offers saving accounts with fixed returns since 2018. The reason behind this is that the bank is obviously trying to reach non-Muslim customers in order to broaden its refinance basis. But on the other hand the existence of a fixed-return product questions the credibility of the underlying business model for Muslim customers.

[21] As there is no information in the home page of KT Bank, the annual financial statements are publicly available in (after filling in "KT Bank" in the search field): https://www.bundesanzeiger.de/ebanzwww/wexsservlet?global_data.language=en&session.sessionid=094082d1418518649a46fcd70e3e9215&page.navid=gotolastpage

[22] See annual financial statements of KT Bank, 2016.

[23] Besides this 1.6 mio is held in cash.

6.6 Remaining Challenges: Regulatory and Governance Issues

As mentioned above there is no Islamic banking-specific regulation in Germany. Therefore, some problems and challenges in Islamic compliant governance are inevitable. Basically, there is a conflict of interest between shareholders, bank management and customers. Between the first two there are well-known issues in principle-agent topics. And often both their interests are in contrast to the customer's. As there are two main sources for the management—shareholders' equity and depositors' money—there is always a conflict of interest on which source exceptionally profitable projects should be invested. The same is true for the degree of capacity utilization. If the management tends to utilize the equity to a higher degree and keep the customers' deposits unused for liquidity reasons, the return for the customers will be less.

6.7 Conclusion and Outlook

Germany has a long tradition in Islamic finance, often as a pioneer. The legal, regulatory framework is still challenging, but—thanks to Kuwait Turk's efforts—not an unbreachable obstacle. What is needed is a neutral institution, which could function as a third-party certification and a mediation body ensuring transparency and good governance.

A lesson from the failures and successful approaches in Germany is that an inclusive, all-customer comprising approach is needed. Certainly, there is great interest and demand for Islamic compliant financial services in Germany. But to be Islamic is a necessary but not a sufficient condition in order to be successful. Quality of service, smart, state-of-the-art and user-friendly technology and competitive prices are of course also of relevance. Islamic compliance is an advantage as a door opener but you have to offer an additional benefit to your customer, regardless of which religion he or she belongs to. It is not by chance that only one Islamic compliant investment fund, Arabesque, which does position itself as a sustainable, socially responsible investment, operates successfully. From that perspective *Al Baraka* Turk's fintech, *insha*, is also a very interesting approach.

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CHAPTER 7

Islamic Finance Under Irish Law

Edana Richardson

7.1 Introduction

Over the last decade, Irish authorities have taken certain accommodative measures to clarify and legislate for Islamic finance activity under Irish law. When discussing the introduction of guidance and legislative amendments aimed at accommodating Islamic finance in Ireland, the Irish Department of Finance (the **Department of Finance**) outlined certain "opportunities" for Ireland that could arise from this accommodation: (a) encouraging investment into Ireland in the form of wholesale Islamic finance activity and the establishment of Islamic financial institutions; (b) the provision of ethical investment opportunities for Irish investors; and (c) the opportunity for Muslims to participate in the financial sector in a manner that is consistent with their religious beliefs.[1] Such statements suggest that the Irish government's focus of accommodation is on both retail and

Lecturer in Law, Maynooth University, Ireland. This chapter reflects the legal position in Ireland as of February 2019.

[1] Department of Finance, *Islamic Finance in Ireland: An Information Note*, (Dublin: Department of Finance, 2010), 4.

E. Richardson (✉)
Maynooth University, Maynooth, Ireland

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M. Hajjar (ed.), *Islamic Finance in Europe*, Palgrave Studies in Islamic Banking, Finance, and Economics,
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wholesale Islamic finance activity. In line with this, the legislative amendments and guidance introduced in Ireland cover financing structures that could be used in retail and in wholesale Islamic finance transactions.

Notwithstanding the Irish government's generally favourable approach to Islamic finance, there remain gaps in the legislative regime applicable to Islamic finance activity in Ireland, particularly at a retail level. As a result, issues surrounding the regulation of Islamic finance activity and institutions, as well as questions of consumer protection, remain unaddressed. At the same time, while the Republic of Ireland's Muslim population of just over 63,000 people increased by 28.9 per cent between 2011 and 2016,[2] it nevertheless remains small, potentially impacting on short-term demand for domestic retail Islamic finance products and services.

Nevertheless, steps taken to date by the Irish government to accommodate Islamic finance activity are to be welcomed and they go some way towards positioning Ireland as an economy in which Islamic finance activity is encouraged. This chapter will consider some of the specifics of Irish law that are relevant to Islamic finance. It will outline the approach to accommodating Islamic finance taken by the Irish government and the applicable legislative and regulatory framework. It will then discuss the current position under Irish law of three Islamic finance products: *ṣukūk*; Islamic investment funds; and Islamic mortgage alternatives.

7.2 Legislative and Regulatory Framework

Islamic finance transactions offered in global financial markets are often structured to comply with the financial principles of Islamic Law, while at the same time replicating the economic substance of conventional interest-based finance products. The economic result of these Islamic finance transactions is, therefore, similar to conventional finance products; the methodology and legal structure used to achieve this result are distinct.[3] In countries that have not introduced legislative frameworks dealing specifically with Islamic finance transactions, these transactions may be subject to regulatory and tax laws based on their legal structure, rather than

[2] Central Statistics Office, *Religion*, Central Statistics Office, Dublin, 2017, 72, available at: http://www.cso.ie/en/media/csoie/releasespublications/documents/population/2017/Chapter_8_Religion.pdf (last accessed: February 22, 2019).

[3] Jonathan Ercanbrack, "The Regulation of Islamic Finance in the United Kingdom", *Ecclesiastical Law Journal*, 13 (2011), 69, 70.

their economic substance. Islamic finance participants could, therefore, be taxed and regulated differently to participants in conventional finance transactions. Where the purpose of an Islamic finance product is to replicate the economic substance of conventional finance products in a *sharī'ah*[4]-compliant manner,[5] differing (and often less favourable) regulatory and tax treatment may make these products less attractive or potentially unviable. In light of this, some jurisdictions have introduced legislative and institutional reforms to establish a more level playing field in the regulation and taxation of certain Islamic finance products and their conventional alternatives.[6]

In October 2009, the Irish Revenue Commissioners (the **Revenue**) published a Tax Briefing focused on Islamic finance (the **2009 Tax Briefing**).[7] The 2009 Tax Briefing did not introduce any legislative amendments into Ireland's tax laws, but rather confirmed that three Islamic finance products—*Takāful* (Islamic insurance), *ijārah* (Islamic leasing), and Islamic investment funds—would be subject to the same tax regimes as conventional insurance, leasing, and investment funds, respectively.[8] Shortly after the publication of the 2009 Tax Briefing, the Finance Act 2010 was enacted introducing amendments to Ireland's existing tax laws (that is, the Taxes Consolidation Act 1997 (the **TCA 1997**)[9] and the Stamp Duties Consolidation Act 1999 (the **SDCA 1999**)[10]). These amendments were designed to facilitate greater equality of tax treatment between certain Islamic and conventional finance products in Ireland.[11]

[4] There is no single correct means of expressing Arabic terms and sounds in the Latin alphabet. Throughout this chapter, quotations and the official names of products and organisations, which contain a transliteration of Arabic terms and use of italicisation which are different from that used in this chapter, will be reproduced without adjustment.

[5] Yusuf Talal DeLorenzo, "Introduction to Understanding Riba", in *Interest in Islamic Economics: Understanding riba*, Abdulkader S. Thomas (ed.), (Oxford: Routledge, 2006), 1, 6.

[6] Over the last 15 years, for example, the UK has introduced comprehensive reforms in this area. See generally, HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, (London: HM Treasury, 2008).

[7] Irish Revenue Commissioners, *Islamic Finance, Tax Briefing Issue 78*, Revenue Commissioners, Dublin, October 2009, available at http://www.revenue.ie/en/tax-professionals/historic-material/tax-briefing/2009/tax-briefing-78-2009.pdf (last accessed: February 22, 2019).

[8] Ibid.

[9] Taxes Consolidation Act 1997 (No. 39 of 1997) (Irl.).

[10] Stamp Duties Consolidation Act 1999 (No. 31 of 1999) (Irl.).

[11] For more recent Irish government discussions on Islamic finance in Ireland, see Department of Finance, *IFS2020: A Strategy for Ireland's International Financial Services sector 2015–2020*

S39 and s137 of the Finance Act 2010 deal with “specified financial transactions”[12] and insert Part 8A[13] into the TCA 1997 and s85A[14] into the SDCA 1999, respectively. While Part 8A TCA 1997 and s85A SDCA 1999 do not refer to Islamic finance explicitly, the stated aim of these sections is to “extend tax treatment applicable to conventional finance transactions to Shari’a compliant or Islamic financial products which achieve the same economic result in substance as comparable conventional products”.[15] This absence of reference to religious compliance in the legislation means that any finance transaction that fulfils the relevant criteria could technically fall within Part 8A TCA 1997 and s85A SDCA 1999. However, in order to benefit from the tax treatment in Part 8A TCA 1997, market participants must positively elect for their transaction to be treated as a specified financial transaction.[16]

As a result of amendments to Ireland’s existing tax laws, three Islamic finance structures are now addressed in the TCA 1997: “deposit transactions” (Islamic deposits); “credit transactions” (Islamic financing transactions—covering *murābaha* and diminishing *mushāraka*); and “investment transactions” (*ṣukūk*).[17] Subsequent Finance Acts have introduced clarifications to Part 8A TCA 1997;[18] however, the scope of the accommodations has remained unchanged since they were introduced by the Finance Act 2010.

Unlike the UK government’s accommodation of Islamic finance, where both the tax *and* regulatory aspects of Islamic finance transactions have

(Dublin: The Stationery Office, 2015), in which it was noted that “Islamic Finance will continue to feature in the sectoral and regional strategies outlined in IFS2020”, 20.

[12] Defined in Part 8A TCA 1997 (Irl.) as meaning a “credit transaction”, a “deposit transaction” or an “investment transaction”.

[13] Inserted by s39 Finance Act 2010 (No. 5 of 2010) (Irl.). See also, Oireachtas, *Finance Bill 2010, Explanatory Memorandum*, 10, available at: https://data.oireachtas.ie/ie/oireachtas/bill/2010/9/eng/memo/b0910d-memo.pdf (last accessed: February 22, 2019).

[14] Inserted by s137 Finance Act 2010 (Irl.).

[15] Department of Finance, *Islamic Finance in Ireland; An Information Note*, *op. cit.*, 5.

[16] See, s267U TCA 1997 (Irl.).

[17] Department of Finance “Publication of Finance Act”, *Press Release* (Dublin: Department of Finance, 2010) noting that the aim of the provisions was to increase the “attraction of Ireland for the development of Islamic finance”.

[18] See s37 Finance Act 2012 (No. 9 of 2012) (Irl.) and s24 and s75 Finance Act 2013 (No. 8 of 2013) (Irl.).

been addressed under English law, in Ireland the focus of accommodation has been on the taxation of these transactions. The regulation of Islamic finance transactions and the institutions that engage in Islamic finance activity has not been the subject of tailored accommodation under Irish law.[19] As a result, the Central Bank of Ireland (the **Central Bank**), as Ireland's financial conduct and prudential regulator, must continue to apply existing regulatory rules to Islamic finance activity and institutions in Ireland. Reflecting this, there has been limited provision of Islamic finance products by Irish-registered entities and no Islamic banks have been established in Ireland.

Particularly in the years following the Finance Act 2010, a small body of academic and industry commentary centred on Islamic finance in Ireland has developed with a number of academic[20] and industry[21] articles and theses[22] written on aspects of Islamic finance in Ireland. The focus of this commentary has rested largely on issues of law, regulation, and tax and, reflecting the trend in Islamic finance in Ireland, has focused principally on wholesale finance transactions and products.

[19] s73 Central Bank (Supervision and Enforcement) Act 2013 (No. 26 of 2013) (Irl.) introduced an amendment to the Central Bank Act 1971 (No.24 of 1971) (Irl.) to allow banks established in non-EEA countries to open branches in Ireland. This could potentially assist with the opening of an Islamic bank in Ireland.

[20] See, for example, Edana Richardson, "Islamic Finance Disputes in Ireland: A comparative study of dispute resolution in Islamic finance contracts" *Irish Jurist* 57 (2017), 35, Edana Richardson, *The Integration of Islamic Finance into the Irish Legal System: Current Issues and Future Challenges*, PhD Thesis, Trinity College Dublin, 2012. Edana Richardson, "The Accommodation of Islamic Finance in Ireland's financial legislation: A Comparative Study of Wholesale Islamic Financial Products" *Dublin University Law Journal*, 34 (2011), 127, Edana Richardson, "Islamic Finance for Consumers in Ireland: A Comparative Study of the Position of Retail-level Islamic Finance in Ireland" *Journal of Muslim Minority Affairs*, 31(4) (2011), 534, Faiza Ismail, "Islamic financing in Europe: recent developments in Ireland", *The Company Lawyer* 38(2) (2017), 48.

[21] Simon O'Neill, "The Islamic finance industry in Ireland", *Islamic Finance News* (December 2015), 84.

[22] Tarek Elbay, *How successful has the Irish government been in promoting Islamic finance in Ireland? An exploratory analysis of the level of awareness of Islamic finance among employees in financial services in Ireland*, Master's Thesis, National College of Ireland, 2014, Faiza Ismail, *Legal uncertainties in the global IF industry as explored in the Irish context*, PhD Thesis, University College Dublin, 2016 and Noorizzati Aini binti Zainal Aalam, *Can Ireland become a "Centre of excellence" for Islamic finance? A study of what is needed, what has been done and what else can be done*, Master's Thesis, Dublin Business School, 2013.

7.3 Islamic Finance Structures

7.3.1 Ṣukūk

Ṣukūk[23] are one of the more high-profile forms of contemporary Islamic financing. Within Ireland, the primary growth of the *ṣukūk* market has been seen in the increasing number of *ṣukūk* programmes and issuances of *ṣukūk* certificates that are listed on the Irish Stock Exchange plc, trading as Euronext Dublin (**Euronext Dublin**).[24] Since the first issuance of *ṣukūk* certificates was listed on Euronext Dublin in 2006,[25] Ireland has become a key jurisdiction for *ṣukūk* listings.[26]

When listed on Euronext Dublin, *ṣukūk* certificates can be admitted to trading on the regulated or unregulated market. In both cases, the process for approval and listing of these *ṣukūk* certificates is identical to that used for conventional bonds and applies to *ṣukūk* issued by Irish or by non-Irish incorporated entities.

In the case of *ṣukūk* certificates that are admitted to trading on Ireland's regulated market (the **Main Securities Market**), the underlying prospectus must be approved by the Central Bank, as the competent authority under Directive 2003/71/EC (as amended, the **Prospectus Directive**).

[23] Plural of *sakk*, Financial Conduct Authority (previously the Financial Services Authority) and HM Treasury, *Consultation on the legislative framework for the regulation of alternative finance investment bonds (sukuk)*, December 2008, 3, available at: http://www.fsa.gov.uk/pubs/cp/sukuk.pdf (last accessed: February 22, 2019).

[24] For consistency, this chapter refers to the Irish Stock Exchange plc as Euronext Dublin, including when referring to listings of bonds and *ṣukūk* certificates that occurred prior to Euronext's acquisition of the Irish Stock Exchange plc in March 2018.

[25] NICBM Ṣukūk Limited US$100,000,000 Trust Certificates due 2011 (the **2006 NICBM *ṣukūk***). Some commentators have indicated that the first *ṣukūk* was listed in Ireland in 2005; however, the author has found no concrete evidence of this. The 2006 NICBM *ṣukūk* referenced above is the earliest listed *ṣukūk* on Euronext Dublin that the author is aware of, see also, Gerard Scully, "Sector set for continued growth", *Finance-Magazine*, 2007, available at: http://www.finance-magazine.com/supplements/abs2007/display_article.php?i=7477 (last accessed: February 22, 2019).

[26] See, for example, Irish Stock Exchange plc (as it was then), *ISE lists world's largest ever sukuk issuance with $9bn Saudi Arabia bonds*, available at: http://www.ise.ie/Media/News-and-Events/2017/ISE-lists-world-s-largest-ever-sukuk-issuance-with-$9bn-Saudi-Arabia-bonds.html (last accessed: February 22, 2019) referring to KSA Sukuk Limited Series 1 (US$4.5 billion 2.894% Trust Certificate due 2022) and Series 2 (US$4.5 billion 3.628% Trust Certificate due 2027) issued under the KSA Sukuk Limited Trust Certificate Issuance Programme.

As is the case for bonds admitted to trading on the Main Securities Market, these *ṣukūk* prospectuses must comply with the requirements of the Prospectus Directive and reflect the same investor protection legends and disclosure standards as other regulated market prospectuses.[27] Once the prospectus is approved, the *ṣukūk* certificates that are issued are admitted to the official list of Euronext Dublin and to trading on the Main Securities Market.[28] Such *ṣukūk* certificates then benefit from the same passporting rights as regulated market bonds.[29]

For unregulated market *ṣukūk* listings, the Central Bank does not approve the underlying offering document (often referred to in the unregulated context as a "listing particulars"). *Ṣukūk* certificates issued pursuant to such listing particulars are listed on the official list of Euronext Dublin but are admitted to trading on Ireland's unregulated market (the **Global Exchange Market**).[30] As is the case for bonds admitted to trading on the Global Exchange Market, the listing particulars for unregulated market *ṣukūk* are not subject to the Prospectus Directive.

7.3.1.1 Regulation of Ṣukūk *Under Irish Law*

The Central Bank has taken a relatively pragmatic approach to the regulation of *ṣukūk* issuances under Irish law. With respect to reviewing and approving regulated market *ṣukūk* prospectuses, the Central Bank has consistently treated these prospectuses as analogous to prospectuses used for bond issuances and has not sought to impose any additional registration or regulatory

[27] See, for example, the Mumtalakat Sukuk Holding Company US$1,000,000,000 Multicurrency Trust Certificate Issuance Programme, which provides at 2 that, "[t]he Central Bank of Ireland only approves this Base Prospectus as meeting the requirements imposed under Irish and European Union … law pursuant to the Prospectus Directive".

[28] See, for example, BBG Sukuk Ltd. US$2,000,000,000 Trust Certificate Issuance Programme, which was updated on May 4, 2017. BBG Sukuk Ltd. is a Cayman Islands incorporated special purpose vehicle established by Barwa Bank Q.S.C., a bank incorporated in Qatar. The base prospectus for this programme was approved by the Central Bank of Ireland and the *ṣukūk* certificates issued under the programme can be listed on the official list and admitted to trading on the regulated market of Euronext Dublin.

[29] Dillon Eustace, *Shari'ah compliant securities listing on the Irish Stock Exchange*, April 2017, 2, available at: http://www.dilloneustace.com/download/1/Publications/Listings/Shari-ah%20compliant%20securities%20listing%20on%20the%20ISE.pdf (last accessed: February 22, 2019).

[30] See, for example, Dana Gas Sukuk Limited, US$425,040,000 Exchangeable Certificates due 2017 and US$425,040,000 Ordinary Certificates due 2017. Page 1 of the Listing Particulars for these *ṣukūk* certificates notes that "[t]he Global Exchange Market is not a regulated market for the purposes of Directive 2004/39/EC".

requirements on *ṣukūk* issuers. As such, the Central Bank has approved *ṣukūk* offering documents as "prospectuses" (in the context of a standalone issuance)[31] or "base prospectuses" (in the context of a *ṣukūk* programme)[32] for the purposes of the Prospectus Directive in the same way that it approves bond offering documents. The Central Bank has also stated that it will generally require the disclosure in regulated market *ṣukūk* prospectuses to adhere to the requirements set by Annexes IX[33] and XIII[34] of the Prospectus Regulation (Commission Regulation 809/2004, as amended), each of which relates to debt securities.[35] While the Central Bank has noted that the requirement that *ṣukūk* prospectuses comply with the same disclosure standards as bond prospectuses does not indicate "any judgement as to whether [*ṣukūk*] are debt instruments",[36] the nature of the disclosure required represents a strong indication that the Irish authorities will look to exercise a level of regulatory oversight over *ṣukūk* certificates that is analogous to their oversight over bonds. Consistent with this, at listing and admission to trading stage, Euronext Dublin has adopted an approach that aligns the treatment of *ṣukūk* certificates with bonds. As a result, the *ṣukūk* certificates issued by Ṣukūk Funding (No. 3) Limited,[37] CBB International Ṣukūk Company 5 S.P.C.,[38] and Saudi Electricity Global Ṣukūk Company 3[39] (by way of example) have all been approved by Euronext Dublin for listing and admission to trading under the category of "debt security".[40]

[31] See, for example, Alpha Star Holding III Limited, US$500,000,000 Trust Certificates due 2022, issued on April 20, 2017.

[32] See, for example, MAR Sukuk Limited US$1,000,000,000 Trust Certificate Issuance Programme, established on November 15, 2016.

[33] Annex IX (Minimum Disclosure Requirements for the Debt and Derivative securities Registration Document) EU Prospectus Regulation (Commission Regulation 809/2004).

[34] Prospectus Directive – Annex XIII (Minimum Disclosure Requirements for the Securities Note for Debt Securities with a Denomination per Unit of at Least EUR 100,000) EU Prospectus Regulation (Commission Regulation 809/2004).

[35] Central Bank of Ireland, *Address by Head of Markets Policy, Martin Moloney at the IFLC at the UCD School of Law*, 14 May 2015, available at: https://www.centralbank.ie/news-media/press-releases/martin-moloney-at-iflc-at-the-ucd-school-of-law (last accessed: February 22, 2019).

[36] Ibid.

[37] Sukuk Funding (No.3) Limited, US$750,000,000 Trust Certificates due 2018.

[38] CBB International Sukuk Company 5 S.P.C., US$1,000,000,000 Trust Certificates due 2024.

[39] Saudi Electricity Global Sukuk Company 3, US$1,500,000,000, 4.00 per cent. Certificates due 2024 and US$1,000,000,000, 5.50 per cent. Certificates due 2044.

[40] This applies to admission to trading on both the regulated and unregulated market. See, for example, Aktif Bank Sukuk Varlik Kiralama A.S. US$118,000,000 Asset-Backed Trust Certificates due 2024.

The Irish authorities' approach of applying the same regulatory treatment to economically comparable *ṣukūk* certificates and bonds reflects the dominance in the *ṣukūk* market of *ṣukūk* structures that operate in substance like conventional debt securities. The entry into force of the Alternative Investment Fund Managers Directive (Directive 2011/61/EU) as implemented in Ireland through the European Union (Alternative Investment Fund Managers) Regulations 2013[41] (as amended, the **AIFM Regulations**) does, however, raise some uncertainty as to the regulatory treatment of any special purpose vehicle (**SPV**) that operates as an issuer and trustee in a *ṣukūk* issuance.[42] An "alternative investment fund" (or **AIF**) is defined in the AIFM Regulations as "a collective investment undertaking, … which (a) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors…".[43] An Alternative Investment Fund Manager (**AIFM**) cannot manage an AIF unless it is authorised to do so and complies with conditions attached to such authorisation.[44] As contemporary *ṣukūk* structures often involve a separately incorporated SPV issuer that uses the proceeds of an issuance of *ṣukūk* certificates to purchase income-generating assets from the entity ultimately looking to raise funds (referred to in this chapter as the "originator"), such SPV issuers could arguably fall within the scope of the AIFM Regulations. This would result in the imposition of onerous authorisation and disclosure requirements over and above those applying to conventional vanilla bond issuers.

Irish regulatory authorities have not confirmed that *ṣukūk* SPV issuers will not be caught by the AIFM Regulations. The Central Bank has, however, suggested that a financial vehicle engaged "solely in activities where economic participation is by way of debt or other corresponding instruments which do not provide ownership rights in the financial vehicle as are

[41] European Union (Alternative Investment Fund Managers) Regulations 2013, SI 2013/257, as amended by European Union (Alternative Investment Fund Managers) (Amendment) Regulations 2014, SI 2014/379.

[42] Bob Penn, *Unintended consequences: application of the Alternative Investment Fund Managers Directive (AIFMD) to SPVs*, Allen & Overy LLP, July 15, 2013, available at: www.allenovery.com/publications/en-gb/Pages/Unintended-consequences-application-of-the-Alternative.aspx (last accessed: February 22, 2019).

[43] Regulation 5(1) AIFM Regulations (Irl.).

[44] Regulation 7(1) AIFM Regulations (Irl.).

provided by the sale of units or shares”[45] will not be required to register as an AIF in the absence of further guidance by the European Securities and Markets Authority (**ESMA**). In practice, in order for *ṣukūk* certificates offered to investors in Ireland to benefit from the same tax and regulatory treatment as bonds, they must reflect the same economic substance as those bonds and so operate like an “economic participation … by way of debt”. While *ṣukūk* certificates may represent a holder’s ownership interest in underlying assets, returns paid to holders of *ṣukūk* certificates are often based on a pre-agreed repayment profile with no recourse to the underlying assets on default. To the extent *ṣukūk* certificates offered in Ireland are economically comparable to bonds, therefore, an SPV issuing those *ṣukūk* certificates should not be regarded as an AIFM. However, without further guidance from the Central Bank, this remains an area of regulatory uncertainty for *ṣukūk* in Ireland.

7.3.1.2 Taxation of Ṣukūk *Under Irish Law*

The focus of legislative accommodation of *ṣukūk* in Ireland has been with respect to tax. This accommodation was driven by the fact that structural differences between bonds and *ṣukūk* raised uncertainty as to whether *ṣukūk* returns would be treated by Irish tax law as fully taxable profit distributions or as equivalent to interest payable on a bond, which is tax deductible.[46] The amendments to Ireland’s tax laws introduced by the Finance Act 2010 sought to address this distinction by incorporating s267R into the TCA 1997. S267R TCA 1997 applies to “investment certificates”, which are certificates that are a financial liability of the issuing entity, establish an investor’s claim over the rights and obligations represented by the certificate and entitle the investor to an amount equivalent to a share in the profits or losses derived from underlying assets.[47] Such investment certificates produce an “investment return” representing periodic payments of profit derived from the underlying assets and any excess amounts payable on redemption of the certificates.[48] Though religiously

[45] Central Bank of Ireland, *AIFMD Questions and Answers*, 30th Edition – 4 May 2018, Question ID 1065.

[46] As distributions in Ireland are not tax deductible for corporation tax purposes while interest payments are.

[47] See s267N TCA 1997 (Irl.) definition of “investment certificate” (Finance Act 2010 as amended by s24 Finance Act 2013 (Irl.)).

[48] See s267N TCA 1997 (Irl.) definition of “investment return”.

neutral in its terminology,[49] s267R TCA 1997 is designed to accommodate *ṣukūk* certificates issued by Irish-incorporated entities.[50]

S267R TCA 1997 provides that "the Tax Acts[51] shall apply to an investment return as if that investment return *were interest on a security*".[52] In order to ensure that only "investment returns" that are economically comparable to interest (as opposed to taxable distributions) are treated as interest, s267R TCA 1997 is explicitly subject to s130 TCA 1997.[53] S130 TCA 1997 covers "matters to be treated as distributions" and defines a "distribution" as any payment by a company the level of which is "dependent on the results of the company's business or any part of the company's business".[54] As such, while investment certificates may represent a holder's right to "share in the profits *or losses* derived from"[55] underlying assets, only where the investment returns constitute periodic payments of *profit* derived from those assets, and such investment returns are not dependent on the results of the issuer's business, will they be treated by Irish tax law as equivalent to interest payable on a bond.[56] This approach was most recently confirmed in the November 2018 update of the Tax and Duty

[49] Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), Irish Revenue Commissioners, Dublin, November 2018, [1.3]. See also, Revenue, *Guidance Notes on the Tax Treatment of Islamic Financial Transactions*, Irish Revenue Commissioners, Dublin, October 2010, 6 (the *Tax and Duty Manual* (Part 08A-01-01) replicates almost exactly the content of the original *Guidance Notes on Tax Treatment of Islamic Financial Transactions*).

[50] Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.*, [8]; Irish Revenue Commissioners, *Guidance Notes on the Tax Treatment of Islamic Financial Transactions*, *op. cit.*, 33. See s267N TCA 1997 (Irl.) definition of "qualifying company" which provides that one of the criteria for being a qualifying company is being "resident in the State".

[51] Defined as the Corporation Tax Acts (enactments relating to corporation tax in the TCA 1997 and in any other enactment, together with the enactments relating to income tax in the TCA 1997 and in any other enactment insofar as those enactments apply for the purposes of corporation tax) and the Income Tax Acts (enactments relating to income tax in the TCA 1997 and in any other enactment).

[52] Emphasis added. Read in conjunction with existing provisions of the TCA 1997, this exemption would appear to apply only to those payments which "represent[] a reasonable commercial return for the use of [the] principal" (s130(2)(d)(iii)(II) TCA 1997 (Irl.)) thus ensuring that only those transactions whose economic implications are similar to conventional bonds will actually benefit from parity of treatment.

[53] s267R TCA 1997 (Irl.).

[54] s130(2)(d)(iii)(I) TCA 1997 (Irl.).

[55] s267N TCA 1997 (Irl.).

[56] s267R TCA 1997 (Irl.).

Manual (Part 08A-01-01)[57] in which the Revenue confirmed that "[i]n general, Revenue will not regard the return as being dependent on the results of the business"[58] as long as the amount of the expected return equates in substance to a commercial return on an investment, the return is determined at the outset of the transaction, it is equivalent to the rate of interest, *and* it is not altered during the course of the transaction except where such alteration follows interest rates.[59]

Stamp duty burdens imposed on *ṣukūk* issuances in Ireland have also, in part, been alleviated by s137 of the Finance Act 2010 through the incorporation of s85A into the SDCA 1999. S85A SDCA 1999 brings the stamp duty treatment of *ṣukūk* certificates in line with that of bonds by providing that stamp duty is not chargeable on the issue, transfer, or redemption of investment certificates.[60] However, s85A SDCA 1999 only relieves stamp duty liability that would otherwise apply to *ṣukūk* certificates themselves, not the assets underpinning those *ṣukūk* certificates. As some *ṣukūk* transactions based on real property may involve multiple transfers of that property (from the originator to the issuer (on behalf of holders of the *ṣukūk* certificates) at the time the *ṣukūk* certificates are issued and then back to the originator on redemption of the *ṣukūk* certificates), *ṣukūk* issuances may result in multiple impositions of stamp duty. Unlike the UK, where this double stamp duty charge has been specifically addressed,[61] Irish tax reforms have not yet addressed this aspect of *ṣukūk* issuances. This may put certain *ṣukūk* transactions at a financial disadvantage as compared to conventional bonds.[62]

[57] Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.*

[58] Ibid., [8.3].

[59] Ibid.

[60] s85 SDCA 1999 (Irl.) exempts the issue and transfer of "loan capital" which refers to any debenture stock, bonds, or funded debt, by whatever name known, or any capital raised which is borrowed or has the character of borrowed money, whether in the form of stock or in any other form.

[61] s5 of schedule 61 of this Finance Act 2009 (UK). The provision was reinforced by the Stamp Duty Land Tax (Alternative Finance Investment Bonds) Regulations 2010 (No. 814 of 2010) (UK) which further extended the scope of alternative finance investment bond (that is, *ṣukūk*) stamp duty land tax relief.

[62] The *Tax and Duty Manual* (Part 08A-01-01) does note, however, that *ṣukūk* "have evolved such that it is not uncommon that they grant an ownership interest to the holder of the investment certificate not in the underlying assets of the qualifying company but instead

Ireland's position as a venue for the listing and admission to trading of international *ṣukūk* continues to strengthen with Ireland being chosen as the listing venue for a number of market leading *ṣukūk* issuances over the last five years.[63] A sensible approach to regulatory oversight and a partially tailored tax regime highlight the Irish government's interest in encouraging the issue and listing of *ṣukūk* in Ireland. Unlike the UK, however, which has seen engagement with the *ṣukūk* market by UK-based entities,[64] the domestic market in *ṣukūk* originated in Ireland has been slower to develop.[65] Some remaining tax issues and uncertainty with respect to certain regulatory aspects of contemporary *ṣukūk* may continue to impact on the further development of this market in Ireland.

7.3.2 Islamic Investment Funds

Islamic investment funds represent a strong segment of the global Islamic finance market.[66] Like conventional investment funds, these funds are structured to spread investment risk and protect returns through the pooling of investor capital. Islamic investment funds do not, however, invest in *haram* or forbidden industries and business.

in an underlying asset which is a financial liability of the counterparty that ultimately underpins the *ṣukūk* arrangement and its related cash flows", Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.* [8.1].

[63] See, for example, Saudi Electricity Global Sukuk Company 3 US$2,500,000,000 Certificates issued in two series (US$1,500,000,000 4.00 per cent. Certificates due 2024 and US$1,000,000,000 5.50 per cent. Certificates due 2044.

[64] See, for example, HM Treasury UK Sovereign Sukuk PLC issue of £200,000,000 Certificates due 2019. Both the Royal Bank of Scotland PLC and HSBC Bank plc have previously established *sharī'ah*-compliant certificate programmes but have not issued listed *ṣukūk* certificates under these programmes. See, The Royal Bank of Scotland PLC Crescent Trust Certificates LaunchPAD Programme and the HSBC Bank plc Programme for the Issuance of Shari'ah-Compliant Certificates.

[65] A press release published on April 5, 2018 indicated that an Irish-incorporated company issued *ṣukūk* certificates. However, no publicly available information on this issuance is available as at the time of writing this chapter, Matheson, *News and Insights, Matheson Advises on the First Irish Issuance of a Sukuk Bond Under Irish Tax Law*, April 5, 2018, https://www.matheson.com/news-and-insights/article/matheson-advises-on-the-first-irish-issuance-of-a-sukuk-bond-under-irish-ta (last accessed: February 22, 2019).

[66] Department of Finance, *IFS2020: A Strategy for Ireland's International Financial Services sector 2015–2020, op. cit.*, 20.

7.3.2.1 Regulation of Islamic Investment Funds Under Irish Law

Ireland has sought to benefit from the global growth in Islamic investment funds and this sector has witnessed considerable development in Ireland over the last decade.[67] Reflecting this, the Central Bank has authorised a number of Irish-domiciled investment companies offering Islamic investment funds. In 2003, Oasis Global Management Company (Ireland) Limited received approval from the Central Bank for the establishment of the Oasis Crescent Global Investment Fund (Ireland) plc investment company. This investment company, which is stated to be "managed in accordance with Shari'ah principles",[68] is authorised in Ireland as an undertaking for collective investment in transferable securities (**UCITS**) pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011.[69] More recently, the Central Bank has authorised the establishment of CIMB-Principal Islamic Asset Management (Ireland) Plc as a UCITS.[70] This was the first Malaysian-based Islamic investment fund platform to be domiciled in Ireland[71] and it has since gone on to establish two Islamic sub-funds, the Islamic ASEAN Equity Fund (launched in 2012) and the Global Ṣukūk Fund (launched in 2016), both of which have shares listed on Euronext Dublin.

In authorising Islamic investment companies and the funds that they offer, the Central Bank has adopted a "no special treatment" approach to this authorisation. These companies have so far been authorised as one of the two main categories of funds in Ireland, UCITS or Alternative Investment Funds, in the same authorisation process as conventional funds.[72] This classification determines to whom the funds can be pro-

[67] Ibid.

[68] Oasis Crescent Global Investment Fund (Ireland) plc, Prospectus dated April 8, 2016, 12.

[69] European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, SI 2011/352 (Irl.). Other Islamic investment funds established and authorised in Ireland include Old Mutual Global Islamic Equity Fund, Deutsche Noor Islamic Funds plc, Mashreq-Al-Islami Arab Tigers Fund, and CIMB - Principal Islamic Asset Management (Ireland) plc (which runs the Islamic ASEAN Equity Fund and the Global Sukuk Fund).

[70] CIMB-Principal Islamic Asset Management (Ireland) Plc, Prospectus dated September 7, 2016, 3.

[71] CIMB, *CIMB-Principal Islamic Asset Management establishes three Islamic investment funds to attract global investors*, 16 January 2012, available at: www.cimb.com/en/news/news/2012/cimb-principal-islamic-asset-management-establishes-three-islamic-funds-to-attract-global-investors.html (last accessed: February 22, 2019).

[72] Central Bank of Ireland, *Address by Head of Markets Policy, Martin Moloney at the IFLC at the UCD School of Law*, *op. cit.*

moted and the applicable regulatory regime. Islamic investment funds in Ireland are, therefore, required to meet the same regulatory and disclosure standards as comparable conventional investment funds. In practice, this has resulted in Islamic investment funds providing disclosure on the types of investments that are prohibited by the fund's investment objectives, the process applied to cleanse any non-Islamic returns, and details of the *sharī'ah* supervisory board's role (to the extent one is appointed).[73]

While the Central Bank will require Islamic investment funds to provide adequate disclosure to investors, it will not look to determine whether the activities of an Islamic investment fund are carried out in accordance with Islamic legal principles, nor will it require the appointment of a *sharī'ah* supervisory board.[74] Nevertheless, the Central Bank has acknowledged the role of these *sharī'ah* supervisory boards in Islamic finance transactions. In doing so, the Central Bank has set out three principles guiding its on-going interaction with *sharī'ah* supervisory boards in Islamic investment funds. First, the Central Bank has confirmed that it would not be appropriate for it to adopt a view on the quality of a *sharī'ah* supervisory board or their suitability to make the judgements they make. Second, it is not for the Central Bank to verify any claim that an Islamic finance transaction is *sharī'ah*-compliant or that it has been approved by a *sharī'ah* supervisory board. Finally, the Central Bank will not subject Islamic investment funds to surveillance in order to check on-going compliance with the terms of any *sharī'ah* supervisory board's approval.[75] The Central Bank's approach to *sharī'ah* supervisory boards aligns with its treatment of Islamic investment funds generally and reflects the fact that a secular regulator is not in a position to determine matters of religious compliance.

[73] Ibid. See, for example, the prospectus for CIMB-Principal Islamic Asset Management (Ireland) Plc, which discloses the restrictions on investing in non-Islamic investments that apply to the funds established by CIMB-Principal Islamic Asset Management (Ireland) Plc [12], divestment of non-Islamic investments, [18] and details of the "Shari'ah Advisor", [9].

[74] Irish authorities have confirmed that it is "a matter for each individual entity wishing to market Islamic finance products to have a Shari'a Board available", Department of Finance, *Islamic Finance in Ireland; An Information Note*, *op. cit.*, 7.

[75] Central Bank of Ireland, *Address by Head of Markets Policy, Martin Moloney at the IFLC at the UCD School of Law*, *op. cit.*

7.3.2.2 Taxation of Islamic Investment Funds Under Irish Law

Ireland's favourable tax environment for investment funds also applies to funds offered by Irish-incorporated Islamic investment funds.[76] Islamic investment funds were not dealt with specifically in the Finance Act 2010; however, the 2009 Tax Briefing confirmed that Islamic investment funds would be subject to the same tax regime as conventional investment funds.[77] As a result, if an Islamic investment fund is structured so that it falls within Chapter 1A, Part 27 of the TCA 1997,[78] a gross-roll-up tax regime will be applied eliminating annual tax on the profits of the fund but requiring the fund to deduct and account for tax when unit holders are paid.[79] Such withholding does not apply in circumstances where as a result of an exemption (such as non-Irish residence) the amounts are to be paid gross.[80] As such, for both Islamic and conventional investment funds, there is no withholding tax on distributions made to non-Irish resident unit-holders[81] or unit-holders classified as exempt Irish domiciled entities.[82] Like a conventional investment fund, no stamp duty liability arises on the issuance or redemption of units in an Islamic investment fund.[83]

[76] s110 TCA 1997 (Irl.), as amended by the Finance Act, 2003 (No. 3 of 2003) (Irl.). See also, Omer Khan and Ken Owens, "A greater understanding brings new opportunities" *Islamic Finance Review*, (2009/2010), 53, 53.

[77] Irish Revenue Commissioners, *Islamic Finance, Tax Briefing Issue 78*, *op. cit.*, 8.

[78] Introduced by s58 Finance Act 2000 (No. 3 of 2000) (Irl.).

[79] Chapter 1A Part 27 TCA 1997 (Irl.). Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.*, [2.2.1].

[80] Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.*, [2.2.1].

[81] The requirement for non-Irish resident investors to make a declaration of non-residence in order to avoid taxation of redemption payments from an Irish domiciled fund has been removed.

[82] Irish Revenue Commissioners, *Revenue Technical Guidelines*, "Investment Undertakings, General Guidelines for Calculating Tax Due and for Completing Declaration Forms", Part 27-01A-02, 6–7, see also, Dillon Eustace, *Taxation of Collective Investment Funds and Availability of Treaty Benefits*, 2010, 7, available at: www.dilloneustace.com/download/1/Taxation%20of%20Collective%20Investment%20Funds%20and%20Availability%20of%20Treaty%20Benefits.pdf (last accessed: February 22, 2019).

[83] See, for example, the CIMB-Principal Islamic Asset Management (Ireland) Plc, Prospectus dated 7 September 2016, 59, which notes that "[unit holders] who are neither resident nor ordinarily resident in Ireland in respect of whom the appropriate declarations have been made … will not be subject to tax on any distributions from the Company or any gain arising on redemption, repurchase or transfer of their shares provided the shares are not held through a branch or agency in Ireland". It also provides that "[n]o Irish stamp duty will be payable on the subscription, transfer or redemption of Shares provided that no application for Shares or re-purchase or redemption of Shares is satisfied by an in specie transfer of any Irish situated property". Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.*, [2.2.3].

The existence of a straightforward, favourable tax regime that does not distinguish between Islamic and conventional investment funds represents a significant advantage for Islamic investment funds in Ireland.[84] From a regulatory and tax standpoint, therefore, parity of treatment between Islamic and conventional investment funds and their investors has to date required no tailored modification of Ireland's existing laws. Reflecting this, the Islamic investment funds industry in Ireland already represents a defined sector of Ireland's financial market.

7.3.3 Islamic Mortgage Alternatives

A number of Islamic mortgage alternatives have been developed by the contemporary Islamic finance industry based on contractual forms that do not involve the payment of interest. These instruments may be structured on the basis of a *murābaḥa* contract (sale of the property to the customer with the purchase price paid on a deferred and marked-up basis),[85] an *ijārah wa-iqtina* contract (lease of the property to the customer ultimately resulting in a transfer of the property's title to the customer),[86] or a diminishing *mushāraka* contract (shared ownership of the property between a financial institution and customer, lease of that property to the customer and ultimately a transfer of the property's title to the customer).[87] In each case, the economic substance of the relevant Islamic mortgage alternative is consistent with an interest-based mortgage, while structurally they are distinguishable from their conventional alternatives.

[84] Deloitte, *Corporate Sukuk in Europe – Alternative financing for investment projects*, (n.d.), 9, available at: https://www2.deloitte.com/content/dam/Deloitte/xe/Documents/financial-services/me_Islamic-finance_corporate-sukuk-in-europe.pdf (last accessed: February 22, 2019).

[85] Under the *murābaḥa* model, the financier buys the property and sells it immediately to the borrower for the original purchase price plus an agreed mark-up (the financier's profit) to be paid in instalments.

[86] Under the *ijārah wa-iqtina* model, the borrower undertakes to purchase the property at the end of the rental period with the purchase price spread out over the duration of the lease—the bank remains owner of the property for the lease term and the rent paid by the borrower represents the banks profit, H. A. Dar, "Islamic House Financing in the United Kingdom: Problems, Challenges and Prospects", *Review of Islamic Economics*, 12 (2002), 47, 51.

[87] Under the diminishing *mushāraka* model, the financier and the customer enter into a joint ownership of a property, the financier leases its share back to the borrower who also progressively purchases the financier's equity in the property until the financiers share in the property is reduced to zero. Michael Ainley, Ali Mashayekhi, Robert Hicks, Arshadur Rahman, and Ali Ravalia, *Islamic Finance in the UK: Regulation and Challenges*, (London: Financial Services Authority, 2007), 20.

7.3.3.1 Regulation of Islamic Mortgage Alternatives Under Irish Law

In Ireland, consumer protection in the context of mortgages is established in the Consumer Credit Act 1995 (the **CCA 1995**).[88] The CCA 1995 defines a "housing loan" as including "an agreement for credit [or refinancing credit] on the security of a mortgage of a freehold or leasehold estate or interest in land"[89] for the purpose of the construction, improvement or purchase of a house, and a mortgage is defined as including a charge.[90] In order to ensure Ireland's consumer protection regime applies to Islamic mortgage alternatives, the structures developed by the Islamic finance industry must be brought within the existing regulatory regime. In the case of *murābaḥa*-based mortgage alternatives, this would seem to be a relatively straightforward process, as these structures involve the transfer of property to the customer who then repays the purchase price over a period of time and grants a charge over the property to the financial institution.[91] *Ijārah wa-iqtina-* and diminishing *mushāraka*-based mortgage alternatives, on the other hand, raise more difficulties. In both of these arrangements, the financial institution assumes full or partial ownership of the property for the duration of the transaction. Only at maturity of the financing arrangement will title to the property be transferred to the customer in full. As such, structurally there is no credit extended to the customer and, as the financial institution maintains all or some ownership interest in the property, there is limited scope for the customer to charge the property in favour of that financial institution.[92] It is arguable, therefore, that other than in the case of structures based on a *murābaḥa* contract, Islamic mortgage alternatives fall outside of Ireland's consumer protection regime. UK authorities faced a similar issue, which they addressed by the creation of a new category of

[88] Consumer Credit Act 1995 (No. 24/1995) (**CCA 1995**) (Irl.).

[89] Interpretation, CCA 1995, (Irl.) as amended by s 33 of, and Part 12 of Schedule 3 to, the Central Bank and Financial Services Authority of Ireland Act 2004 (No. 21 of 2004) (Irl.).

[90] s2(1) CCA 1995 (Irl.), as substituted by s33 of, and Part 12 of Schedule 3 to, the Central Bank and Financial Services Authority of Ireland Act 2004 (Irl.).

[91] Currently, Community Finance Ireland is developing a *murābaḥa*-based product to be used to finance the acquisition of properties by Muslim community groups or social enterprises, although not by individuals directly; see further, Philip Lee, "Ireland's First Islamic Financing Product: The First Of Many", 2018, available at: https://www.philiplee.ie/irelands-first-islamic-financing-product-the-first-of-many/ (last accessed: February 22, 2019).

[92] *Secretary of State for Work and Pensions v UP* [2010] UKUT 262 (AAC), [13].

regulated activity relating to "Home Purchase Plans"[93] and by amending the Financial Conduct Authority's "Mortgage and Home Finance: Conduct of Business Sourcebook" (**MCOB**) to cover Islamic mortgage alternatives.[94] This extended the disclosure, treatment of arrears, repossessions, and responsible lending[95] provisions of MCOB to *sharī'ah*-compliant finance activity.

Lack of regulatory clarity in Ireland, particularly when compared with the regulatory changes introduced in the UK, may lead to inconsistent regulation of Islamic and conventional home financing products and uncertainty as to who is authorised to offer these products in Ireland.

7.3.3.2 Taxation of Islamic Mortgage Alternatives Under Irish Law

The amendments to the TCA 1997 that were introduced by s39 of the Finance Act 2010 provided some legislative accommodation in terms of the taxation of Islamic mortgage alternatives. Following the Finance Act 2010, the TCA 1997 now provides for a number of "credit transactions" that are structurally similar to *murābaḥa*[96] and diminishing

[93] Financial Conduct Authority (previously the Financial Services Authority), *Regulation of Home Reversion and Home Purchase Plans*, (London: Financial Services Authority, 2006), 6.

[94] MCOB 1.2.1 (1) noting that: "This sourcebook applies to every firm that: (a) carries on a home finance activity (subject to the business loan application provisions); or (b) communicates or approves a financial promotion of qualifying credit, of a *home purchase plan* or of a home reversion plan" (emphasis added).

[95] MCOB 4.10 (advertising and selling standards), MCOB 5.8 (pre-application disclosure), MCOB 6.8 (Disclosure at the offer stage), MCOB 7.8 (Disclosure at start of contract and after sale), MCOB 11 (Responsible lending and responsible financing of home purchase plans), MCOB 12.7 (Charges), MCOB 13.8 (Arrears and repossessions).

[96] Paragraph (a), definition of "credit transaction", s267N TCA 1997 (Irl.), which provides as follows:

(a) an arrangement whereby a finance undertaking acquires an asset for the purpose of disposing of the full interest in that asset to a borrower in circumstances where—
   (i) the consideration paid or payable by the borrower exceeds the consideration paid or payable by the finance undertaking for the asset,
   (ii) all or part of that consideration is not required to be paid until a date later than the date of the disposal, and
   (iii) the excess of the consideration paid or payable to the finance undertaking by the borrower in respect of the asset over the consideration paid or payable by the finance undertaking for the asset is equivalent to the return on a loan of money at interest.

mushāraka[97] transactions.[98] As long as certain conditions are met, the provisions of Part 8A TCA 1997 seek to treat these credit transactions as if they establish a loan relationship between a financial institution and a customer. Pursuant to s267O TCA 1997, therefore, the return payable to a financial institution pursuant to a credit transaction shall be treated for the purposes of the Tax Acts as if it were interest paid or payable on a loan and chargeable to tax accordingly.[99] The financial institution's return will not be treated for the purposes of the Tax Acts as expenditure on an asset.[100]

[97] Paragraph (c), definition of "credit transaction", s267N TCA 1997 (Irl.), which provides as follows:

(c) an arrangement whereby—
  (i) a finance undertaking and a borrower jointly acquire an asset or
  (ii) a finance undertaking acquires an interest in an asset from a borrower, in circumstances where the borrower retains an interest in that asset,

on terms whereby—

I. the borrower—
  A. in the circumstances referred to in subparagraph (i) has exclusive use of the asset immediately and, in the circumstances referred to in subparagraph (ii), retains exclusive use of the asset immediately, as the case may be,
  B. is exclusively entitled to any income, profit or gain arising from or attributable to the asset (including any increase in the value of the asset), and
  C. agrees to make payments to the finance undertaking amounting to the aggregate of the consideration paid or payable by the finance undertaking for the acquisition of its interest in the asset and any consideration paid or payable by the borrower for the use of the asset during the period of the arrangement,

II. the excess of the consideration (including any consideration paid or payable for the use of the asset during the period of the arrangement) accruing to the finance undertaking from the borrower in respect of the interest of the finance undertaking in the asset over the consideration paid or payable by the finance undertaking for the asset is equivalent to the return on a loan of money at interest, and

III. the finance undertaking's interest in the asset passes either immediately or by the end of a specified period of time, to the borrower for a consideration which exceeds the consideration paid by the finance undertaking for the asset.

[98] While the Revenue's *Tax and Duty Manual* (Part 08A-01-01) suggest that *ijārah wa-iqtina* structures would fall within the provisions of the Finance Act 2010, it acknowledges that the provisions do "not apply to a lease *of immovable property*" (Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.*, [3.3.1.3], emphasis added).

[99] s267O(1) TCA 1997 (Irl.).

[100] This is relevant for the purposes of relief on capital expenditure and capital gains tax.

The amendments introduced by the Finance Act 2010 seek to bring these credit transactions within Irish tax law applying to loans and interest where the structure of such credit transactions would otherwise have precluded them from being treated as such. The returns paid to a financial institution pursuant to a credit transaction will now be taxed and relieved as if they were interest payments made pursuant to a conventional mortgage. This approach reflects similar accommodations introduced in UK tax law.[101]

The taxation of Islamic mortgage alternatives in Ireland has not, however, been brought completely in line with the corresponding tax framework applying to interest-based mortgages. One of the obstacles preventing comparable taxation is the multiple impositions of stamp duty liability with respect to Islamic mortgage alternatives. Each of the three forms of Islamic mortgage alternative technically involves at least two sales of the underlying property, the first when the financial institution acquires ownership of the property from the original vendor and the second when it transfers ownership of that property to the customer.[102] This two stage transfer may result in a double imposition of stamp duty.[103] UK authorities addressed this issue early in their legislative accommodation of Islamic finance transactions by eliminating the double stamp duty land tax imposed on *murābaḥa* transactions[104] in 2003 and diminishing *mushāraka* and *ijārah wa-iqtina* transactions in 2005.[105] As such, as is the case for conventional mortgages, there is now only one imposition of stamp duty land tax on Islamic mortgage alternatives in the UK.[106] In the absence of clarity with respect to the stamp duty position of Islamic mortgage alternatives in Ireland, these instruments could potentially be prohibitively expensive.

[101] HM Land Registry, *Practice guide 69: Islamic financing*, 2015, https://www.gov.uk/government/publications/islamic-financing/practice-guide-69-islamic-financing (last accessed: February 22, 2019).

[102] Fahim Uz-Zaman, *Shariah-Compliant Financial Services: A Guide to Products, Markets and Trends*, (London: VRL KnowledgeBank Ltd., 2006), 37; Reinhard Leopold Klarmann, *Islamic Project Finance; a Legal Study with Particular Reference to the Laws of Switzerland and the United Arab Emirates*, (Zurich: Schulthess, 2003), 252.

[103] The Irish Revenue Commissioners's Tax and Duty Manual, while referring to the stamp duty issue, reiterates that "stamp duty will arise under normal rules". Irish Revenue Commissioners, "Tax Treatment of Islamic Financial Transactions", *Tax and Duty Manual* (Part 08A-01-01), *op. cit.* [6.3.8].

[104] s73 Finance Act 2003 (UK).

[105] s71A Finance Act 2003 (UK), inserted by the Finance Act 2005, s94, Schedule 8 [1]–[2].

[106] Cosgrave, Barry, "United Kingdom" in *The Islamic Finance and Markets Law Review*, Andrew M Metcalf and Michael Rainey (eds.), (London: Law Business Research, 2016), 68, 73.

7.4 Conclusion

Over the last decade, the Islamic finance sector has matured and diversified. While its growth globally has perhaps not quite aligned with the lofty expectations of its early proponents, Islamic finance nevertheless represents an identifiable sector of the global financial market and offers market participants an alternative means of accessing financing and investment opportunities.

In Ireland, positive steps have been taken to legislate for, and to clarify the legal treatment of, certain Islamic finance products. These accommodative measures reflect an amenable attitude towards Islamic finance activity amongst Irish government authorities and follow similar accommodations introduced in other Western countries. In practice, however, the perceptible growth of the Islamic finance industry in Ireland today has generally taken place outside of these legislative accommodations, with only limited domestic Islamic finance activity. Ireland has increasingly become a jurisdiction for the approval and listing of *ṣukūk* certificates and programmes. The issuers of these instruments have to date generally not been Irish-incorporated entities, but are instead international entities that are not subject to the accommodative provisions of Ireland's tax laws. As such, growth in this sector has been largely unaffected by the legislative reforms introduced by the Finance Act 2010. Equally, while the number of Irish-domiciled Islamic investment funds has grown in recent years, this market sector has again developed without the need for legislative accommodation.

Since the Finance Act 2010, there have been limited further legislative amendments to accommodate Islamic finance within Irish law. Rather than a lack of support for Islamic finance amongst Irish authorities, however, this arguably suggests that market demand is not yet significant enough to justify further accommodation. The generally pragmatic and accommodative attitude of the Irish authorities to date indicates that, should the market require them, further accommodations may be introduced to build on those already laid down by the Finance Act 2010.

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CHAPTER 8

Developments and Prospects for Islamic Finance in Italy

Sabrina Iannazzone

Abbreviations and Acronyms

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABI	Associazione Bancaria Italiana
ABS	Asset-backed security
AIAF	Associazione Italiana degli Analisti Finanziari
ASSAIF	Associazione per lo Sviluppo di Strumenti Alternativi e di Innovazione Finanziaria
BCC	Banche di Credito Cooperativo
CARIFAC	Cassa di Risparmio di Fabriano e Cupramontana
CESPI	Centro Studi di Politica Internazionale
CONSOB	Commissione Nazionale per le Società e la Borsa
CO.RE.IS	Comunità Religiosa Islamica Italiana
CSR	Corporate Social Responsibility
ECB	European Central Bank
ESG	Environmental, Social, Governance
EU	European Union

S. Iannazzone (✉)
Relazioni e Istituzioni dell'Asia e dell'Africa, Università degli Studi di Napoli "L'Orientale", Naples, Italy

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EURIBOR	Euro Interbank Offered Rate
EUROSIF	European Sustainable Investment Forum
FEBEA	Fédération Européenne de Finances et Banques Ethiques et Alternatives
FSA	Financial Services Authority
GCC	Gulf Cooperation Council
IAS/IFRS	International Accounting Standards/International Financial Reporting Standards
IBF	Islamic banking and finance
IFI(s)	Islamic financial institution(s)
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
ILO	International Labor Organization
IME	Islamic moral economy
ISESCO	Islamic Educational, Scientific and Cultural Organization
ISFIN	Islamic finance lawyers
ISTAT	Istituto Nazionale di Statistica
LIBOR	London Interbank Offered Rate
MENA	Middle East and North Africa
MOT	Mercato telematico delle obbligazioni e dei titoli di Stato
MRI(s)	Morally responsible investment(s)
OECD	Organization for Economic Co-operation and Development
OICR	Organismi di Investimento Collettivo del Risparmio
ONLUS	Organizzazione Non Lucrativa di Utilità Sociale
PBUH	Peace Be Upon Him
PLS	Profit and Loss Sharing
SDG	Sustainable Development Goals
SDLT	Stamp Duty Land Tax
SEE	Social, Environmental, Ethical
SEFEA	Società Europea di Finanza Etica e Alternativa
SGR	Società di Gestione del Risparmio
SICAF	Società di investimento a capitale fisso
SICAV	Società di investimento a capitale variabile
SIMEST	Società Italiana per le Imprese all'Estero
SME(s)	Small and Medium Enterprise(s)
S.p.A	Società per Azioni
SPV	Special purpose vehicle
SRI(s)	Socially responsible investment(s)
SSB	*Sharīʿa* Supervisory Board
TUIR	Testo Unico delle Imposte sui Redditi
UCITS	Undertakings for Collective Investment in Transferable Securities
VAT	Value Added Tax

8.1 Introduction

Islamic finance is a fairly recent phenomenon in Italy. While Italy may count on long-standing trade relations with the Arab-Muslim countries, domestic institutions started to raise public awareness of Islamic banking and finance relatively late. The Bank of Italy released the first paper specifically focused on the interaction between Islamic finance and the conventional financial system in October 2010.[1] This delay has resulted in two main consequences: there are no fiscal and legal adjustments yet to accommodate Islamic finance in Italy; conversely, many bottom-up initiatives have followed one another and revealed a growing interest toward the implementation of Islamic finance in Italy, not only from the Italian Muslim community but also from financial institutions and associations as well as academia. A new draft law is currently under debate in the Parliament about the regulation of *Sharīʿa*-compliant products and financial operations within the Italian legal and fiscal framework. This would be in line with the political and regulatory initiatives that other European countries, such as the UK, France, and Luxembourg, have already taken.

Italy could contribute to the financial integration of the second generation of Muslim migrants, who are permanent residents in Italy and have different needs compared to those of their parents. Furthermore, a dense network of Italian Small and Medium Enterprises (SMEs) is dependent solely on bank financing and is now seeking access to new sources of funding, notably from the capital market. Recent steps forward and proven interest within the context of academia and the Islamic financial market, such as from institutes like Associazione Italiana degli Analisti Finanziari (AIAF) and companies like Azimut Holding, have tremendous potential to transform the prospects of Islamic finance in Italy. All these factors make Islamic finance in Italy a promising field of research and economic development in the years ahead, notwithstanding the many hurdles to leap and the stereotypes that must be debunked. Therefore, this chapter aims to analyze the transition from the 'Arab finance' to Islamic finance; the approaches held by various institutions (i.e. ABI, CONSOB and the Bank of Italy); projects implemented and projects that could be carried out in

[1] G. Gomel, A. Cicogna, D. De Falco [et al.]. Finanza Islamica e sistemi finanziari convenzionali. Tendenze di mercato, profili di supervisione e implicazioni per le attività di banca centrale. [online]. Rome: Banca d'Italia, Occasional Paper No. 73, October 2010. Updated on October 31, 2010. [accessed April 4, 2017]. Available on Internet: http: //www.bancaditalia.it/pubblicazioni/qef/2010-0073/QEF_73.pdf

the near future, as illustrated in the case study of *Sharīʿa*-compliant mini-bonds; and financial instruments and activities that are feasible within the Italian regulatory, political and cultural framework. A part of the analysis delves into a comparison between Islamic and ethical finance, due to the peculiar Italian religious backdrop and a long tradition of ethical and cooperative banking in the country. The purpose consists in exploring the possibility of interaction between both models of ethical banking and investing while understanding whether such interaction may transform the prospects for Islamic banking in Italy in the near future.

8.2 The Early Stage of Islamic Finance

8.2.1 From the 'Arab Finance' to Islamic Finance

Italy and Arab countries have always maintained business relationships and agreements, but only recently has Italy started to look at Islamic finance as a viable way to strengthen these ties. The Union of Arab and European Banks (UBAE) has operated in Italy since 1972 as a banking company whose shareholders include major Arab and Italian banking groups. In fact, it aimed at increasing financial and industrial relationships, as well as trade between Arab countries and Europe. Specifically, it provides companies operating in different countries with consulting and brokerage services. Similarly, other commercial initiatives were the Mediterranean Partnership Fund and the Memorandum of Understanding between the Italian Banking Association (*Associazione Bancaria Italiana*; ABI) and the Union of Arab Banks in 2007. The Mediterranean Partnership Fund envisaged a partnership between Società Italiana per le Imprese all'Estero—SIMEST (a financial institution supporting Italian enterprises abroad) and governments as well as banking institutions from the Middle East and North Africa (MENA) and Gulf regions in order to boost trade and the growth of SMEs. It contained a proposal to introduce a *Sharīʿa*-compliant part into the fund. As for the Memorandum of Understanding, its parties are committed to fostering integration and partnerships between Arab and Italian banking and financial institutions as well as best practices. They are also committed to increasing trade and investments flows, and to promoting round tables in order to find common solutions to critical issues and investment opportunities.

Moreover, ABI confirmed its support to the development of economic exchanges with the Gulf countries during the Internationalization Forum

in Rome in 2010, even through the possible entry of *Sharīʿa*-compliant instruments in Italy. In 2013, *Commissione Nazionale per le Società e la Borsa* (CONSOB) and Dubai Financial Services Authority signed a memorandum for mutual cooperation. CONSOB is a public authority that regulates the Italian securities market. In this agreement, both authorities recognized the need for enhancing mutual assistance related to the exchange of information in order to fulfill their respective supervisory and oversight responsibilities. Lately, the Italian Strategic Fund has opened new opportunities for the internationalization of Italian enterprises and for *Sharīʿa*-compliant investments in Italy. In fact, the Italian Strategic Fund represents an institutional intermediary for the investment in the venture capital of enterprises, which either have a substantial impact on the national territory or work for a strategic sector of Italian economy. Therefore, it seeks to attract foreign capital in favor of higher productivity and expansion of Italian companies, thereby making domestic firms more competitive in the international market. In practice, the Fund acquires a minority stake in the companies in order to contribute to the corporate growth and to long-term industrial projects. In this context, partnerships or joint ventures with international investors play a pivotal role. Agreements have been signed with Qatar Holding LLC and Kuwait Investment Authority. More precisely, the Italian Strategic Fund together with Qatar Holding LLC founded IQ Made in Italy Investment Company—a joint venture provided with €300 million supporting exporting firms in the sector of Made in Italy. The sovereign wealth fund of Kuwait contributed to the creation of an investment vehicle acting as a typical co-investment, apart from some sectors which are financed exclusively by the Italian Strategic Fund—alcoholic drinks, gambling, national security system, telecommunications, and transport. In a nutshell, it seems clear that Italy gradually shifted its attention from 'Arab finance' to Islamic finance proposed by Arab-Muslim foreign investors and partners. In addition to this, although Italy cannot benefit from an ad hoc regulatory framework—for the time being—this has not totally hindered the search for various ways to implement investment models, which do not contravene the requirements of Muslim investors.

8.2.2 The Influence of Migration Phenomenon on the Development of Islamic Banking and Finance

With regard to the 'actual start' of Islamic banking and finance in Italy, it is usually pinpointed by the establishment of the Iranian private Islamic

bank, Bank Sepah. However, the internal debate about Islamic banking and finance has grown and evolved along with the characteristics of the recent migratory phenomenon in Italy. Gradually, Muslim immigrants became citizens in all respects, because social integration and financial inclusion of the new community started to be considered a top priority at national and regional level. There might be many good reasons motivating Italy to find a viable way to integrate these 'new citizens', both socially and financially. According to data provided by the Pew Research Center, in 2010, there were 2.22 million Muslims in Italy. What is more, the Pew center estimates that, in 2030, 3.65 million Muslims—6.1% of the Italian population—will live in Italy. Muslims will surpass five million in 2050, that is to say roughly 10% of the whole population.[2] Most of the Italian Muslim population reside in the regions of Lombardy, Emilia Romagna, Piedmont, and Veneto.[3] Furthermore, at the beginning of 2015, there were about five million legal foreign residents in Italy. Among them are the 3.5 million non-Europeans—a substantial proportion (1.6 million) is coming from Muslim countries, such as Albania and Morocco. In 2013, migrant workers contributed to 8.8% of the gross domestic product. Nonetheless, the high cost of rent, the employment crisis, and the lack of access to bank loans have had a negative impact on migrant communities—some of whom have faced eviction and had to apply for public housing.[4] These data confirm that the Muslim population in Italy is growing rapidly, and there are substantial barriers to them for accessing the real estate market. Several studies and regional initiatives lay emphasis on the scope of the phenomenon of financial exclusion and the demand for social housing by immigrants living in Italy. For instance, in 2002, the NGO Alisei launched a social housing project through 'self-construction' called 'A Roof for All' to provide a home for Italian and foreign families with limited economic resources. In practice, the future owners were involved

[2] Pew Research Center. Religious Composition by Country, 2010–2050. [online]. Washington: April 2, 2015. Updated on April 2, 2015. [accessed February 8, 2016]. Available on Internet: http://www.pewforum.org/2015/04/02/religious-projection-table

[3] A. Santoni. La Finanza Islamica nel mondo, un business profittevole per l'Europa – 2012. [online]. Banca Monte dei Paschi di Siena, 2012, p. 23. Updated on November 5, 2012. [accessed January 19, 2016]. Available on internet: http://www.west-info.eu/it/finanza-islamica-alle-porte/montepaschi_ricerca-finanza-islamica-maggio-2012-2

[4] Centro Studi e Ricerche IDOS. Dossier Statistico Immigrazione 2015. [online]. Rome: IDOS Edizioni, 2015. Updated on November 20, 2015. [accessed January 19, 2016]. Available on Internet: http://www.dossierimmigrazione.it/docnews/file/Scheda%20Dossier%202015(4).pdf

in the construction of their new house. *Centro Studi di Politica Internazionale* (CESPI) implemented a long-term project, 'National Observatory for the Financial Inclusion of Migrants in Italy', co-financed by the European Fund for the integration of Third-Country Nationals and by the Ministry of Interior, with the aim of promoting the theme of economic citizenship. The forth report of the project highlights the pivotal role of immigrant entrepreneurs, who represent 8.6% of Italian companies as of December 2014 and boost the exchanges between the Italian production system and foreign countries. It also points out that 'bankarization' has become a conscious choice of migrants as a necessary instrument of integration rather than a requirement to access the labor market. Recently, *Comunità Religiosa Islamica Italiana* (CO.RE.IS) and the National Agency for Microcredit have signed a Memorandum of Understanding to enable migrants to benefit from microcredit, micro-insurance, and housing microfinance and offer them programs of financial and entrepreneurial training both in Italy and in the countries of origin.[5] In short, foreign residents are now actors of the Italian economic and financial realm, and this current trend requires a change of the old paradigm of migrant banking or mere remittance transfer operators. They tend to use a wide array of financial products and services; thus, the financial institutions have to satisfy these market expectations.

What emerges from the above data is that these initiatives always refer to the category of 'immigrants'. This is due to the relatively new migratory flow to Italy, which started from the 1980s, and its instability caused by the status of temporary residence of a large part of foreigners. However, the acquisition of citizenship is increasing—671,000 foreigners acquired Italian citizenship—an increase of 135% compared to 2001, according to the CESPI's fourth report.[6] Furthermore, the second generation is more likely to have a permanent residence in Italy. More importantly, these data show that there is a large market share which could be positively affected by the introduction of Islamic banking and financial services.

[5] AGCnews. Italia: microcredito per gestire l'immigrazione. [online]. Roma: AGCnews, July 14, 2017. Updated on July 14, 2017. [accessed July 22, 2017]. Available on Internet: http://www.agcnews.eu/italia-microcredito-per-gestire-limmigrazione/

[6] D. Frigeri. Osservatorio Nazionale sull'Inclusione Finanziaria dei Migranti in Italia. [online]. Roma: CESPI, IV Rapporto, 2015. Updated on December 4, 2015. [accessed December 13, 2016]. Available on Internet: https://www.abi.it/DOC_Lavoro/Csr/Inclusione%20finanziaria/Inclusione%20finanziaria%20migranti/IV%20Rapporto%20Osservatorio-versione-light.pdf.

8.2.3 Islamic Banking Takes Its First Steps in Italy Through a Mortgage Plan

One of the first *Sharīʿa*-compliant experiments regarded a *Qur'ān*-friendly mortgage plan launched by Cassa di Risparmio di Fabriano e Cupramontana (CARIFAC) savings bank. It was structured as a real estate leasing that entitled the holder to some tax advantages. The project remained in its early stages and was never sufficiently advertised. Subsequently, in 2006, the first *Sharīʿa*-compliant real estate transaction was executed in the city of Pavia by *Fondazione Housing Sociale*. In this case, a dismantled factory was acquired and transformed into a mosque. Mr. Alberto Brugnoni, the founder of Associazione per lo Sviluppo di Strumenti Alternativi e di Innovazione Finanziaria (ASSAIF), conducted a study on the various options to finance home purchase abiding both by *Sharīʿa* requirements and the Italian Civil Code. According to his study, only a small percentage of immigrants who have enough resources to buy their first house turn to conventional banks. The study was published under the title *Accesso alla casa per gli immigrati – il Mutuo Islamico*. Mr. Brugnoni devised a limited liability corporation distinct from any financial institution bound by fixed and restrictive criteria for authorization and management of activities, like a bank. In a nutshell, the main purpose of the project was to find potential contractual forms, in which the investor and the purchaser could be partners of the corporate enterprise without infringing Islamic and Italian rules. The rationale for the choice of a limited company depends on the number of advantages regarding the risk profile of the loan and the unlimited scope of the business venture. In fact, commercial risk lies only on the asset or the capital invested in the company. The majority shareholder, who is the partner owing financial resources, plays the role of the investor and finances the company through an interest-free loan called *versamento in conto capitale*—an Italian contractual arrangement that allows incentives to be granted to companies in the form of reserve capital without an obligation of repayment; in other words, a nonrefundable grant. Furthermore, the Italian Civil Code contemplates the case of an unprofitable mortgage: […] *except where parties agree otherwise, the borrower must pay interest to the lender.*[7] In the light

[7] R.D n. 262 of March 16, 1942, Civil Code, Book IV, Title III, Chapter XV, Art. 1815, "Interessi". [online]. Updated on March 15, 2017, D.Lgs n. 38, OJ n.75 of March 30, 2017. [accessed June 29, 2017]. Available on Internet: http: //www.altalex.com/documents/news/2014/04/18/del-mutuo

of this, the parties might expressly agree on sharing profits rather than interests. Thanks to the money collected through *versamento in conto capitale*, the liability company could purchase the property to resell to the purchaser afterwards, according to a simple purchase/sale transaction. More precisely, once the company owns the property, it can avail itself of several options to transfer the property to the other partner, such as the deferred resale or the simultaneous resale. In both cases, however, for tax purposes, the payment is deferred assuming that the underlying interests are incorporated in the deferred price. When a deferred resale occurs, the company leases the property to the buyer at a pre-determined fee. At the same time, it signs a promise to sell the property to the buyer by means of a preliminary arrangement for deferred sale at a given date, against periodic payments as a deposit. Alternatively, the company could entitle the buyer to a purchase option at a future date; in this case, lease installments include both the rent fee and the contribution to the capital account of the enterprise. Eventually, the company sells the property to the purchaser with a notary deed, and the buyer pays for the second registration tax. This option resembles the mechanisms of *'ijāra wa-iqtinā*. Conversely, if the simultaneous resale is preferred, the payment of the price is, by mutual consent, rescheduled in pre-determined and fixed installments. The difference between the purchase price and the resale price ensures the profitability of the transaction and enables deferred repayments, likewise for *murābaḥa*.

The outlined model shows that the Italian legal framework offers instruments that can be compatible with Islamic mortgages. Moreover, on the one hand, the idea of devising a limited liability corporation as a credit institution, instead of a bank, bypasses the restrictive conditions that must be satisfied in order to operate as a bank in Italy. On the other hand, it embodies the mode of financing which is commonly known, within the corpus of Islamic jurisprudence, as *sharikat al-ʿaqd*, the traditional commercial partnership effected through a mutual contract. Therefore, in Italy, the fiscal treatment seems to be the only stumbling block for granting a *Sharīʿa*-compliant mortgage loan. This is due to the double stamp duty for two purchase transactions in the case of *murābaḥa* and to the nontax deductibility of financial charges associated with *'ijāra*. However, fiscal adjustments do not represent an insurmountable obstacle, and national authorities can easily implement these. Indeed, any future tax amendment is in line with Article 20 of the decree of the President of the

Republic 131/86,[8] which regulates the application of the stamp duty. Article 20 establishes that this tax shall be applied in accordance with the inherent substance and legal effects of transactions rather than the formal legal structure.

8.3 Islamic Banking and Finance in Italy: Is It Possible?

8.3.1 Accommodating Islamic Banking and Finance Within the Italian Banking Framework: Pros

The Italian legal framework offers a wide range of financial institutions and contractual forms that could be adapted to the scope of Islamic finance. At first, however, national studies focused on the adaptability of the Islamic bank within the Italian context. In fact, bank is the dominant financial intermediary in Italy, and it can carry out many kinds of activities. The Banking Law (*Testo Unico Bancario*) issued by the Bank of Italy, in accordance with the Legislative Decree No. 385, September 1, 1993, defines the banking business as [...] *collecting savings from the public and providing credit; the bank functions as a company. In addition to the banking business, banks are entitled to provide financial services as well as any kind of activity connected with it, except activities whose exercise is reserved by law to other intermediaries*—Article 10.1 and 10.3.[9] Therefore, the current banking practice allows banks to go far beyond the traditional banking activities (taking deposits and lending) and to specialize in other activities, such as investment and financial activities. What a bank cannot do is supplying services and activities that, according to current legislation, other intermediaries, such as insurance companies, exclusively carry out. Lastly, the bank is a business enterprise that has the economic function of a joint-

[8] L. n. 131 of April 26, 1986, *Testo unico delle disposizioni concernenti l'imposta di registro*, OJ n. 99 of April 30, 1986, Art. 20. [online]. [accessed July 26, 2017]. Available on Internet: http://www.gazzettaufficiale.it/atto/serie_generale/caricaDettaglioAtto/originario?atto.dataPubblicazioneGazzetta=1986-04-30&atto.codiceRedazionale=086U0131&elenco30giorni=false

[9] D.Lgs n. 385 of September 1, 1993, *Testo Unico Bancario*, Banca d'Italia, February 2016, p. 37. [online]. Updated on November 16. 2015, D.Lgs n. 180. [accessed November 20, 2016]. Available on Internet: http://www.bancaditalia.it/compiti/vigilanza/intermediari/Testo-Unico-Bancario.pdf

stock company. In a nutshell, the 1993 Banking Law no longer makes distinction between commercial and investment banks. Consequently, the characteristics of an Italian bank could be conducive to the accommodation of an Islamic bank or an Islamic window within a conventional bank in Italy. In fact, the scope of a typical Italian bank does not contradict the nature of an Islamic bank. However, whereas no law sets out a minimum threshold of deposit-taking and lending for a bank to operate, and whereas a bank can decide to specialize in investment services, it cannot give up on its primary roles, which are accepting deposits and lending. Article 10.3 clearly states […] *in addition to banking business.* Indeed, traditional banking activities operate in a manner contrary to *Sharīʿa*: they apply rates of interest and guarantee deposits.

8.3.2 Cons: The Deposit-Guarantee Scheme

The deposit-guarantee scheme is the thorniest issue as far as its incompatibility with *Sharīʿa* is concerned. In Europe, the provision of a deposit guarantee is established by the European Directives 94/19/EC, subsequently repealed by 2014/49/EU.[10] In fact, Islamic investment accounts do not guarantee the repayment of principal, even if these are classified as savings instruments. Only recently, EU Directive 2014/59/EU stated that: […] *shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution* […]—point 67 in the preamble.[11] Its rationale has, however, nothing to do with a substantial change in the relationship between bank and clients, unlike the case of the Islamic bank. Article 11.1 of the Italian Banking Law states that: […] *savings are meant to be funds, either in the form of deposits or in other forms, provided with repayment obligation.*[12] The Interbank Deposit Protection Fund, which is a mandatory syndicate under Italian private law, sets out specific rules to regulate the mechanism

[10] Directive 2014/49/EU of the European Parliament and of the Council of April 16, 2014, on deposit guarantee schemes, OJ L 173/149, 12.6.2014. [online]. [accessed June 10, 2016]. Available on Internet: in http://eur-lex.europa.eu

[11] Directive 2014/59/EU of the European Parliament and of the Council of May 15, 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173/190, June 12, 2014, p.11. [online]. [accessed June 7, 2016]. Available on Internet: in http://eur-lex.europa.eu

[12] *Loc. cit*, p. 37.

of deposit-guarantee. Article 30 of its Statute[13] offers a comprehensive legal framework with regard to the categories of depositors that may be included in and excluded from the fund. According to Article 30, claims eligible for reimbursement are those relating to repayable funds acquired by the members, in the form of deposits or in other forms, as well as bank drafts and equivalent instruments. A number of instruments, however, are exempted from the protection of the fund. Among them are the bearer deposits (and other funds reimbursable to the bearer), bonds, security transactions, and the financial instruments regulated by the Civil Code. In other words, the only types of deposits that are excluded from the deposit-guarantee are those funds which cannot be subsumed into the category of savings deposits. In essence, Islamic savings deposits do not correspond to their counterparts within the Italian context, where all savings deposits benefit from the mandatory legal guarantee.

8.3.3 Collective Investment Undertakings Open the Door to Islamic Investment Deposits

Other types of conventional structures, which could better fit in with the scope of Islamic investment deposits, such as mutual funds, may unleash the potential of Islamic investment accounts to operate in the national internal market. Indeed, such an opportunity arises when reading legal clauses attentively. In fact, as stated earlier, financial instruments regulated by the Civil Code are exempted from the deposit-guarantee. If the broad category of financial instruments regulated by the Civil Code is analyzed in depth, it is clear that undertakings for collective investment schemes, *Organismi di Investimento Collettivo del Risparmio* (OICR), are part of this group. Legal details about financial instruments are contained in the second clause of the Law on Finance[14] (*Testo Unico della Finanza*) enacted on the basis of the Legislative Decree No. 58, February 24, 1998. By implication, undertakings for collective investment schemes are not mandated to adhere to the deposit-guarantee and could be used to implement

[13] Statutes and By-Laws of Fondo Internabancario di Tutela dei Depositi of February 2014, p. 29. [online]. [accessed February 18. 2016]. Available on Internet: in https://www.fitd.it/normative/stat_reg/statuto_regolamento.pdf

[14] D.Lgs n. 58 of February 24, 1998, *Testo Unico della Finanza*, CONSOB, January 2017, p. 18. [online]. Updated on December 30, 2016, D.Lgs n. 254. [accessed March 31, 2017]. Available on Internet: http://www.consob.it/documents/46180/46181/dlgs58_1998.pdf/e15d5dd6-7914-4e9f-959f-2f3b88400f88

Sharīʿa-compliant alternative schemas for managing savings funds. Within the set of OICR, two typical tools of collective investment of savings in Italy are asset management companies (*Società di Gestione del Risparmio*; SGR) and open-end collective investment companies (*Società di Investimento a Capitale Variabile*; SICAV).

Both are joint-stock companies, also known as *Società per Azioni* (S.p.A), where three entities interact: depositors/investors, the management company, and the bank acting as a custodian bank; namely, the latter safeguards financial assets and securities associated with the mutual funds that an asset management company administers. It also supervises the legitimacy of funds' activities. Specifically, according to Article 1 of the Law on Finance,[15] the SGR is a limited company in the form of a S.p.A, headquartered in Italy, which provides services of collective asset management. Its main activity consists in setting up, promoting, and managing mutual funds. In a few words, the SGR collects money from many depositors and invests it collectively, as a unique independent pool of assets. Participants in the mutual fund subscribe to one or more shares represented through certificates issued by the fund. In this way, each participant becomes entitled to the rights connected with the pool of assets in proportion to their contribution to the mutual fund. Therefore, investors draw their share of profits and bear risks arising from investments made by the fund manager, including the risk of losing the entire initial capital. At the same time, investors cannot affect or interfere with the management methods as well as investment choices. The SICAV's function is similar to the SGR—it is a limited company in the form of a S.p.A provided with variable capital and headquartered in Italy, which deals exclusively with the collective investment of funds raised through the supply of treasury shares. Its peculiar trait regards its contractual form. In fact, in an SICAV, investors also act as shareholders of the company, thus they can exercise their right to vote and affect the investment policy of the company. SICAVs are open-end collective investment schemes because investors can subscribe to and redeem their shares from the fund at any moment. In a few words, the share capital is variable. Hence, investors in SGR and SICAV seem to correspond to Islamic investment account holders, in addition to avoiding the issue of deposit-guarantee associated with the core activity of a typical Italian and European bank. However, SICAV investors hold the right to vote and to determine investment decisions, unlike investment account holders in an Islamic bank.

[15] Ibid., p. 20.

8.3.4 Benefits of the Asset Management Companies: Società di Gestione del Risparmios s—To Integrate Islamic Banking

The SGR could be a more versatile device to shape an Islamic investment deposit within the Italian framework. In fact, in the case of SGR, there are two potential obstacles which are, nonetheless, surmountable. First of all, a *Sharīʿa* Board should be introduced in order to abide by quantitative and qualitative criteria commonly applied to Islamic mutual funds and to ensure the compliance of shares and investments with *Sharīʿa*. This body could primarily play an advisory role, as the British and French experience shows. Second, according to the regulation of an Italian SGR, the assets of the fund are separate from the management company's own assets and single investors' assets, likewise. Although Islamic banks are not mandated to keep their funds separate, there are several potential models, within the current practice of Islamic banking, which could be implemented to launch a *Sharīʿa*-compliant SGR. Should the Islamic bank regulate the accounting of profit sharing between shareholders and depositors/investors in consonance with the so-called separation method, depositors only participate in the financial results (profit, loss, risk costs) of investments. Alternatively, the two-windows model of an Islamic investment bank envisages that liabilities are divided into two different windows: one is set apart for monetary deposits, while the other window is dedicated to deposits/investments; customers are entitled to select one of these. Furthermore, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 1999 and the Islamic Financial Services Board (IFSB) in 2005 speculated the separation, for accounting purposes, between the share of deposits/investments and the part financed by the bank's own capital and deposits, in order to make a specific distinction between investment and banking activities. The allocation of a part of deposits/investments to a separate fund would be a fair compromise in order to outsource the management of the fund's assets to an Italian *Sharīʿa*-compliant SGR.

8.3.5 'Associazione in partecipazione' *Might Help Understand Islamic Banking and Finance's Mechanisms*

The Bank of Italy, in the Supervisory Bulletin of January 2003, identified *associazione in partecipazione* with a potential counterpart for the assets and liabilities composition of a typical Islamic bank and, particularly, for Islamic Profit and Loss Sharing (PLS) investment deposits. This contract

is a type of joint venture regulated by the Civil Code—Articles 2549–2554.[16] *Associazione in partecipazione* represents a business partnership, whereby an entrepreneur attributes to one or more persons, as associates, the participation in the profits deriving from the joint venture or from one or more businesses, in exchange for a contribution from the associate(s). The Bank of Italy tried to replant this contractual model in a banking *muḍāraba* deposit. In this case, the bank is the entrepreneur that shares profits, deriving from banking activity with depositors, in return for an economic contribution. According to the legislative provisions contained in the Civil Code, the management of the joint venture or the business is in the hands of the entrepreneur, even if the contract can leave a margin of control over the joint venture or the business to the associate(s). Unless otherwise agreed, the associate(s) participate in the loss to the same extent they receive profits, but losses resting on the associate(s) cannot exceed the value of their input. The Bank of Italy raised two possible risks. First, the above contractual framework may lead non-banking persons to interfering with the management of the bank. Second, by means of the profit and loss sharing mechanism, non-financial third-party associates could acquire a leading position over the acquisition of equity, thus breaching the law which lays foundation for the separation between banking and all non-financial business enterprises—Article 19.6 of the Banking Law.[17] Nonetheless, the Legislative Decree No. 185 of November 29, 2008 repealed the latter. As for the first potential problem identified, the risk does not subsist, as long as the bank does not share its exclusive supervisory and managerial power with non-banking associates.

8.3.6 The European Passport Could Facilitate the Islamic Banking and Finance's Growth in the Near Future

A possible path for the implementation of Islamic banking, in the short term, in Italy—retail banking, in particular—is certainly the establishment of a branch of an Islamic bank operating in another European Union (EU) country. In fact, thanks to the European passport introduced by the

[16] R.D n. 262 of March 16, 1942, Civil Code, Book V, Title VII, Art. 2549–2554, 'Dell'associazione in partecipazione'. [online]. Updated on March 15, 2017, D.Lgs n. 38, JO n.75 of March 30, 2017. [accessed July 19, 2017]. Available on Internet: http://www.altalex.com/documents/news/2013/10/08/dell-associazione-in-partecipazione

[17] *Loc. cit*, p. 44.

Directive on markets in financial instruments and investment services[18] (2004/39/EC), the supervisory authorities of the home EU country simply have to notify the opening-up of the branch to their counterpart authorities in the EU target country. In fact, the directive allows a single authorization regime for a financial institution that is then entitled to settle in and provide its services throughout the EU. For instance, Al Rayan Bank, which is currently operating in the UK, could launch a branch in Italy in the future without any regulatory barrier. Indeed, it is worth considering that EU banks expanding to Italy are not required to adhere to the Italian Interbank Deposit Protection Fund. At any rate, they could participate in the fund on a voluntary basis, if deemed necessary to supplement the deposit protection provided by their home country scheme—Article 2.2 of the Statute of Interbank Deposit Protection Fund.[19]

However, in line with the common practices of European supervisory authorities, a newly formed bank in an EU country is not authorized to expand its activities abroad outright. National supervisory authorities, in substance, would first verify the bank's capital base, its governance, its management, and internal auditing mechanisms. What motivates this cautious attitude lies on the common principle of prevention of transferring unstable conditions from one national market to another. Once the home country authorities have ascertained the conditions for a sound management and a consistent plan of activities, the European host country cannot deny the entry of the new branch.

8.4 Italian Ethical and Cooperative Banking Models Can Give a Boost to the Accommodation of Islamic Finance into the Italian Regulatory and Economic Framework: How Feasible?

8.4.1 The Religious Background

Islamic finance could be integrated into the sector of ethical banking in Italy, especially in light of the religious background of Italian society, which may favor the development of Islamic finance as an ethical sys-

[18] Directive 2004/39/EC of the European Parliament and of the Council of April 21, 2004, on markets in financial instruments, OJ L 145/1, April 30, 2004. [online]. [accessed April 7, 2016]. Available on Internet: in http://eur-lex.europa.eu

[19] *Loc. cit*, p. 11–12.

tem contributing to corporate social responsibility (CSR). CO.RE.IS, an association of Italian Muslims, pointed out that the frame of reference contained in the '*Caritas in Veritate*' encyclical by Benedetto XVI is shared, to a large extent, by ethical tenets of Islam in conjunction with their ethical economic outgrowth. According to the Pope, the market economy should not overlook distributive and social justice to the detriment of the common good: […] *it is not the instrument that must be called to account, but individuals, their moral conscience and their personal and social responsibility*—Chapter Three, paragraph 36.[20] *The economy needs ethics in order to function correctly – not any ethics whatsoever, but an ethics which is people-centered*—Chapter Four, paragraph 45. At the same time, according to Haniffa and Hudaib,[21] Islamic banks are deemed to be ethical and to have a high level of corporate social responsibility since they are embedded with *Sharīʿa* business ethics, which bolsters social justice and economic welfare while obtaining God's blessing.

Indeed, Italian social and legal framework relies heavily on several mechanisms that can adapt to a kind of ethical/religious-oriented corporate social responsibility (CSR). For instance, the so-called *Organizzazione Non Lucrativa di Utilità Sociale* (ONLUS), which is a type of non-profit private association, such as cooperative companies and foundations, operates in favor of social benefit. ONLUS has to carry out activities related to those set out in their statutes, such as charity, social and health care, cultural heritage, civil rights, and scientific research. Ecclesiastical bodies and religious associations can deal with different activities which do not necessarily fall within the list of aforementioned activities. In addition, each citizen, when filling his/her individual income tax return, can donate, on a voluntary basis, part of the income tax in favor of entities carrying out socially relevant activities, among which are religious and/or non-profit associations. This option is known as *Cinque per mille*.

[20] Benedict XVI. *Caritas in Veritate* Encyclical. [online]. Rome: Libreria Editrice Vaticana, 2009. Updated on December 29, 2009. [accessed June 29, 2017]. Available on Internet: http://w2.vatican.va/content/benedict-xvi/en/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate.html

[21] R. Haniffa, M. Hudaib, "Exploring the ethical identity of Islamic banks via communication in Annual Reports", *Journal of Business Ethics*, 2007, vol. 76, no. 97, p. 116.

8.4.2 The Regulatory Framework of Ethical Banking and Finance in Italy

The analysis of the guidelines of legal treatment of ethical banking and finance in Italy could help understand whether these may facilitate the implementation of Islamic banking and finance in Italy. Article 28 of the Banking Law sets out that: *The exercise of banking activity by cooperative companies is carried out by popular banks and cooperative banks [...].*[22] Generally speaking, national authorities have acknowledged the legitimacy of a category of Italian savers who orient their investment decisions in accordance with other criteria rather than pure profit. Consequently, the supervisory authorities have also coped with the protection of these savers. In this respect, no derogation from the common rules on financial intermediation can be permitted. Far from representing a restrictive approach toward ethical products, the position of supervisory authorities aims to ensure a level playing field for all products and stakeholders. By implication, it is not possible to accept that certain investments may be less guaranteed than others or that some financial intermediaries may neglect the common supervisory requirements. The same approach, thus, could be extended to the Islamic financial sector, if the relationship between Islamic and ethical finance is recognized and regulated.

8.4.3 Requirements and Proposals by the Bank of Italy

In its report on Islamic finance,[23] the Bank of Italy reiterated that the access to a guarantee scheme for depositors is a necessary condition for obtaining a banking license in Italy and an Islamic bank or window cannot be free from this general requirement. At the same time, the Bank of Italy highlighted that mechanisms of deposit-guarantee are not alien to the current practice of some countries where Islamic banks operate. For instance, Malaysia provides a guarantee fund, in the event that a bank declares the state of insolvency due to its mismanagement. In addition to this, the Bank of Italy underlined that, by and large, there are no regulatory barriers to the authorization of an Islamic bank in Italy, provided that the Islamic bank complies with the same parameters of prudential supervision which their conventional counterparts

[22] *Loc. cit*, p. 54.
[23] *Loc. cit*, p. 25–34.

abide by, that is to say the capital adequacy, the quality of risk management, and auditing systems.[24]

Furthermore, the Bank of Italy suggested taking a legislative measure, for the purpose of enhancing the accommodation of Islamic finance, which may be akin to the legislative provision introduced by Law on Finance with reference to ethical finance. According to Article 117-ter,[25] CONSOB should be held responsible for defining the requirements of disclosure of information and account related to those intermediaries that promote products and services qualified as ethical or socially responsible. By the same token, a similar legislative measure targeting the Islamic Financial Institutions (IFIs) would enable the establishment of recognized standards for *Sharīʿa*-compliant products in Italy and greater transparency on the characteristics of Islamic tools as well as clear guidelines that may facilitate and harmonize the definition of what is *Sharīʿa*-compliant and what lays outside related reference parameters.

8.4.4 A Comparison of Two Models of Ethics in Finance and Corporate Social Responsibility

In the light of the earlier considerations, the link between Islamic finance and ethical investing should be object of further investigation in the near future because it may open attractive prospects for new developments of *Sharīʿa*-compliant ethical activities in Italy. Italy can count on a long-standing background of ethical and cooperative banking, which, nowadays, is identified with models of governance and corporate social responsibility (CSR) of cooperative and rural banks (*Banca di Credito Cooperativo—Casse Rurali*) and the Ethical Popular Bank (*Banca Etica*). The European Commission defined CSR as *the responsibility of enterprises for their impacts on society*—Article 3.1., within the renewed EU strategy 2011–2014 No. 681.[26] The

[24] L. Donato, M. A. Freni, "Attività bancaria islamica e controlli di vigilanza", in G. Gimigliano et G. Rotondo (dir.), *La banca islamica e la disciplina bancaria europea*, Milan, Giuffré Editore, 2006, pp. 183–195.

[25] S. Alvaro, La finanza islamica nel contesto giuridico ed. economico italiano. [online]. Rome: CONSOB, Quaderni giuridici, n. July 6, 2014. [accessed January 12, 2016]. Available on Internet: http://www.consob.it/main/consob/pubblicazioni/studi_analisi/quaderni_giuridici/qg6.html, p. 57.

[26] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A renewed EU strategy 2011–2014 for Corporate Social Responsibility, COM (2011) 681 final, October 25, 2011, p. 6. [online]. [accessed May 4, 2016]. Available on Internet: in http://eur-lex.europa.eu

Civil Code defines cooperatives as companies endowed with variable capital and mutualistic principles—Article 2511.[27] The core principle of mutuality concerns the organizational model of corporate management, according to which bank's activities are designed to secure sustained growth of its members, their enterprises, and their local territory. In fact, it promotes the improvement of economic, moral, and social conditions of its members, clients, and other stakeholders, by means of their financial inclusion and education regarding the use of savings, their social cohesion, as well as sustainable development of local communities. Cooperative and rural banks, for example, can be devised as non-profit cooperatives. This feature does not entail that cooperative banks do not produce or distribute profits; profits, actually, are used to preserve their share capital in order to continue providing its services to members at favorable conditions. Furthermore, a share of annual net profits has to be earmarked for mutual funds and charity, after allocating profits to shareholders, legal reserves, or for the increase of shares' value—Articles 37.2 and 37.3 of the Banking Law.

Therefore, Italian ethical finance and CSR rely on social values and the redistribution of profits rather than moral tenets rooted in religion. However, there are some peculiar aspects that may resemble Islamic banking cornerstones: the profit-sharing mechanism, the payment of *zakāt*, and, broadly speaking, the concept of money not as a mere means to maximize profits but also to create social added value. In the same way as an Islamic bank, Banca Etica links the return on capital to the viability and performance of its projects and activities.

Although the concept of modern credit cooperative and popular banks stems from ethical grounds of Christian origin, today's cooperative and ethical banks stand out from Catholic teachings, do not waive the interest rate, and use the same financial tools and legal framework as the conventional banking system, as well as the same parameters of risks on loans and cost-effectiveness.[28] Their distinctive features, instead, are the bank's vision and values, together with the organizational model of one person

[27] L. n. 99 of July 23, 2009, Civil Code, Book V, Title VI, Chapter I, Art. 2511, "Delle società cooperative". [online]. Updated on November 15, 2009, D.Lgs n. 6, OJ n.17 of January 22, 2003, Supp n. 8. [accessed June 29, 2017]. Available on Internet: http://www.brocardi.it/codice-civile/libro-quinto/titolo-vi/capo-i/sezione-i/art2511.html

[28] Federcasse Federazione Italiana delle Banche di Credito Cooperativo Casse Rurali ed. Artigiane. Il Credito Cooperativo: la Storia. [Online]. Roma: ICCREA Banca. Updated on August 14, 2016. [accessed December 15, 2016]. Available on Internet: http://www.creditocooperativo.it/template/default.asp?i_menuID=35348

for one vote. By way of illustration, they allocate credit in a socially responsible way—financing is likely to address disadvantaged or specific social groups or to support environmental and sustainable projects, for example—and funding might exclude harmful sectors, such as investments in the weapons industry. They may prefer certain instruments more than others, such as microcredit and crowdfunding, but they do not make use of distinctive contracts and economic system. In addition to this, certain features of a typical Islamic bank would sound unethical to Banca Etica, namely the lack of operating standards, poor transparency and quantitative estimate of social impact of the bank's activities, and insufficient rights of investment account holders. Hence, Islamic economic principles and banking practices can be hardly blended with the models of governance and CSR of Banca di Credito Cooperativo and Banca Etica.

However, recognizing common objectives between Islamic banking and ethical banking in Italy discloses an untapped potential to open the Italian market, including the nonreligious one, to new forms of ethical banking and investing.

8.4.5 Socially Responsible Investments as a Liaison Between Two Ethical Financial Systems

The mechanism of ethical investment funds offers interesting inputs that might pave the way for greater opportunities for the implementation of Islamic banking in Italy. The definition of a socially responsible investment (SRIs) by the Social Investment Forum, in 2006,[29] identifies the same backdrop as an Islamic investment, albeit applying different criteria and values. In fact, both kinds of investments take into account a company's ethical, social, and environmental performance besides the purely financial performance. Therefore, *Sharīʿa*-compliant services and products also exercise a certain appeal toward non-Muslim customers.

Ethics committee supervises the selection of investment funds distributed by cooperative and popular banks.[30] The asset management company Etica SGR, which manages open-end mutual funds for Banca Etica, for example, makes a positive and negative screening to select investments, by

[29] E. Alberola, O. Azoulay, P. Bollon, [et al]. "L'investissement socialement responsable", *Revue d'économie financière*, 2006, no. 85, Sept. 2006.

[30] Banca Popolare Etica S.C.P.A. Statuto, Sezione VI, Titolo IV, Art. 48: Comitato Etico. [online]. Padova: Banca Etica, 1998. Updated on November 28, 2015. [accessed February 23, 2016]. Available on Internet: https://www.bancaetica.it/sites/bancaetica.it/files/web/la-banca/Chi-siamo/statuto/Banca%20Popolare%20Etica_Statuto.pdf

using criteria based on the respect for the environment, human rights, social banking, and governance—the so-called Environmental, Social, Governance (ESG) criteria. The ethics committee, however, is quite different from a *Sharīʿa* Board. They use different criteria and operational methods, but they may pursue more or less identical objectives. No faith-based filters are considered, but the principle of applying qualitative criteria when screening companies and securities is akin to the Etica SGR's common practices—for example, it does not invest in the gambling industry.

Certainly, a *Sharīʿa* Board has to abide by faith-based filters and strict qualitative and quantitative criteria. According to the Dow Jones Islamic Market Indices, *Sharīʿa*-compliant socially responsible investments (SRIs) should deny access to all companies in which more than one-third of a company's total assets is debt capital and/or more than one-third of their revenues depend on interest on cash or securities. Qualitative screening may rule out some *ḥarām* sectors: alcohol, pork, gambling, conventional financial institutions, *ribā*-based and speculative activities, tobacco, weapons, and entertainment.[31] Therefore, there is no doubt that conventional and *Sharīʿa*-compliant SRIs use different screening criteria and operational standards, though they may pursue similar objectives.

However, a report by OWW Consulting, a CSR and SRI consulting company, reveals the high compatibility between *Sharīʿa* tenets and the UN Global Compact principles.[32] The OWW report shows that, notwithstanding different sources and ethical standards, the tenets of Islam are theoretically compliant with all Global Compact principles on anti-corruption, environment, human rights, and labor. According to the analysis, *Sharīʿa* safeguards and supports human rights, environment, labor, and anti-corruption, either explicitly or indirectly. *Sharīʿa* advocates popular consultation, the welfare state, freedom of religion, and expression and also condemns the waste or superfluous consumption of natural resources, since the human being is considered as a steward over divine creation and his/her task is to preserve the environment where he/she lives. Furthermore, it clearly forbids forced labor, exploitation of workers, and

[31] I. Cekici, "Du filtrage islamique", in M. Storck, L. Weill, I. Z. Cekici et E. Forget (dir.), *Finance éthique et finance islamique: quelle convergence?*, Cahier de la Finance Islamique n° 1. Strasbourg: l'Ecole de Management Strasbourg, 2009, pp. 11–18.

[32] Islamic finance and SRI: any crossover?. Novethic. [online]. Paris: Working Paper, May 2009. Updated on October 6, 2009. [accessed February 1, 2015]. Available on Internet: https://www.responsible-investor.com/images/uploads/resources/research/11248094270Working_paper_on_islamic_finance_and_SRI.pdf

child labor. Lastly, corruption is deemed to contravene *Sharīʿa* because it undermines the envisioned model of social justice, equal treatment before law, and transparency in trade and financial contracts. Interestingly, the OWW report acknowledges that there is a large gap between theory and practice regarding the application of these principles, due to cultural and regional backgrounds, or to an erroneous interpretation of religious writings and sayings.

Therefore, although Islamic companies are not expected to adopt ESG screening, there is no divergence between the tenets of Islamic religion and the principles of the UN Global Compact. In addition to this, *Sharīʿa*-based funds are not at odds with most of SRIs' areas of interest and have to satisfy the public interest (*maṣlaḥa*). At the same time, the evident flaws in the practical application of the Islamic theoretical framework[33] imply that, on the one hand, corporate governance, transparence, and human rights are not given due consideration in Islamic mutual funds. On the other hand, Islamic funds could legitimately integrate these aspects in their policy because they are not alien at all to the religious view of a holistic and comprehensive social responsibility.

After all, the rationale for further investigation is not resolving differences between Islamic and ethical finance, but recognizing that these can be complementary, rather than mutually exclusive and competing, and opening room for mutual learning and further interaction in Italy. Indeed, morally responsible mutual funds are a subset of the broader category of SRIs[34] and most of the companies in which Islamic equity funds invest are already quoted on Western markets. The overriding consideration ought to be the economic substantive purposes rather than the regulatory superstructure that is inevitably different in the various contexts. With this in mind, further convergence between Islamic finance and ethical finance is likely to transform the prospects for IBF in Italy in qualitative terms rather than in quantitative terms, since both ethical markets still represent niche markets.

[33] M. N. Barom, 'Conceptualising Strategic Framework of Social Responsibility in Islamic Economics', *International Journal of Economics, Management and Accounting* 2013, 21, no. 1, pp. 65–95.

[34] G. Forte et F. Miglietta, Islamic Mutual Funds as Faith-Based Funds in a Socially Responsible Context [Online]. August 1, 2007. Updated on April 24, 2011. [accessed May 20, 2016]. Available on internet: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1012813; and W. GHOUL et P. KARAM, 'MRI and SRI Mutual Funds: A Comparison of Christian, Islamic (Morally Responsible Investing), and Socially Responsible Investing (SRI) Mutual Funds', *Journal of Investing*, summer 2007, vol. 16, no. 2, pp. 96–102.

8.5 From Potentiality to Recent Developments

8.5.1 Associazione Bancaria Italiana and Commissione Nazionale per le Società e la Borsa: Considerations on Practical Issues

Recently, ABI shed light on the process of convergence toward a uniform European regulatory framework under the rules established by the European Central Bank (ECB). In fact, during the Turin Islamic Economic Forum (TIEF) 2015, Mr. Pierfrancesco Gaggi, Head of the International Affairs Office of ABI, directed attention to the necessity of equal treatment for all types of business in Europe, including Islamic finance.

In the juridical report released in July 2014,[35] CONSOB delved into a number of issues that are remarkably important in understanding the prospects of implementation of Islamic banking and finance in Italy. According to the report, the Islamic financial market in Italy might grow in three ways: through the provision of Islamic financial products and services in Italy; through the role of Italian intermediaries which may raise capital among Muslim investors by means of conventional products respecting the specific rules of Islamic finance; and through the investments of Muslims into Italy in conformity with the rules of conventional finance. As far as the role of the *Sharīʿa* Board is concerned, CONSOB brings into play EU legislation when considering that the company's management pertains to the administrative body only and that, consequently, the *Sharīʿa* Board can only play an advisory role in Europe. However, the administrative committee is responsible for ensuring that the products and services offered by the company adhere to criteria of *Sharīʿa*-compliance established by the *Sharīʿa* Board. For example, if an SGR provides the public with shares of mutual funds which have been certified as compatible with *Sharīʿa*, the Board of Directors should select the assets in which to invest in full coherence with the legal opinion expressed by the *Sharīʿa* Board. This approach does not entail a subordination of the Board of Directors; on the contrary, it aims to ensure that operational procedures of the company may be transparent and consistent with the public statements.

Furthermore, CONSOB handled the issue of the compensation scheme for investors and investment activities as well as the deposit-guarantee within the banking sector, in accordance with European

[35] *Loc. cit*, p. 30–60.

standards. In fact, as for investment services and activities, Italy puts in place a guarantee system against the risk of a crisis of financial intermediaries, whereby investment services and activities are not authorized before applying the investor's compensation scheme—Article 59 of the Law on Finance.[36] With regard to the banking deposit-guarantee, CONSOB identified two main threads. On the one hand, under Italian law, only deposits with a repayment obligation can subscribe to the interbank guarantee system. Since Islamic investment accounts do not have the characteristics of deposits with repayment obligation—as opposed to Islamic current accounts and demand deposits—these could be exonerated from the participation in the Interbank Deposit Protection Fund. On the other hand, some Muslim scholars, like M. U. Chapra and T. Khan,[37] have acknowledged that deposits/investments cannot be left out of an insurance system because investment depositors are required to share only market risks and not risks related to mismanagement, lack of diversification, or fraud. Finally, CONSOB pointed out the need for Italian companies to become aware of the importance of being included in Islamic indexes. Currently, just seven Italian companies are included in the Dow Jones Islamic Market Indexes: Tod's, Diasorin, Luxottica, Ferragamo, Recordati, Parmalat, Moncler. In fact, savings collected from Muslim investors and managed by Islamic funds can be directed toward a non-Muslim-listed company only if the latter is included in the list of *Sharīʿa*-compliant indexes.

8.5.2 The Untapped Potential for Stocks, Mutual Funds, and **Ṣukūk** *in Italy*

In addition to Islamic banking, as CONSOB highlighted, there is a high potential for Islamic financial products, which is still largely untapped in Italy. Some of the most popular *Sharīʿa*-compliant financial tools, such as stocks, mutual funds, and *ṣukūk*, do not conflict with the Italian legal framework. Indeed, these could help Italian enterprises to increase their

[36] *Loc. cit*, p. 113.

[37] M. U. Chapra, T. Khan, Regulation and Supervision of Islamic Banks. [online]. Jeddah: Islamic research and Training Institute, Islamic Development Bank, Occasional Paper n. 3, 2000, p. 62. [accessed September 15, 2015]. Available on Internet: http://www.sbp.org.pk/departments/ibd/Regulation_Supervision.pdf

liquidity and their investment capacity. Once recognized that *Sharīʿa*-compliant stocks, mutual funds, and *ṣukūk* operate in agreement with standard rules, and that they can be traded on the capital market, these instruments could be included in the category of transferable securities (*valori mobiliari*) explained in Article 1-bis of the Law on Finance, or in the group of EU financial instruments in Article 93-bis of the Law on Finance. *Valori mobiliari* subsume companies' shares, stocks, bonds, any kind of securities, giving the right to buy and sell stocks and bonds. Evidently, it is possible to constitute a *Sharīʿa*-compliant subgroup within *valori mobiliari*. EU financial instruments represent the group of *valori mobiliari* along with shares of closed-end collective investment schemes. In substance, most of EU financial instruments have a *Sharīʿa*-compliant counterpart, and some of these are very successful worldwide. The case for the Islamic mutual fund is illustrative. Although Islamic funds must follow some common strict criteria, such as the prohibition to pay interests and to invest in over-indebted firms or in firms that in turn invest in *harām* sectors or activities, the industry of Islamic funds is rapidly growing globally.

Additionally, there are quite a few Islamic index funds known as Exchange Traded Funds that invest exclusively in *Sharīʿa*-compliant indexes. Also, equity investments are increasing and usually target companies that carry out *ḥalāl* activities and refrain from pure speculation. As already highlighted by CONSOB, brokers and Italian companies do not yet get the best of the investment potential of Muslim savers, within and outside Italy. In this regard, the Italian listed companies should take into account the option to access indexes of *Sharīʿa*-compliant financial products, such as Dow Jones Islamic Market Indices, FTSE *Sharīʿa* Global Equity Index Series, and MSCI Global Islamic Indices. Not to mention the outstanding growth of *ṣukūk* in Europe, despite being quite different from their conventional counterpart. *Ṣukūk* can be versatile and innovative instruments in line with Islamic principles, likewise for European financial needs, such as project financing.

In line with the European 2020 Project Bond Initiative and the Project Bond Credit Enhancement program by the European Investment Bank, the Italian government enacted some laws to improve the regulatory framework of project bonds and extend its application to the investment financing through public-private partnerships—Legislative Decrees

No. 83/2012,[38] No. 1/2012[39] and No. 133/2014.[40] Project bonds could make a great contribution to the Italian infrastructure system, and these are likely to operate in the future as *Sharīʿa*-compliant instruments issued by project companies or companies holding a public-private partnership contract. For instance, *Sharīʿa*-compliant financial leases would enable the construction of buildings for public administration purposes through long-term *ṣukūk al-ʾijāra* rather than conventional tenders and bank loans. This option is convenient to attract Islamic investors to contribute to public-private partnership capital and Islamic banks to act as guarantors. Moreover, the operating methods of *ṣukūk al-ʾijāra* are very similar to those of typical Italian contracts for financial leases aimed at financing real estate for public entities, such as the leasing of a building under construction (*leasing immobiliare in costruendo*) and the 'sale and lease-back' formula.

8.5.3 The Italian Association of Financial Analysts and Advisors Examined Various Options to Issue Ṣukūk *in Italy*

In 2015, the Italian Association of financial analysts and advisors (AIAF) has published an in-depth study of prospects for issuing different types of *ṣukūk* in Italy.[41] This analysis shows the potential for diversifying funding

[38] D.Lgs n. 83 of June 22, 2012, 'Misure urgenti per la crescita del Paese', OJ n. 147 of June 26, 2012. [online]. [accessed March 14, 2016]. Available on Internet: http://www.gazzettaufficiale.it/eli/id/2012/08/11/12A08941/sg

[39] DLgs n. 1 of January 24, 2012, 'Disposizioni urgenti per la concorrenza, lo sviluppo delle infrastrutture e la competitività', OJ n. 19 of January 24, 2012, Supp. n. 18. [online]. Updated on March 24, 2012, L. n. 27, OJ n. 71 of March 24, 2012, Supp. n. 53. [accessed December 30, 2016]. Available on Internet: http://www.gazzettaufficiale.it/gunewsletter/dettaglio.jsp?service=1&datagu=2012-01-24&task=dettaglio&numgu=19&redaz=012G0009&tmstp=1327500624126

[40] D.Lgs n. 133 of September 12, 2014, 'Misure urgenti per l'apertura dei cantieri, la realizzazione delle opere pubbliche, la digitalizzazione del Paese, la semplificazione burocratica, l'emergenza del dissesto idrogeologico e per la ripresa delle attività produttive', OJ n. 212 of September 12, 2014. [online]. Updated on November 11, 2014, L. n. 164, OJ n. 262 of November 11, 2014, Supp. n. 85. [accessed January 3, 2017]. Available on Internet: http://www.gazzettaufficiale.it/eli/id/2014/09/12/14G00149/sg

[41] E. Giustiniani, G. C. Brugnoni, A. Caragnano, [et al]. Obbligazioni Islamiche e Cartolirizzazioni immobiliari. Le prospettive Italiane per l'emissione di un sukuk. [online]. Milan: AIAF, October 2015, Paper No. 167. [accessed September 15, 2016]. Available on Internet: in http://www.aiaf.it/pubblicazioni/2015-n-167-i-quaderni-aiaf-online-obbligazioni-islamiche-e-cartolarizzazioni

sources in Italy through *Sharīʿa*-compliant options: the issue of *ṣukūk* as an alternative to a mini-bond, for example, or project financing through bonds that adhere to the schema of sovereign and corporate *ṣukūk*. In this respect, authors have conducted a feasibility study regarding financial leasing for the construction of public works or the issue of sovereign *ṣukūk* by an Italian public body in order to attract Muslim investors, modeled on those issued in Luxembourg in 2014.

The study also takes into account relevant opportunities to make real estate funds *Sharīʿa*-compliant, especially real-estate investment trusts. In fact, in a traditional real estate fund, the financial intermediary and the customer cooperate and share the risk. In addition to this, the relationship between investors and financial intermediaries of a *muḍāraba*-based real estate fund can easily be replicated into the Italian framework through an investment company with fixed capital or *Società di Investimento a Capitale Fisso* (SICAF). SICAF has been introduced into the Italian regulatory system in 2014 by means of the Legislative Decree no. 44, March 4, 2014,[42] amending the Law on Finance or *Testo Unico della Finanza*, in accordance with the Alternative Investment Fund Managers Directive 2011/61/EU. This is a very versatile tool to collect and invest collective savings. It operates in a similar way to joint-stock companies (S.p.A.), but it can invest collected savings not only via the issue of their own shares but also via other participatory financial instruments, with the exception of bonds.

Furthermore, in 2013, AIAF launched an Islamic index of the Italian stock exchange to assess the performance of *Sharīʿa*-compliant investments from a basket of securities listed on the stock exchange of Milan. This initiative stresses the importance of the financial sectors of *Sharīʿa*-compliant investment funds for the Italian market. It also explains the rationale for a thorough study of the management methodologies of Islamic funds and the employment of their ethical criteria. In fact, the Islamic index of the Italian stock exchange has shut out 189 over-indebted companies, in addition to 64 companies which cannot be taken into consideration due to their non-*Sharīʿa*-compliant activities.

[42] D.Lgs n. 44 of March 4, 2014, OJ n. 70 of March 25, 2014. [online]. [accessed July 23, 2017]. Available on Internet: http://www.gazzettaufficiale.it/eli/id/2014/03/25/14G00056/sg%20

8.5.4 *An Overview of the State of the Art and Possible Reasons for the Italian Delay in Regulating Islamic Banking and Finance*

To sum up, there are no insurmountable legal obstacles to launch a range of *Sharīʿa*-compliant retail and investment products in Italy. In fact, Italy, like other European countries, applies objective rules in the banking and financial sectors that derive from the European legal framework and aim to provide a level playing field to all market players, regardless of their nationality or religious views. What is more, Italian law contains several contractual options that could be employed to market *Sharīʿa*-compliant mutual funds or investment deposits, like the SGR and the *associazione in partecipazione*. The most critical issue, which is the participation in the Interbank Deposit Protection Fund, can be solved through various options discussed earlier: by using financial instruments regulated by the Civil Code which are exempt from the deposit-guarantee or by accepting that Islamic investment accounts do not have the characteristics of deposits with repayment obligation, for instance.

Therefore, the delay that Italy encounters in adopting the necessary reforms to accommodate IBF seems to depend on reasons other than legal incompatibility or lack of interest from institutional stakeholders. The real issue at stake is the recent influx of two million Muslims living in Italy, who have different profiles of income and consumption as well as various degrees of knowledge of Islamic finance. Consequently, the market demand could still be insufficient. In addition to this, Italian regulators follow a '*laissez-faire*' approach. Market forces and Muslim consumers are more likely, than national authorities, to trigger the development of this new financial industry, although national authorities are not contrary, by and large, to the accommodation of Islamic banking and finance in Italy. Similarly, Italy's delay does not strictly depend on the lack of interest of market stakeholders. This can be illustrated by the case of Azimut Holding, an Italian asset management company that, in 2013, launched Az Multi Asset Global Ṣukūk, the largest European investment fund in *ṣukūk*. Nowadays, the fund manages €130 million and has been renamed as Azimut MAMG Global Ṣukūk after the recent partnership between Azimut Holding and the Malaysian Maybank Asset Management group.[43] This agreement has placed the *ṣukūk* fund in the Southeast Asian market.

[43] F. Habibeddine. Azimut Global Sukuk: accordo con Maybank. [online]. London: La Finanza Islamica, January 10, 2017. [accessed July 12, 2017]. Available on Internet: http://www.lafinanzaislamica.it/azimut-global-sukuk-accordo-maybank/

Mr. G. M. Baudo, member of CO.RE.IS, explained that there might be several reasons which can possibly justify Italy's delay in the process of adjustment and adaptation of IBF at national level. In his opinion, Italy does not have enough stakeholders that are qualified in Islamic finance, within the Italian Muslim community as well as the institutional class. In particular, within the Italian Muslim community, those who could start a dialogue with the Italian authorities have tended to disengage from the local community and/or to promote IBF abroad. As for the institutional class, only a few stakeholders have taken a proactive approach and proposed concrete initiatives to implement Islamic finance in Italy, such as the Bank of Italy. In addition to that, the sporadic presence of Muslims in Italy over the last centuries and the policies adopted by the Catholic majority regarding the integration of migrants have not helped the mutual understanding between the native population and the communities of migrants, together with their values and cultures. These are the reasons why Mr. G. M. Baudo suggests the employment of a soft and gradual approach in Italy to fully implement IBF.

Furthermore, the fiscal framework awaits urgent reforms to ensure a level playing field for Islamic products and services, in the same way that the UK and France have already implemented reforms about the stamp duty land tax and the treatment of profits as means that are equivalent to interests for products performing similar economic goals. Such fiscal reforms would also encourage the establishment of a branch of an Islamic bank operating in an EU country through the European passport.

Since Islamic finance is quite a new field in Italy, it might be necessary to make both pedagogical and marketing efforts in order to stimulate social awareness and demand for these new products. In this regard, an official market survey may help to estimate the actual market demand and uptake on the part of social, banking, and financial stakeholders. Lastly, Italy is certainly a leader in some specific sectors related to the brand of Made in Italy, such as food, fashion, design, and cosmetics, as Expo and TIEF 2015 pointed out. Simultaneously, these sectors are growing fast within the Muslim world and the global market through the *ḥalāl* certification provided by specific bodies. Illustrative examples in Italy are ḥalāl Italia and Whad Certification Centers. Italy has what it takes in order to combine both brands, Made in Italy and *Sharīʿa*-compliant, and outpace other market players.

8.5.5 Islamic Finance in Education and Academia

With regard to pedagogical efforts and the interest for Islamic finance in academia, both are gradually increasing, but these are still limited to specific initiatives. While there are no departments focused exclusively on Islamic banking and finance, several universities offer courses on economics in Islamic countries, such as University of Rome Tor Vergata and University of Naples L'Orientale. In 2015, University of Bologna included Islamic finance in a course aimed at examining ethical financial systems in depth, in particular, socially responsible investing and corporate social responsibility. The objectives of this course bring out a clear sensitivity to ethical financial markets and confirm the academic interest in pursuing research on the relationship between Islamic and ethical finance. Recently, LUISS School of Government has launched a second-level master's degree program in Economics and Institutions of Islamic countries, which includes trainings on principles and instruments of Islamic finance. Nuovo Istituto di Business Internazionale (NIBI), in Milan, provides lawyers, entrepreneurs, and consultants with a highly specialized executive course on Islamic finance. This course examines practical aspects of *Sharīʿa*-compliant products, prospects for their development in Italy, and implications for the Italian fiscal and financial system.

Turin aims to become the Italian hub for Islamic finance. The University of Turin is deeply involved in the yearly initiative of the Turin Islamic Economic Forum, together with the municipality, the chamber of commerce, and ASSAIF, in order to increase prospects for the economic growth and development of the local territory. Furthermore, the department of economics and management designed a course of Islamic finance that is open to students from other fields and welcomes PhD research proposal on this topic. Exchange programs with major universities in the Middle East are also under way. Paolo Biancone, professor at the management school of the University of Turin, is now editor in chief of the *European Journal of Islamic Finance* and Director of the European Research Center for Islamic Finance, which offers a space for debate for those who are interested in knowing more about Islamic finance and the pros of its implementation in Italy, such as higher liquidity and internationalization. However, the Italian audience still lacks in academic and cultural maturity regarding new fields of study such as Islamic finance. Professor Paolo Biancone, in a written interview in June 2017, outlined that: *About 120 students take part in the course of Islamic finance at the University of Turin each year. I believe that we should investigate the topic from a cross-sectoral and multidisciplinary*

perspective, because specific knowledge should be supported by open-mindedness towards new kinds of business. The culture gap is still very deep and is likely to slow down many opportunities for local economic growth. Cultural change has started, but it is only in its infancy.

8.5.6 The Crucial Role of Political Initiative and Fiscal Reforms for the Future of Islamic Banking and Finance in Italy

Political will can play a pivotal role in the future accommodation of Islamic finance within the Italian regulatory framework. In 2017, Maurizio Bernardo, President of the Finance Committee of the Parliament has presented a new bill, which is currently under review, concerning the tax treatment of Islamic financial operations. The bill no. 4453[44] is still to be approved by the Chamber of Deputies but represents an outstanding initiative that could lead to the recognition of *ṣukūk* and their assimilation into the category of transferable securities. In addition to this, *ʾijāra*, *Istiṣnāʿ*, and *murābaḥa* are likely to become regulated contracts in Italy. The political momentum might not be fully in favor of Islamic financial operations due to the international concern about the religious-driven terrorism and national political divergences. However, the bill ensures that all new operations will be subject to constant monitoring and mandatory verification in accordance with the anti-money laundering regime of Legislative Decree no. 231 of November 21, 2007—Directive 2005/60/EC on preventing the use of the financial system for money laundering and terrorist financing.

In detail, the law proposal regulates the above financial operations within the Italian fiscal framework in order to make such transactions possible. *Sharīʿa*-compliant financial operations, which contain several legal steps, are qualified as a single transaction for tax purposes. In fact, when *ʾijāra*, *Istiṣnāʿ*, and *murābaḥa* take place, a substitute tax is applicable pursuant to Art. 17 of Decree no. 601 of September 29, 1973,[45] and the stamp duty is imposed only once when transferring the ownership to the bank. *ʾIjāra* is equated with leasing, and the same tax treatment is applied. The profit margin is considered as property income and is deductible

[44] D.L n. 4453 of May 2, 2017, 'Disposizioni concernenti il trattamento fiscale delle operazioni di finanza islamica'. Parliamentary Acts. [online]. [accessed July 2, 2017]. Available on Internet: http://www.camera.it/_dati/leg17/lavori/stampati/pdf/17PDL0052870.pdf

[45] D.P.R n. 601 of September 29, 1973, OJ n. 268 of October 16, 1973. [online]. Updated on December 23, 2013, L. n. 145, OJ n. 300 of December 23, 2013. [accessed July 17, 2017]. Available on Internet: http://def.finanze.it/DocTribFrontend/getAttoNormativoDetail.do?ACTION=getSommario&id={A2AB2374-12D3-47 AC-9140-D8ACDB7869A9}

according to the regulation income taxes (*Testo Unico delle Imposte sui Redditi*—TUIR, Art. 96[46]). Likewise, the margin and commission paid by the customer to the bank under a *Sharīʿa*-compliant financial operation are considered exempt for Value added tax (VAT) purposes, as they are included in the Art. 10 of the Decree no. 633 of October 26, 1972.[47]

The bill offers interesting insights regarding *ṣukūk*. First, it contributes to its classification into the category of *valori mobiliari* or transferable securities, which are also regulated by the directive on Undertakings for Collective Investment in Transferable Securities (UCITS) at the EU level. In fact, in principle, *ṣukūk* are neither fully bonds nor participatory bonds, shares, or atypical securities according to the Italian regulatory framework. Second, Art. 5[48] of the law proposal applies the same fiscal treatment of securities (Art. 44.1b, Decree no. 917 of December 22, 1986—TUIR) to *ṣukūk*. Therefore, all the necessary steps required to issue and market *ṣukūk*—i.e. the originator sells the asset to the special purpose vehicle (SPV), leases it back, and then the SPV securitizes the asset through the sale of investment certificates—are considered as a single financial operation conforming with the conventional tax provisions for credit securitization operations, provided that the SPV is a company with share capital. The originator is taxable with VAT only in the event that he/she also plays the role of agent providing services. The SPV is subject to direct taxation until all investors have been fully reimbursed.

8.6 *Ṣukūk* and SMEs: Prospects for *Sharīʿa*-Compliant Mini-Bonds in Italy

8.6.1 Favorable Legislation and Predominance of Small and Medium Enterprises in Italy Represent Compelling Reasons

The earlier analysis points out that the possible implementation of Islamic banking and finance in Italy has focused on the search for equivalent legal instruments within the Italian legal framework. The core reason behind

[46] D.P.R n. 917 of December 22, 1986, 'Testo unico delle imposte sui redditi', OJ n. 302 of December 31, 1986. [online]. Updated on December 12, 2003, D.Lgs n. 344, OJ n. 15 of January 20, 2004, Supp. n. 8. [accessed July 14, 2017]. Available on Internet: http://presidenza.governo.it/USRI/ufficio_studi/normativa/DPR.%20917_22.12.1986.pdf

[47] D.P.R n. 633 of October 26, 1972, 'Istituzione e disciplina dell'imposta sul valore aggiunto', OJ n. 292 of November 1, 1972. [online]. Updated on December 11, 2016, L. n. 232, OJ n. 297 of December 21, 2016, Supp. 57. Available on Internet: http://def.finanze.it/DocTribFrontend/getAttoNormativoDetail.do?ACTION=getSommario&id={75A4827C-3766-4ECC-9C45-00C8D6CDC552}

[48] *Loc. cit*, p. 8.

this approach is that Italy has not yet adopted any specific legal and fiscal framework for Islamic finance. However, some recent legislative decrees seem to be favorable to a *Sharīʿa*-compliant interpretation which could potentially contribute to issuing *ṣukūk*. Legislative Decrees No. 83 of June 22, 2012 (The Development Decree) and No. 145 of December 23, 2013[49] (Destination Italy Decree) introduced new models to issue bonds. First of all, companies that are not listed on the stock exchange, such as SMEs, are now allowed to issue corporate bonds—the so-called mini-bonds—and access to the capital market with no intermediation of banks or financial institutions. Second, bonds can include a provision for participation in profits, according to which returns consist of a fixed and a variable part whereby the variable component is proportionate to corporate profits associated with funding via bonds—the so-called participatory bonds. In a nutshell, non-listed companies are entitled to benefit from the same fiscal treatment that is conceded to listed companies, such as the deductibility of interests on the part of the issuer and the exemption from withholding tax for foreign investors operating in White Listed countries.

The rationale for this new legal framework lies on the specific economic realm in Italy. According to data provided by the Italian National Institute of Statistics (ISTAT), in 2011,[50] 4.4 million SMEs were operating in Italy and employed 16.4 million workers. Most of them are family-run micro-enterprises that used to depend on the bank financing and used to be non-competitive on the global market because of structural reasons: lack of capital, insufficient demand, and bureaucratic burdens. Overall, 64% of Italian SMEs are conservative microenterprises: they present simplified profiles of governance and strategies, which are risk-adverse, reluctant to embrace innovation, and target local markets. A total of 16.6% of Italian SMEs gather a number of enterprises provided with heterogeneous size and profiles, but all of which work with networks of international investors and are prone to innovation.

[49] D.Lgs n. 145 of December 23, 2013, OJ n. 300 of December 23, 2013. [online]. Updated on February 21, 2014, L. n. 9, OJ n. 43 of February 21, 2014. [accessed January 5, 2017]. Available on Internet: http://www.gazzettaufficiale.it/eli/id/2013/12/23/13G00189/sg

[50] Italian National Institute of Statistics (ISTAT), 9° Censimento Generale dell' Industria, dei Servizi e delle Istituzioni Non Profit, Check-up delle imprese italiane. [online]. Milan: Press Release ISTAT, November 2013. Updated on November 28, 2013. [accessed August 9, 2016]. Available on Internet: in http://www.censimentoindustriaeservizi.istat.it/

Therefore, national authorities took note of the economic engine represented by SMEs as well as of their specific shortcomings, and, in light of the bank credit crunch due to the financial crisis, they decided to offer a legal and fiscal framework conducive to business innovation, diversification of funding sources, start-up financing, corporate turnaround, and internationalization. In this regard, attracting foreign capital or savings managed in conformity with *Sharīʿa*, through mini-bonds, would encourage Italian companies to launch long-term development projects and access diversified funding sources. Now, the question is: is it possible to structure a *Sharīʿa*-compliant mini-bond in Italy? Preliminarily, a mini-bond is a debt instrument as much as any conventional bond. Table 8.1 outlines the main characteristics of both bonds and *ṣukūk*.

Table 8.1 Differences between mini-bonds and *ṣukūk*

Parameters	*Bonds/mini-bonds*	*Ṣukūk*
Activity	Investors are not owners of shares in the ownership of assets, projects, or joint ventures. Bonds represent the issuer's debt owed to the bond underwriter	Investors are owners of shares in the ownership of the underlying asset
Investment criteria	Bonds can finance any activity, project, or joint venture that is compatible with local legislation	*Ṣukūk* can only finance *Sharīʿa*-compliant activities
Bond's units	Bonds represent shares of debts	*Ṣukūk* represent shares in underlying assets
Bond's value	The market value of a bond hinges upon creditworthiness and the rating of the issuer	The market value of a *ṣukūk* hinges upon the market value of the underlying asset
Returns and investment risks	In general, bondholders receive interests regularly during the period of validity of bonds and, at maturity, they can redeem the initial capital	*Ṣukūk* holders receive a share of profits deriving from the underlying asset and bear a share of any losses
Costs	In general, bondholders are not affected by management costs related to the activity, project, or joint venture; performance of underlying assets does not influence returns to investors (unless the issuer is in default)	*Ṣukūk* holders are affected by management costs related to underlying assets. Higher management costs could entail lower profits for investors and vice versa

Source: E. Giustiniani, G. C. Brugnoni, A. Caragnano, [et al]. Obbligazioni Islamiche e Cartolirizzazioni immobiliari. Le prospettive Italiane per l'emissione di un sukuk. Milan: AIAF, October 2015, Paper No. 167, p. 66

8.6.2 A Feasibility Study on the Issuance of Ṣukūk by an Italian SME

Considering that there are significant differences between bonds and *ṣukūk*—not least that a *ṣukūk* holder in Italy would be protected from the risk of capital losses through the Financial Services Compensation Scheme—it is necessary to understand whether an Italian SME could issue a *ṣukūk* that may be compatible with both *Sharīʿa* and Italian law.

First of all, the target group of the Development Decree is represented by the group of Italian SMEs, which are active in the international market and have the capacity to innovate and diversify production. In fact, micro-enterprises do not have marketing and governance profiles suited to bear high costs and business risks, to establish direct relations with foreign investors, nor to provide a detailed planning of long-term activities and their estimated cash flows.

Furthermore, from a structural and operational point of view, the SME should identify a potential project or any kind of tangible asset that could grab the attention of Islamic investors. Two key elements of this initial phase are an accurate business plan, provided with all details about phases, feasibility, and profitability of the activity, and the support of a *Sharīʿa* advisor or consultant. The *Sharīʿa* advisor(s) would assist the company with screening those options that could contribute to make the whole operation more *Sharīʿa*-compliant. For instance, the project's capital could be kept separate from the other business activities managed by the enterprise, in order to open the funding of bonds' issuance to Islamic equity funds—as in the case of Az Fund Global Ṣukūk fund managed by the group Azimut.

In addition to this, *ṣukūk* holders should be entitled to receive the compensation scheme, in the event they lose their capital; at the same time, they could be informed about the possibility to dismiss this option, so that their investments may be fully *Sharīʿa*-compliant, if they so wish. As for the Italian SME, it would play the role of an SPV in a typical *ṣukūk* issuance. In fact, the SPV issues investment certificates in the asset or the project they want to finance and sells these certificates to investors who are remunerated in accordance with the project performance. Returns on the investment can be made *Sharīʿa*-compliant through the provision for participation in profits, whereby the fixed component, that is to say the interest rate, can be limited to the minimum required by law, while the yield rate owed to the *ṣukūk* holder might consist of variable returns depending

on corporate profits. In short, the issuer undertakes to annually pay an amount—which is proportional to its economic results—to the *ṣukūk* holder, according to the pre-determined rate at the time of issue. This rate can also be very high because variable returns have been excluded from the anti-usury legislation.

In the absence of corporate profits, the investor is, however, entitled to the repayment of principal. Mini-bonds can be listed on the bond markets managed by the Italian stock exchange, namely the regulated bond market (MOT) and the multilateral trading facilities (ExtraMOT). Specifically, within the ExtraMOT market, the Italian stock exchange launched the ExtraMOT PRO section which is specialized in listing debt securities, equity instruments, participatory bonds, and project bonds issued by Italian SMEs. The launch of ExtraMOT PRO is in line with European best practices, such as the range of offerings by other European stock exchanges like Luxembourg and Ireland. What is more, issuing companies interact directly with the Italian stock exchange, without resorting to other intermediaries such as listing sponsors.

As far as fiscal issues are concerned, the Development Decree introduced three major tax concessions in favor of the issuing companies: the deductibility of interests, the exemption of withholding tax on paid interests, and the deductibility of the issue costs. Listed mini-bonds can benefit from more advantages than their unlisted counterparts. For example, in the case of unlisted mini-bonds, interests are deductible, provided that investors belong to the category of 'qualified investors' in accordance with the Law on Finance, such as pension funds, insurance companies, and banks; investors do not, either directly or indirectly, hold more than 2% of the capital or assets of the issuer; investors are resident in Italy or in White Listed countries. Countries in the white list are those countries which implemented the Organization for Economic Co-operation and Development (OECD)-agreed tax standards about an adequate level of information exchange and which are not resident in tax havens. Furthermore, the withholding tax on paid interests amount to 20% of interests on unlisted bonds issued by non-listed companies.

In conclusion, the analysis of the legal framework is of paramount importance for understanding the operational conditions of Islamic instruments in Italy. The legal compatibility between national and 'foreign' instruments also determines the applicable fiscal regime. In fact, it is unlikely that the economic outcome of products—though similar to the economic substance of products belonging to other legal systems—

overrides any concerns of formal adaptation to a legal category in force under Italian law. In the present case, the tax treatment applicable to *ṣukūk* would correspond to the fiscal regime associated with mini-bonds. In addition, the PLS mechanism characterizing the remuneration of participatory bonds facilitates the issue of *Sharīʿa*-compliant bonds by unlisted Italian enterprises. Fiscally, as in other European countries, profits accrued to *ṣukūk* holders would be classified as interests in order to benefit from the same tax advantages. What is more, *ṣukūk* returns, albeit variable and uncertain, are aligned with parameters used for conventional bonds (Euribor, for instance).

The leading Italian law firm NCTM has recently made some significant steps toward the issuing of Islamic bonds, in the wake of growing demand for mini-bonds from Italian SMEs. NCTM had formerly signed a partnership agreement with Islamic Finance Lawyers (ISFIN), a global advisory platform for professional firms specialized in Islamic finance, investments from and to Muslim countries, and the ḥalāl industry. In fact, in 2013, ISFIN chose NCTM as the exclusive Italian partner for the network of lawyers dealing with Islamic finance. Now NCTM seeks to implement a consultancy window to advise customers interested in Islamic markets. The Shariyah Review Bureau, a global *Sharīʿa* advisory company, will cooperate and help NCTM design and certify *Sharīʿa*-compliant mini-bonds that Italian SMEs could use.

8.7 Concluding Remarks

This study set out to explore how Islamic finance can be implemented in Italy. For this purpose, the theoretical literature on this subject and its related sources have been analyzed from a comparative perspective, juxtaposing the European framework, the Italian context, and the Islamic framework. When these proved to be inconclusive and better understanding was needed, the analysis also made use of data and information gathered from interviews with experts in the field of Islamic finance in Italy. The research revealed some key findings. The investigation of the Italian legal and regulatory framework shows that there are no insurmountable obstacles to settle IBF activities in Italy. Indeed, several structures have been identified to accommodate *Sharīʿa*-compliant banking and financial activities. Islamic investment accounts can take the form of undertakings for collective investment schemes, which are also exempt from the deposit guarantee, for example. Hence, Italy's delay in providing the necessary

regulatory and fiscal adjustments to accommodate Islamic finance hinges on reasons other than legal incompatibility or lack of interest from the market that could impede *Sharīʿa*-compliant retail and investment products. Among possible reasons, the following emerged as the most plausible. The demand for IBF products from the Italian Muslim community is still low due to the recent migratory phenomenon and the shortage of people qualified in Islamic economics and finance. In addition to this, regulatory authorities have adopted a soft approach that is to let market forces decide when IBF may enter the country. In this regard, the best example could be the opening of a branch of an IFI operating in another European country through the European Passport. However, the bill submitted to the revision of the Chamber of Deputies, on May 2, 2017, at the initiative of Maurizio Bernardo, has opened new prospects for the successful implementation of Islamic financial operations in Italy.

The research also suggests further examination of the integration/interaction of Islamic finance with the context of cooperative and ethical banking as well as SRIs in Italy. Such analysis might expand the scope for action of Islamic finance in Italy and help to overcome the traditional approach of harmonizing inconsistencies between the Islamic *modus operandi* and national European regulatory frameworks, to the detriment of common end objectives. Its starting point could be the study of the modern concept of ethics, which goes beyond but does not ignore religious-oriented social and economic values. In fact, the study pointed out that, despite different operational methods and standards, conventional ethical finance and Islamic finance can complement, rather than contradict each other, in particular, in the field of socially responsible investments.

Lastly, there are several decisive variables at stake to determine the end result of the startup process of Islamic finance in Italy: political will and social and cultural acceptance, as outlined by Mr. Baudo and Mr. Biancone. Education, particularly a better understanding of the relationship between economics and values, will certainly play a crucial role in the achievement of further developments of Islamic finance in Italy. In the long term, negative public opinion and misconceptions about Islam, political climate, and a superficial dialogue between the various social and cultural circles could impinge on the evolution of Islamic finance in Italy, more than any regulatory challenge. In addition to representing a profitable market and new sources of capital to inject into the national economy, Islamic finance can represent a chance to enhance cross-cultural cooperation, financial inclusion, and social cohesion, in support of the common good and future challenges.

Glossary of Selected Foreign Words

associazione in partecipazione Type of joint venture where an entrepreneur has a partnership with associate(s) who undertake to carry out an activity for the company and have the right to obtain a share of the company's profits as remuneration. Likewise, associates take partial responsibility for the business risk.

cinque per mille Literally: five for a thousand. It is a fiscal measure that allows taxpayers to allocate a share of their personal income taxation to organizations dealing with activities performed in the public interest. It is free of charge for citizens, though it is not considered as a donation.

Ḥadīth (plural: aḥādīth) A saying, deed, or endorsement of the Prophet (PBUH) narrated and transmitted by his Companions.

ḥalāl and ḥarām Things or activities that are permitted and prohibited by *Sharīʿa*, respectively.

ʾijāra Leasing; the sale of usufruct of an asset.

istiṣnāʿ A contract whereby a manufacturer agrees to produce and deliver a predetermined product at a given price on a given date in the future. Unlike *salam*, the payment is not made in advance—the parties may agree on the payment method.

maṣlaḥa Literally, public interest. It refers to any action taken to protect the public interest and common good. It can be used as a secondary legal source to establish legal rules or issue juridical opinions.

muḍāraba A contract whereby a financier, *rab al-māl*, and an investment manager, *muḍārib*, enter into a partnership. Profit is distributed in accordance with the ratio upon which both parties agree at the time of the contract, while loss is borne only by the financier.

murābaḥa Sale at a specified profit margin or markup. It refers to a sale agreement whereby the seller purchases the good(s) on behalf of the buyer and then sells them at an agreed marked-up price, which includes the cost of the risk borne by the seller as long as it holds ownership of the good(s). Delivery to the buyer and the payment method are settled within an agreed time frame.

mushāraka A partnership agreement or joint venture according to which all partners participate in the management as well as the provision of capital and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each partner's share in the capital.

organismo di investimento collettivo del risparmio Category of financial intermediaries offering collective asset management services. These services include the promotion, establishment, and organization of mutual funds and the management of relations with the participants.

organizzazione non lucrativa di utilità sociale Private entity, with or without legal personality, which carries out no-profit activities with the exclusive purpose of social solidarity. It must operate in one of the sectors identified in the

legislative act 460/4 December 1997, and it cannot carry out activities other than those indicated in its statute. Profits have to be used for the implementation of planned activities and cannot be distributed between its members.

Qur'ān The Holy Book of Islam, consisting of the revelations made by God to the Prophet (PBUH).

ribā Literally, increase, addition, or growth. Technically, it refers to the compensation that the borrower must pay to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Nowadays, it is understood as interest or usury, since any form of interest is deemed to be usury in accordance with *Sharīʿa*.

salam a sale in which payment is made in advance by the buyer, and the delivery of the good is deferred by the seller.

Sharīʿa The corpus of Islamic Law; the path of conduct based on Divine guidance as given by *Qur'ān* and *Sunna*. It embodies all aspects of the Islamic faith and way of life.

Sharikat al-ʿaqd Joint commercial enterprise effected by a mutual contract.

ṣukūk (singular: *ṣakk*): these are Islamic investment certificates backed by real underlying assets relating to specific projects or investment activities. *Ṣukūk* provide their holders with undivided shares in the ownership of the underlying asset(s), along with the commensurate cash flows and risk.

Sunna It refers to the Prophet's (PBUH) example as indicated by his practice of the faith. The only way to know *Sunna* is through the collection of *aḥādīth*.

Takāful The Islamic form of insurance based on the principles of mutual support and solidarity. A group of persons agree to share a certain risk by regularly donating a pre-determined sum to a *Takāful* operator. In the case of loss to any of the group, the loss is met from the collected funds. At the same time, a part of the contributions to the *Takāful* pool is earmarked for an investment fund that the operator's shareholders manage on behalf of the policyholders. The latter are joint investors with the insurance company, and they share in the investment pool's profits, in addition to benefiting from any cash surplus or dividends.

valori mobiliari Transferable and negotiable securities issued by public bodies or private companies, which represent interest-bearing cash liabilities (return in a form of fixed payments) and interest-bearing shares invested in companies (variable returns), respectively. Since the entry into force of the Law on Finance, in 1998, *valori mobiliari* are called financial instruments and encompass bonds, shares of mutual funds, warrants, options, futures, swaps, securities traded in the money market, and others.

versamento in conto capitale Contribution to the equity capital of a company, through a special-purpose reserve, with no obligation to repay.

zakāt The compulsory charity due from every Muslim on his/her net worth, as a part of his/her religious obligations, mainly for the benefit of the poor and the needy. It is a duty on every adult Muslim who owns more than a certain threshold of wealth.

Appendix

Interview (March 18, 2016) with Mr. Giuseppe Mansur Baudo, CO. RE.IS—Italy.

Q: *In your opinion, what are the prospects for Islamic banking and finance in Italy?*

A: 'I point out two main prospects for Islamic banking and finance within the Italian market: mutual funds investing in *Sharīʿa*-compliant activities and microcredit loans with no interest rates. On the contrary, it may be more difficult to establish an Islamic retail bank, unless the major banking groups take some action in this direction. In this case, however, the risk is that these initiatives target all immigrants, rather than the Muslim community in particular. Therefore, they would foster the integration of migrants in general but they do not specifically aim to implement Islamic banking and finance in Italy. Moreover, there is a number of projects with high potential in Italy. For example, launching investment funds, based on the structure of *ṣukūk muḍāraba*, for the purpose of maintenance and improvements of major Italian sites of cultural and artistic importance. Additionally, creating *Sharīʿa*-compliant private investments facilities to which foreign companies could contribute through consortiums'.

Q: *In your opinion, what are the reasons behind Italy's delay in accommodating Islamic banking and finance, unlike other European countries?*

A: 'I would say that there are various institutional, cultural and social reasons. First of all, the local market is still immature due to the shortage of qualified stakeholders both within the Italian Muslim community and the institutional class. As for the Muslim community, those who would be qualified to interact with the institutional class and advance the interests of the Muslims disengage from the local community. At the same time, there is a double-edged cultural policy rooted in national religious sensitivities in Italy. On the one hand, religious sensitivity encourages effective forms of dialogue and interaction between the Catholic, Jewish and Muslim communities. On the other hand, the sporadic and unregulated presence of Muslims in Italy over the past seven centuries has deprived the Italian society of the knowledge of Islam. In addition, the Catholic majority has sought the integration of Muslim migrants in the form of full integration into national and European socio-economic structures. Nonetheless, the new native community of Italian Muslims will be able to establish new

balances and forms of dialogue with institutions and society, in order to dispel the mutual stereotypes and preconceptions.

As far as institutions are concerned, the Bank of Italy launched a department for the study of Islamic finance under the direction of Mr. Giorgio Gomel. Furthermore, various initiatives by ABI, the home office, law firms and the Chamber of Commerce in Milan have increased the awareness of Islamic finance through papers, conferences and training courses, for example. However, just a few of them suggested concrete solutions to implement Islamic banking and finance in Italy. I mention the seminar organized by the IFSB and hosted by the Bank of Italy in Rome in April 2013. Among the issues that could inhibit the development of Islamic finance in Italy, they identified the role of the *Sharīʿa* Board. In fact, the bank's management decisions are typically entrusted to a single board. Therefore, the forum discussed ways in which to allow the interaction between two supervisory bodies.

In this respect, CO.RE.IS devised the project of an external *Sharīʿa* Board, composed of Muslims as well as non-Muslims and supervised by the Bank of Italy, which may certify the compliance of products within conventional banks with *Sharīʿa* on a voluntary basis. This soft approach could be easily accepted by national authorities and implemented through *ḥalāl Italia*. The only downside would be that if the products become non-compliant over a period of the time, these may lose their right to certification but continue to be marketed to the detriment of the credibility of the whole Islamic financial sector.

Finally, in light of the reasons stated earlier, I think that we should proceed by taking small steps to allow Islamic finance to integrate into Italian fabric, especially considering that the recession has had a negative impact on business initiatives in Italy'.

Q: *Do you find any common ground between Islamic finance and conventional ethical finance and how do you think it could affect the prospects for Islamic banking and finance in Italy?*

A: 'We must definitely overcome prejudices and consider how Islamic finance could be embedded in ethical finance, given that both converge in the so-called alternative finance. We lean toward further integration in favor of the common good, much more than Gulf countries that have adopted a restrictive approach. Certainly, both financial systems could fall within the same regulatory framework. Nevertheless, we also need to preserve the distinctive features of

Islamic finance. I mean that what is ethical is not necessarily *Sharīʿa*-compliant, e.g. investing in the wine industry. In fact, the rationale behind Islamic investments lies on religious principles, which are distinct from ethical reasons. What is more, the certification of *Sharīʿa*-compliance has to keep the distinction between what is lawful and unlawful clear and guarantee transparence about each aspect of transactions, though it may refer to the same regulatory framework as ethical finance. In short, we support the interaction between Islamic and ethical finance, provided that unambiguous information about ethical and Islamic criteria are supplied to the market'.

Q: *What steps CO.RE.IS has taken to implement Islamic finance in Italy?*

A: 'We have a *Sharīʿa* Board that is an Ethical Committee with the aim of spreading the knowledge about Islamic principles and rules among institutions, private companies and banks. Among our initiatives, we responded to the Pope's appeal to all people of good will in the encyclical "*Caritas in Veritate*", through an official document intended to create synergies between the three monotheistic religions on the common themes of brotherhood, civil society and economic development. We participated in international forums on Islamic finance as well as the Italian festival of the Church's social teachings. We held training courses for the BCC and we contributed to projects that are still in their embryonic stages for devising *Sharīʿa*-compliant loans at the request of banking groups. What is more, Imam Yahya Pallavicini is the chairman of the Supreme Council for Education, Science and Culture for Muslims outside the Islamic world, within ISESCO, under the umbrella of the Organization of Islamic Cooperation. This organization allows us to keep a close eye on the cultural initiatives of Muslim communities and on the dialogue between civilizations in the West, notably in Europe'.

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CHAPTER 9

Islamic Finance in Luxembourg in 2019

Jihad Laarab

9.1 Abbreviations

ADGM	Abu Dhabi Global Market
ALFI	Association of the Luxembourg Fund Industry
BCL	Banque Centrale du Luxembourg
BEPS	Erosion of the Tax Base and the Transfer of Profits
BIS	Bank of International Settlements
CIF	Collective Investment Fund
CIF	Common Investment Fund
CRS	Common Reporting Standard
CSSF	Commission de Surveillance du Secteur Financier
FDEF	Faculté de Droit, d'Économie et de Finance
IBQ	Islamic Banking Qualification Program
IFSB	Islamic Financial Services Board
IILM	International Islamic Liquidity Management Corporation
INCEIF	International Center for Education in Islamic
ITQ	Islamic *Takāful* Qualification Program
LFF	Luxembourg for Finance

J. Laarab (✉)
Paris, France

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https://doi.org/10.1007/978-3-030-04094-9_9

LSF	Luxembourg School of Finance
OECD	Organisation for Economic Co-operation and Development
QFMA	Qatar Financial Market Authority
RAIF	Reserved Alternative Investment Fund
SICAR	société d'investissement en capital à risque (Investment Company in Risk Capital)
SIF	Specialized Investment Fund
UCITS	Undertakings for Collective Investment in Transferable Securities

9.2 Introduction

Luxembourg mainly depended on the agricultural sector and then on the steel industry until industrial declined. At that time, the direction of the growth policy turned to the financial sector. The Luxembourg financial sector has been developed from the 1960s; foreign banks operated their activities on the Euromarket. Other activities have been developed such as private banking, wealth management, and investment fund management. Luxembourg is also the first country to have adopted the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive in 1988, conferring it the status of first-rate financial place as a domicile of investment funds in Europe and around the world. At the international level, the Luxembourg financial sector is particularly recognized for ongoing diversification of products and offering services where Islamic finance is a part.

The first Islamic financial institution in Europe was established in Luxembourg. Today, it is one of the most important Islamic financial centers in Europe. Luxembourg has seen considerable changes in the cooperation and exchange of information and the high capacity to adapt economic strategies. Islamic finance found in Luxembourg an excellent host country. Various products and services of *Sharīʿa* compliant *Sharīʿa*-compliant are proposed by Luxembourg with an ideal legal framework for their creation and commercialization. However, academic studies and training remain limited.

9.3 Luxembourg and Islamic Finance: A Cross-Border Market with High Potential

9.3.1 Key Dates of Islamic Finance in Luxembourg

1978: Establishment of the first Islamic institution in Luxembourg.[1]
1982: Creation of the first Islamic insurance company in Europe—Takāful S.A.[2]
2002: The Luxembourg Stock Exchange is the first European Exchange to quote *Ṣukūk*.[3]
2008: The Luxembourg Investment Fund Association (ALFI) has launched a working group focused on the development of Luxembourg as a center of excellence for funds conforming to the *Sharīʿa*.[4]
2009: Launch of the Luxembourg "Al Mi'yar" platform, developed by Deutsche Bank, with the Luxembourg Financial Group as investment manager of *Sharīʿa* compliant. The central bank of Luxembourg is the first European bank to become a member of the Islamic Financial Services Board (IFSB).[5]
2010: Signing of the "Memorandum of Participation" to establish an international Islamic Liquidity Management Corporation (IILM). The central bank of Luxembourg (BCL) is the only European shareholder of the IILM, which was established on October 25, 2010.
Publication of a circular by the Direct Taxation Authority aims to clarify the terms of taxation of *Mūrabaḥa* and *Ṣukūk* on January 12, 2010.[6]
2011: Publication of a statement by The Financial Sector Supervisory Board (CSSF), which sets out certain rules applicable to *Ṣukūk* in particular regarding the annexes of the Prospectus in order to strengthen the legal security of issuers of *Ṣukūk* and investors.[7]

[1] Le Mensuel d'Agefi Luxembourg, http://www.agefi.lu/mensuel/article.asp?numarticle=12854

[2] Muhammad Akram Khan, Islamic Economics and Finance: glossary, The Taylor & Francis e-Library, 2005.

[3] Bourse de Luxembourg, https://www.bourse.lu/luxse-lists-luxembourg-sukuk-fr

[4] ALFI, http://www.alfi.lu/setting-luxembourg/*Sharīʿa*-compliant-funds

[5] IFSB, list of members Associate member, http://www.ifsb.org/membership.php?id=2

[6] Le Gouvernement du Grand-Duché De Luxembourg Circulaire du directeur des contributions L.G.-A n° 55 du janvier 12, 2010, http://www.impotsdirects.public.lu/legislation/legi10/Circulaire_L_G__-_A_n___55_du_12_janvier_2010.pdf

[7] Commission de Surveillance du Secteur Financier, Communiqué Règles applicables aux Sūkūk, janvier 26, 2011, http://www.cssf.lu/fileadmin/files/Publications/Communiques/Communiques_2011/C_sukuk_260111.pdf

CSSF states in another document that the legislative and regulatory frameworks of the financial sector in Luxembourg are designed in such a way that it can welcome actors and products from different traditions and cultures.[8]

2011: Luxembourg hosts the 8th Annual IFSB summit dealing with the globalization of Islamic finance and its growing contribution to global financial stability and economic growth.[9]

2012: ALFI's publication of best practices for the establishment of Islamic funds. This document includes detailed information and advice on the legal framework, banking services, and Islamic funds in Luxembourg. It also gives a high-level indication on compatibility of Islamic financial instruments with Luxembourg UCITS laws.[10]

2014: The Chamber of Deputies approved the draft law No. 6631, allowing the Ministry of Finance to set up the *Ṣukūk*.[11] Luxembourg is the first country that issued sovereign *Ṣukūk* in Eurozone worth €200 million on July 9, 2014, and quoted on Euro Multilateral Trading Platform (MTF) of the Luxembourg Stock Exchange.[12]

2014: Luxembourg for Finance (LFF) publishes in September 2014 a brochure "vehicles for Islamic finance" describing in detail the Luxembourg investment vehicles. This brochure is intended for those interested in setting up a product conforming to the *Sharīʿa* in Luxembourg. It provides information on the legal and tax framework.[13]

[8] Commission de Surveillance du Secteur Financier, Les OPC et la Finance Islamique Les OPC et la Finance Islamique, mai 11, 2011, http://www.cssf.lu/fileadmin/files/Finance_islamique/OPC_finance_islamique.pdf

[9] IFSB, 8th Islamic Financial Services Board Summit, http://www.bcl.lu/en/Media-and-News/Press-releases/2011/04/IFSB/Brochure.pdf

[10] ALFI, Islamic Funds Collection of best practices for setting up and serving Islamic funds, decembre 2012, http://www.alfi.lu/sites/alfi.lu/files/files/Publications_Statements/Brochures/ALFI-Islamic-funds.pdf

[11] Le Gouvernement Du Grand Duché du Luxembourg, Approbation du Projet de Loi 6631 "Sūkūk", Communiqué juillet 10, 2014, http://www.gouvernement.lu/3842071/09-pl-sukuk

[12] Le Gouvernement Du Grand-Duché du Luxembourg, Communiqué octobre 1, 2014, http://www.gouvernement.lu/4054591/30-sukuk

[13] Luxembourg for Finance, Luxembourg Vehicles for Islamic Finance Structures, avril 2010, http://www.luxembourgforfinance.com/sites/luxembourgforfinance/files/islamic_finance_brochure_apr10.pdf

2015: Signing the Memorandum of Understanding between Qatar Financial Market Authority (QFMA) and the Financial Sector Supervisory Commission (CSSF) on October 5, 2015. It is an agreement on mutual assistance and the exchange of information relating to the supervision of markets and securities.[14]

2016: Signing the Memorandum of Understanding between Abu Dhabi Global Market (ADGM) and Luxembourg for Finance (LFF). Held on March 10, 2016, in Luxembourg on the margins of the second meeting of the United Arab Emirates (UAE)-Luxembourg Council for cooperation on Islamic finance and banking.[15]

9.3.2 Demand and Supply

Islamic finance in Luxembourg is targeting actors around the world not only the domestic market. Since 1979, the law has banned any census relating to religion. The last census was done in 1970. According to the official portal of the Grand Duchy of Luxembourg, there would be 96.9% Catholics, 1.2% Protestants, 0.2% Jews, and 1.7% others. And according to the survey of Luxembourg Institute of Socio-Economic Research (LISER) published, Luxembourg is predominantly a Catholic country.

> *Religious affiliation remained stable between 1999 and 2008. The only significant change is the progression of the Muslim religion, which, due to significant immigration from the former Yugoslavia, has risen from 0.7% to 2% over this period*[16]

According to the American Institute "Pew Forum" study published in 2011, Luxembourg Muslims represented only 2.3% of the population in

[14] Commission de Surveillance du Secteur Financier, Signature of a Memorandum of Understanding Between the Qatar Financial Markets Authority (QFMA) and the Commission de Surveillance du Secteur Financier (CSSF), October 14, 2015, http://www.cssf.lu/fileadmin/files/Publications/Communiques/Communiques_2015/Communique_MoU_CSSF_QFMA_141015.pdf

[15] Luxembourg for Finance, Luxembourg bilateral corporation with Abu Dhabi Global Market, mars 2016, http://www.luxembourgforfinance.com/en/news/luxembourg-signs-mou-bilateral-cooperation-abu-dhabi-global-market

[16] Les cahiers du ceps/instead religions au luxembourg. Quelle évolution entre 1999–2008? Monique Borsenberger, Paul Dickes cahier n°2011—janvier 2, 2011, page 6 population & emploi

2010, and according to the forecast, they should reach 14,000 or 2.3% of the total population by 2030 (Table 9.1).

According to the institute "Pew Forum", Muslims have gone from a percentage of 4.1% of the European population in 1990 to 6% in 2010 and would be estimated at 8% by 2030. The demand does not come from the Luxembourg Muslim population, which represents only a minority.

The Luxembourg's interest in Islamic finance is explained by the growth potential in Europe, Asia, and Middle East and North Africa (MENA) countries (Table 9.2).

Table 9.1 Muslim population of Luxembourg

Estimated population in 2010	11,000	2.30%
Projection of the Muslim population in 2030	14,000	2.30%

Adapted from Pew Research Center's Forum on Religion & Public Life. The future of the Global Muslim Population, January 2011. http://www.euro-muslims.eu/future_global.pdf

Table 9.2 Muslim population by region

Muslim population by region	*2010*		*2030*	
	Estimated Muslim population	*Estimated % of Muslim population*	*Projection of the Muslim population*	*Projected % of the Muslim population*
World	1,619,314,000	100	2,190,154,000	100
Pacific-Asia	1,005,507,000	62.1	1,295,625,000	59.2
Middle East/ North Africa	321,869,000	19.9	439,453,000	20.1
Sub-Saharan Africa	242,544,000	15	385,939,000	17.6
Europe	44,138,000	2.7	58,209,000	2.7
Americas	5,256,000	0.3	10,927,000	0.5

	1990	*Growth rate 1990–2010*	*2010*	*Growth rate 1990–2010*	*2030*
Europe	26,650,000	48.90%	44,138,000	31.90%	58,209,000
Growth	4.10%	(+) 1.9 points	6%	(+) 2 points	8%

Adapted from Pew Research Center's Forum on Religion & Public Life. The future of the Global Muslim Population, January 2011. http://www.euro-muslims.eu/future_global.pdf

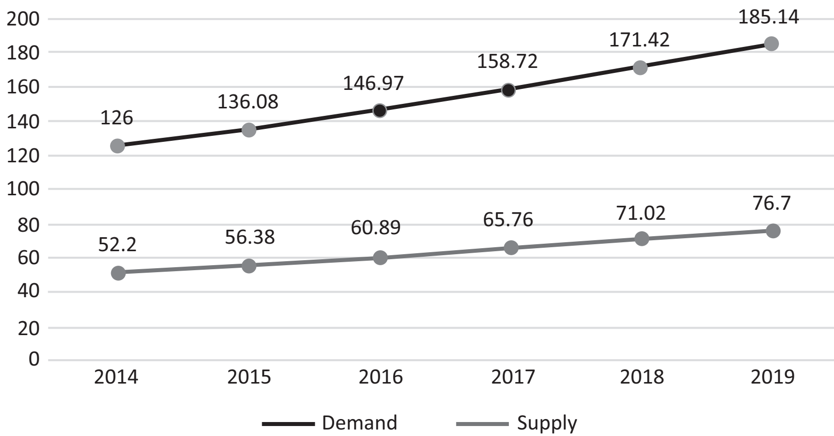

Fig. 9.1 The growth of Islamic funds. (Adapted from Thomson Reuters global Islamic asset management outlook 2015 unlocking potential)

On the supply side, the growth rate of Islamic funds is estimated at 8% with a market of US$77 billion in 2019. The demand (which mainly covers the developing economies of MENA and Southeast Asia) was 126 billion in 2014 with an overdemand of 73.8 billion. The demand is estimated at US$185 billion in 2019 with an overdemand of US$108.44 billion (Fig. 9.1).[17]

Islamic banks and Windows should be the main drivers of growth for Islamic finance and should reach US$2.825 trillion in 2021; with market share of 75% in 2015, they are expected to increase to 80% in 2021.

Overall growth for Islamic financial assets will reach US$3.54 trillion by 2021 (Fig. 9.2).[18]

Luxembourg is a carrier market, which is distinguished by its political and economic stability. Several specificities and advantages make the country competitive:

The Government's willingness to promote these activities through the analysis of compatibility with Luxembourg legislation, innovation, and the

[17] http://www.zawya.com/mena/en/business/islamic-finance

[18] Islamic Corporation Development (ICD), Thomson Reuters, Islamic Finance Development Report 2016 Resilient Growth, http://www.zawya.com/ifg-publications/report/20161213065838706.pdf/

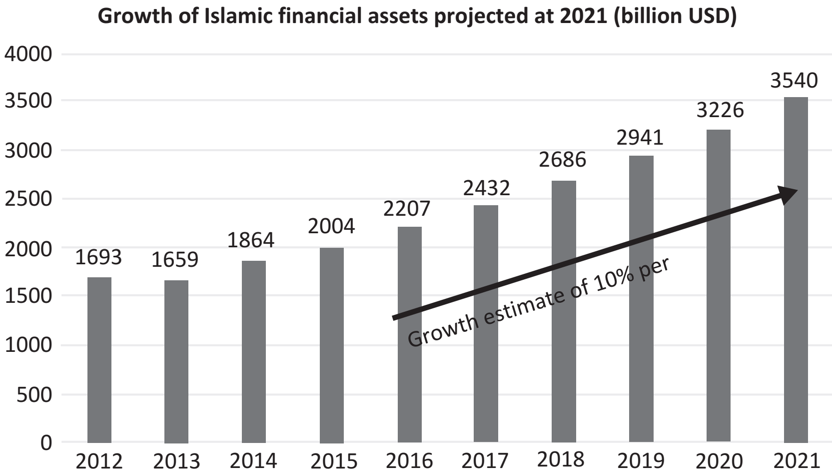

Fig. 9.2 Growth of Islamic financial assets projected at 2021. (Adapted from ICD, Thomson Reuters, Islamic finance development report 2016 resilient growth)

adoption of a discourse promoting a stable and internationally oriented policy. Luxembourg has a modern legal and regulatory framework that is continually updated through regular consultations between the government, legislators, and the private sector. Luxembourg has very good political relations with the countries of the Gulf and Malaysia, which increases the attractiveness of the country for these two centers of Islamic finance.

The favorable economic situation in Luxembourg: The financial sector represents a large part of GDP. The diversification of the products and services are proposed in order to maintain the added value of this sector (Fig. 9.3).

Rigorous and secure financial and commercial policy: The Luxembourg member of the European Union and the Organisation for Economic Co-operation and Development (OECD) is characterized by a strong culture of investor protection. Luxembourg is a leader in the field of cross-border fund distribution, and it is positioned as the first investment fund center in Europe. According to the Bank of International settlements (BIS), Luxembourg's cross-border position is more important than the local position (Fig. 9.4).

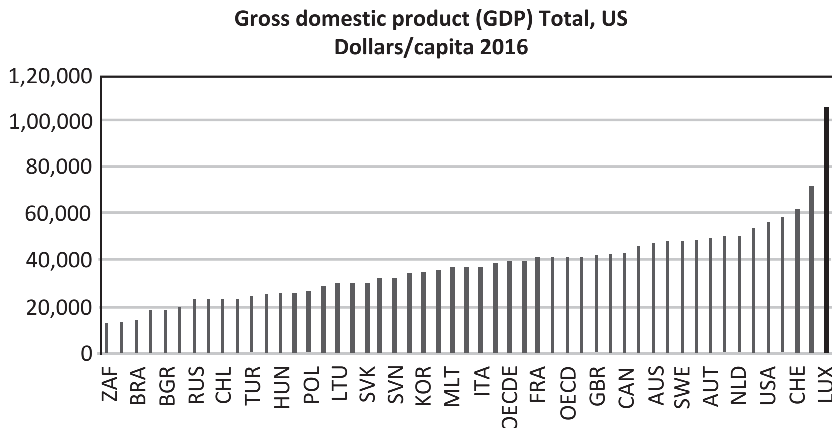

Fig. 9.3 Gross domestic product. (Adapted from OECD, Data. https://data.oecd.org/fr/gdp/produit-interieur-brut-pib.htm)

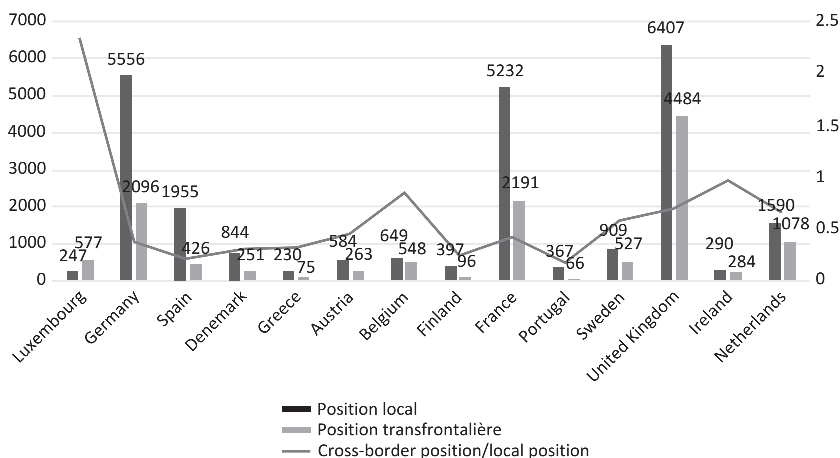

Fig. 9.4 Bank Assets. (Adapted from BIS statistics explorer. http://stats.bis.org/statx/srs/table/a5)

In 2016, Luxembourg remained the dominant cash directing for international distribution with 64% of the shares (Fig. 9.5).

In June 2017, there were 4130 Comment Investment Fund (CIF) with a total net assets of €3.9 trillion; it is noted that the fund promoters domiciled in Luxembourg are mainly American, English, German, and Swiss (Table 9.3).

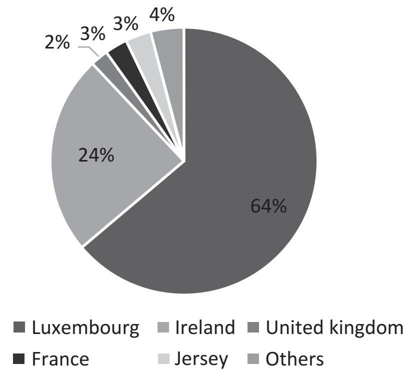

Fig. 9.5 Share of authorizations for cross-border distributions. (Adapted from PWC Benchmark your global distribution 2017. https://www.pwc.lu/en/fund-distribution/docs/pwc-publ-gfd-march-2017.pdf)

Table 9.3 Origin of the initiators of the Luxembourg collective investment funds June 2017 (billions of Euros)

Countries	*Net assets*	*In %*	*Number of CIF*
US	802,268	20.3%	167
GB	683,523	17.3%	274
DE	567,162	14.4%	1398
CH	529,305	13.4%	531
IT	339,092	8.6%	142
FR	323,256	8.2%	273
BE	165,288	4.2%	165
NL	92,546	2.4%	49
LU	81,827	2.1%	212
DK	78,949	2.0%	23
Others	280,382	7.1%	897

Adapted from CSSF, June 2017. https://www.cssf.lu/surveillance/vgi/sicar/statistiques/statistiques-mensuelles/origine-des-initiateurs-des-opc-luxembourgeois/

Flexible legal and regulatory framework makes it possible to propose a wide range of Islamic products and services marketable at the global level. The Luxembourg financial market has become a specialized platform for the cross-border distribution of Islamic funds. Despite the costs, it is considered a quality label. In the first quarter of 2017, the global total of Islamic assets under management (AuM) was US$70.8 billion and the number of Islamic funds was 1535. Luxembourg occupies the third place

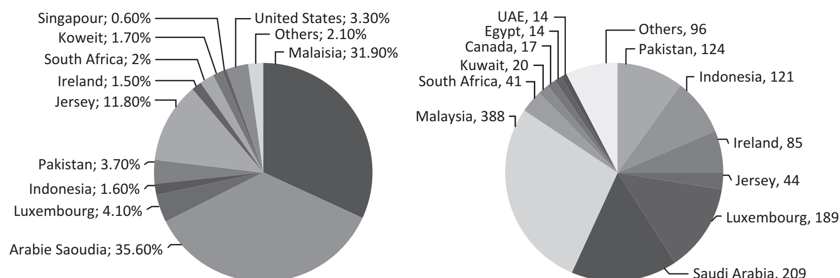

Fig. 9.6 Assets under management AuM of Islamic funds, 1st quarter of 2017. (Adapted from Thomson Reuters, MIFC estimates Islamic funds gearing up 2017. http://www.mifc.com/index.php?ch=28&pg=72&ac=180&bb=uploadpdf)

in terms of the number of Islamic funds with 189 active funds domiciled in Luxembourg and the fourth position in terms of assets under management at global level with US$2.9 billion, that is, 4.10% (Fig. 9.6).[19]

The investment funds allow offshore fortunes to do interesting returns, benefiting from the diversity of products offered, the access to several markets, and advantageous taxation; no withholding tax (under conditions) for dividends, interest, and royalties. Some tax arrangements are aimed at the transfer of profits in a legal way. In order to improve fiscal transparency, the OECD developed a common reporting standard (CRS) in 2013 and gave birth to the law of December 18, 2015, which entered into force on January 1, 2016, by mandating the exchange of information on financial accounts and transparency to the tax authorities of the other participating jurisdictions. The fight against tax evasion through the OECD Action Plan attempts to counteract the erosion of the tax base and the transfer of Profits (OESP), thereby ensuring taxation where the value created by economic activity is effective.[20]

[19] Islamic funds: Gearing up, http://www.mifc.com/index.php?ch=28&pg=72&ac=180&bb=uploadpdf

[20] https://www.oecd.org/fr/fiscalite/centre-de-politique-et-administration-fiscales-brochure.pdf

9.3.3 *Geographical Location Is Strategic: Luxembourg Is Located in the Heart of Europe*

Great experience in the field of Islamic finance: Luxembourg mobilizes the necessary means to increase its expertise through seminars and trainings. The ALFI decided, in 2008, to establish a working group which brings together Islamic finance professionals and representatives of the authorities concerned to examine the different ways of further developing this sector. The result of the study was favorable and the tax authorities published two circulars in connection with Islamic financial products. In 2012, ALFI published a compendium of best practices and rules for the establishment and maintenance of Islamic investment funds. Luxembourg, which has the advantage of being a multilingual country, ensures a high level of service.

9.4 Legal Framework Adapted to Islamic Finance in Luxembourg

There is currently no Islamic bank or Islamic windows in Luxembourg because the Muslim population is not sufficient to develop this activity.[21] However, the legal framework is adapted to products such as *Murābaḥa*, *Muḍāraba*, *Mushāraka*, *Istiṣnāʿ*, and *Ijāra*, and some banks have experts in Islamic finance. The circular of January 12, 2010, specifies the terms of taxation of the *Murābaḥa*, which is treated as a contract of sale with deferred payment. The profit is fiscally assimilated to interest due to the economic aspect of the transaction.

Luxembourg is however a pioneer in the rapid transposition of European directives, and Undertaking for Collective Investment in Transferable Securities (UCITS) occupies a reference place in the industry of investment funds.[22]

9.4.1 *Islamic Investment Funds*

The Luxembourg regulation allows the establishment of investment funds without any specific legal requirements. Directive UCITS IV lays down

[21] Paperjam, La finance islamique est. éthique et participative, avril 2016, http://paperjam.lu/news/la-finance-islamique-est-ethique-et-participative

[22] ALFI, historical overview and upcoming changes, http://www.alfi.lu/setting-luxembourg/ucits/historical-overview-and-upcoming-changes

the common rules for the creation and management of investment funds in the European market. Luxembourg has thus benefited from the strengthening of investor confidence and the reduction of administrative formalities for the marketing of products in the European Union countries through the European passport.

The recent economic crisis has highlighted the need to improve internal control and risk management procedures for alternative investment fund (AIF) managers. The Alternative Investment Fund Managers Directive was transposed on July 12, 2016, in Luxembourg in order to meet this need. The Act of May 10, 2016, transposing Directive 2014/91/EU "UCITS Directive V" amending Directive 2009/65/EC introduces changes in the functions of depositary, remuneration policies, and sanctions.

There are several investment vehicles that admit investment strategies of *Sharīʿa* compliant:

Collective Investment Fund (CIF): An investment fund that will raise funds to invest them in securities.

Specialized Investment Fund (SIF): An Alternative Investment Fund (AIF), this category includes hedge funds, private equity funds, real estate funds, raw material funds, securitization agencies, and so on. It is a wide range of investment strategies but remains reserved for qualified investors. Risk diversification is specified and is less restrictive than for the funds part I and part II of the UCITS Act.[23]

The investment company in risk capital (société d'investissement en capital à risque—SICAR): An investment structure in venture capital and private equity. The structure is simple to create and flexible to manage. This is a highly attracting solution for professional venture capital investors. It can be created as a single structure or an umbrella structure composed of several separate compartments, each having its own investment policy.[24]

Reserved Alternative Investment Fund (RAIF): This type of fund was launched in 2015; the objective is to maintain Luxembourg's competitiveness. This new type of alternative investment fund will combine the

[23] Arendt & medernach, FIA—Fonds d'Investissement Alternatifs, septembre 2015, http://www.arendt.com/emails/2015.09.publications.on.if/AIFFR.pdf

[24] Arendt & medernach, FIA—Fonds d'Investissement Alternatifs, septembre 2015, http://www.arendt.com/emails/2015.09.publications.on.if/AIFFR.pdf

legal and tax advantages of the specialized investment funds and those of venture capital companies without being subject to the supervision of the Authority of Luxembourg Monitoring.[25]

In tax matters, the RAIF may opt:

- *For the same tax system as a SIF (default) i.e. the 0.01% subscription fee applicable to the net asset value;*
- *For the same specific tax regime as the SICAR (optional scheme) on venture capital investments, namely that the entity is in this case fully taxable (allowing it to be able to access international non-double taxation treaties) But with the possibility of exempting from the taxable base all capital gains and income from securities.*[26]

9.4.2 Securitization Vehicles

The law of March 22, 2004, was adopted by Luxembourg and lays down the legal, regulatory, and fiscal framework for securitization undertakings in Luxembourg. These organizations must have either the form of funds managed by a management company or a simple contractual form as a securitization fund. Their flexibility makes it possible to emit *Ṣukūk*.[27]

The *Ṣukūk* is an effective property in an underlying asset. The holders of *Ṣukūk* are entitled to a share of the profits generated. The *Ṣukūk* are issued by a special-purpose vehicle (SPV). The same securitization mechanism is found in conventional finance. The treatment of *Ṣukūk* is identical to the treatment of the debt of conventional finance. "*The income of Ṣukūk would thus be equated with income from movable capital within the meaning of article 97, paragraph 1, number 3 I.T.A. (or commercial profit). The tax provisions relating to funders and participatory obligations (articles 146 (1) 2 and 3 and 164 (2) I.T.A.) are not applicable to this type of financial instrument.*"[28]

[25] Agefi Luxembourg, FIAR—Fonds d'Investissement Alternatif Réservé, janvier 2016, http://www.ey.com/lu/en/newsroom/pr-activities/articles/article_20160114_reserved-alternative-investment-fund

[26] AGEFI Luxembourg—article paru en janvier 2016 FIAR—Fonds d'Investissement Alternatif Réservé, http://www.ey.com/

[27] Memorial Journal Officiel du Grand – Duché de Luxembourg, Loi du March 22, 2004, relative à la titrisation, http://www.impotsdirects.public.lu/legislation/legi04/Titrisation-loi_du_22_March_2004.pdf

[28] Circulaire du directeur des contributions L.G.-A n° 55 January 12, 2010.

The Luxembourg stock market was the first in Europe to list *Ṣukūk* in 2002. Luxembourg issued a sovereign *Ṣukūk* in 2014 type *Ṣukūk* al-Ijāra, with maturity of five years and worth 220 million Euros. The launch of Sovereign *Ṣukūk* is invested in projects of public interest but above all to reassure investors and encourage them as the debt of Luxembourg is very low. The AAA rating of Luxembourg is also an important element. The issuance acts as an appeal product, with the aim of reassuring any other issuer of the legal feasibility.

The stages of the operation

- *Phase 1: The Luxembourg state will sell for 200 million Euros the three buildings to a Special purpose Vehicle (SPV), of which it will remain the sole owner.*
- *Phase 2: SPV will issue certificates with a maturity of 5 years equivalent in value to the purchase price of buildings.*
- *Phase 3: Investors purchase certificates and receive regular remuneration in the form of income generated by the rental of buildings.*
- *Phase 4: At the end of the 5 years, the SPV will sell the buildings to the Luxembourg state at the market price and investors can recover their capital.*

This remuneration cannot be regarded as interest since it is an income generated by a tangible asset.[29]

Malaysia accounts for 67% of total global emissions from *Ṣukūk* to the end of 2015. Thirty countries other than Malaysia are issuers of *Ṣukūk*, including Luxembourg with a percentage of 0.076%. The interest of Luxembourg is mainly focused on the countries of the Middle East and Asia in order to take advantage of the liquidity in these markets.

9.4.3 Takāful

In 1983, Luxembourg was the first European country to host a *Sharīʿa*-compliant insurance company (TAKĀFŪL). In Luxembourg, there is an evolution, especially in the field of life insurance. The Takāfūl is an Islamic

[29] https://saafi.fr/tags/luxembourg/

insurance, the insurer offers life insurance, the premiums of which are invested in an investment fund. The insurer pays for providing the legal, tax, and regulatory envelope. It is a compensation for product delivery. In exchange, the subscriber is subject to the risk of the investment made on his account and his capital is not guaranteed. The management company receives remuneration (management fees and commissions). The fund manager acts as Mūdārib for investors and therefore perceives as a consequence of its *Muḍāraba* a contractual percentage in case of profit.[30]

> *At the moment, Islamic insurance is not yet available in the Luxembourg market. On the other hand, of the approximately 100 insurance companies established in Luxembourg, which are almost all specialized in cross-border distribution, several offer takāful insurance in Malaysia and the Arab Gulf countries.*[31]

One can quote the FWU Life Lux which markets Family *Takāful* products specifically developed for the Middle East and Far East markets and also marketed in Europe or the Solidarity *Takāful* S.A. Luxembourg, a subsidiary of Solidarity Group.

Like the SICAV, the insurance branch 23 is placed in shares, bonds, real estate, or other securities.

The Salam-Pax SICAV Ethical Fund of Funds of Swiss life is a life insurance of Luxembourg Law:

- It is a multi-support savings contract: This contract is invested in several supports (or several funds).
- Unsecured funds by amount. With each payment, a share number is allocated according to the course of the fund. The value of the share varying upward or downward. Only this number of shares acquired is guaranteed. These are funds in units of account.
- SALAM-PAX SICAV (Investment Company with variable capital) is registered under part I of the Luxembourg Law of December 17, 2010, on collective investment funds.
- The passport for investment management companies: The management companies may exercise in other member states the activities for which they have received authorization in their country of origin.

[30] Cheikh Ali Mohyeddine Qurradaghi, L'Assurance Islamique *Takāful*, 2011, Paris, Bayane Editions

[31] Luxembourg for finance, http://www.luxembourgforfinance.com/fr/finance-islamique

- Key Investor Information (KII) provides accurate, precise, and understandable information.
- Ethical Fund of Funds: The performance is linked to several other funds. But it has a cost. First, the investor must pay the funds of the Fund but also the costs of the funds that constitute the Fund's portfolio (umbrella fund). Responsibilities at the sub-fund level are clearly separated with its own investment policy. The fund invests in companies that respect qualitative, quantitative, and *Sharīʿa* compliance.

9.5 Academic Situation of Islamic Finance in Luxembourg

A single doctoral thesis was made in Luxembourg on the theme of Islamic finance under the title of *Régulation ou réglementation des fonds islamiques en Europe?* (Regulation or regulation of Islamic funds in Europe). The thesis was supported on Thursday July 26, 2015, by Bahya BOUHARATI at the Faculty of Law, Economics and Finance (FDEF), Law Research Unit of the University of Luxembourg.

Training in Islamic finance is short lived and offered in continuous or distance training. Some courses may include a module or a course on Islamic finance. It is, therefore, organized as follows:

Executive MBA—Expert en Finance Participative et Assurance Solitaire: The training includes a module on ethical finance which can be independently monitored in module alone. The duration of the training is 27 days organized within Wedge Business School.

Islamic Finance—Principles, Theory, and Applied Practices: The Luxembourg School of Finance (LSF) of the University of Luxembourg provided an eight-day executive course in Islamic finance in 2011 in collaboration with the Centre for Education in Islamic Finance.

The Chartered Islamic Finance Professional (IPHC): The University of Luxembourg has partnered with International Centre for education in Islamic finance (INCEIF) to conduct the second executive program of Islamic finance in Luxembourg in 2012 for a period of three days at the University of Luxembourg.

Islamic Capital Markets Principles and Practices in Collaboration with INCEIF: The LSF proposed a full course on Islamic capital markets in 2013 for a period of four days.

Islamic Finance: A Workshop dedicated to understanding the fundamental principles of Islamic Finance was organized in 2017 by PwC Academy for one day.

An Introduction to the Middle East and Islamic Finance[32]: A Workshop dedicated to providing an overview of the region of the Middle East and Islamic Finance of one day organized in 2017 by PwC Academy.

Finance Islamique[33]: The training provides an overview of the Middle East and Islamic finance region launched in 2017 in the IFE Benelux and lasted two days.

Formation Connaissances Fondamentales Bancaires—Module "Nouveaux axes de la place financière[34]*"*: This module offers four-hour Islamic finance courses within FSI.

Islamic banking and finance—An Introduction[35]*/Islamic banking and finance—Financial Instruments*[36]*/Islamic banking and finance—Wealth Management*[37]: *The* Governance People has proposed in 2017 three distance training courses each lasting one hour.

IBQ program Islamic Banking Qualification Program[38]*/ITQ Program Islamic Takāful Qualification Program*[39]: Two practical bank certifications dedicated to Islamic banking principles and practices of AL Maali institute/Daveran Consulting; it was launched in 2017. The first lasts three days and the second two days.

Islamic Finance Foundation Certificate[40]*/Islamic Finance Diploma*[41]: The Institut de Formation Bancaire, Luxembourg (IFBL) has launched a certifying training program in partnership with International Capital Market Association (ICMA) University of Reading. The program covers the fundamental aspects of Islamic finance in 2010 and lasts ten days.

[32] http://www.pwcacademy.lu/Pages/courses/modules/islamicfinance.aspx

[33] http://www.ifebenelux.lu/fr/formation/finance-islamique.html

[34] http://www.fsi.lu/actualite?page=2

[35] http://elearn.lu/shop/financial-markets/elearning-course-islamic-banking-finance-an-introduction/

[36] http://elearn.lu/shop/financial-markets/elearning-course-islamic-banking-finance-financial-instruments/

[37] http://elearn.lu/shop/financial-markets/elearning-course-islamic-banking-finance-wealth-management/

[38] https://saafi.fr/formation-et-seminaires-islamic-banking-qualification-program-ibq/

[39] https://saafi.fr/formation-et-seminaires-islamic-*takāful*-qualification-program-itq/

[40] http://www.alfi.lu/sites/alfi.lu/files/files/IFBL_ISLAMICFINANCE_2010.pdf

[41] http://www.alfi.lu/sites/alfi.lu/files/files/IFBL_ISLAMICFINANCE_2010.pdf

Islamic finance University Certificate[42]: The Louvain School of Management (LSM) has partnered with Islamic Finance & Islamic Markets Advisors (ISFIN) to launch the first university certificate in Islamic finance in the Benelux. The training took place in 2017 and lasted 14 days.

Master en Droit Bancaire et Financier Européen—Islamic Banking[43]: It offers in the first semester the specialized banking and financial law module which includes a course entitled Islamic Banking. The course spans four days.

9.6 Conclusion

The specifics related to compliance with the *Sharīʿa* are described in the OPC prospectus. "If a discrepancy between the laws of Luxembourg and the rules and principles of Sharia is manifested, it is the law and regulations of Luxembourg law which take over". Luxembourg Law does not provide for provisions relating to the liability of a *Sharīʿa* Board or a councilor *Sharīʿa*. Liability will only be covered by the contract established between the Fund and the latter.

Luxembourg's financial market has developed considerable know-how and has been able to meet the expectations of international investors by adopting a policy for Islamic finance. The potential for growth at the global level is very important and could encourage more to promote this sector. The development of investment funds which is one of the most important axes in Luxembourg is in line with the requirements of an ethical finance that approaches the most of Islamic finance by advocating investment, profit, and loss sharing to have a real impact on the real economy.

And lastly, with regard to the courses offered, they remain very limited, in particular the long courses, and are more aimed at professionals.

[42] http://www.uclouvain.be/cps/ucl/doc/formationcontinue/documents/UCL_DpltLSMFinIslamique_Web_5.pdf

[43] https://wwwfr.uni.lu/media/files/maquette_m2_dbfe_hl_s1_s2

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Thomson Reuters Zawya. ICD Thomson Reuters Islamic Finance Development, Report 2016 Resilient Growth: http://www.zawya.com/mena/en/business/islamic-finance

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Pew Research Center Forum, The Future of the Global Muslim, 2011, http://www.euro-muslims.eu/
Arendt & medernach, FIA Fonds d'Investissement Alternatifs, 2015, http://www.arendt.com/emails/2015.09.publications.on.if/AIFFR.pdf
Thomson Reuters, MIFC estimates Islamic Funds Gearing Up 2017: http://www.mifc.com/index.php?ch=28&pg=72&ac=180&bb=uploadpd
PWC. Benchmark your global distribution 2017 https://www.pwc.lu/en/fund-distribution/docs/pwc-publ-gfd-march-2017.pdf
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BIS, Statistics Explorer. [En ligne]. http://stats.bis.org/statx/srs/table/a5
CSSF, Origine des initiateurs des OPC luxembourgeois 2017, https://www.cssf.lu/surveillance/vgi/sicar/statistiques/statistiques-mensuelles/origine-des-initiateurs-des-opc-luxembourgeois/
OCDE. https://www.oecd.org/fr/fiscalite/centre-de-politique-et- administration-fiscales-brochure.pdf
OCDE. https://data.oecd.org/fr/gdp/produit-interieur-brut-pib.htm
COMCEC Coordination Office, National and Global Islamic Financial Architecture: Problems and Possible Solutions for the OIC Member. 2016. http://www.mod.gov.tr/Lists/RecentPublications/Attachments/117/National%20and%20Global%20Islamic%20Financial%20Architecture%20Problems%20and%20Solutions%20for%20the%20OIC%20Member%20Countries%20.pdf
FundsquareMarketInfrastructure. https://www.fundsquare.net/homepage
Fundinfo. http://www.fundinfo.com/fr/home/
TrustNetOffshor. http://www.fundinfo.com/fr/home/

CHAPTER 10

Pioneer Islamic Economics and Banking Experience in Tsarist Russia

Mohyedine Hajjar and Fatih Habib

10.1 Introduction

The essays on the history of Islamic economic, banking, and financial thought take as their point of departure the Arabic, Urdu, and English writings that appeared in the middle of the twentieth century. However, several important activities were already present well before. An interesting essay appeared early in Algeria, in 1904, on the Islamic economy, by two Muslim theologians Abdelqadir al-Mijāwī (1848–1914) and ʿUmar Brīhmāt (1859–1909),[1] but this masterful production remains in the context of individual activities. On the other hand, Russia Tsarist recognized a great collective activity held by the Muslim Tatars elite whose colossal contribution so far remains silent and suffocated under the dust of time and the lids of language and space.

[1] Abdelqadir al-Mijāwī & ʿUmar Brīhmāt: *Al-Mirṣād*, reedited by Abdelrazzak Belabes, Center of scientific publications, King Abdelaziz University, 2014.

M. Hajjar (✉)
Pantheon-Sorbonne University, Paris, France

F. Habib
University of Kazan, Kazan, Russia

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After the Tsarist regime fell, the Soviet Union introduced a policy of state atheism, which impeded the practice of Islam and led to the execution and suppression of various Muslim leaders. Following the collapse of the Soviet Union, Islam regained a prestigious, legally recognized space in Russian politics. More recently, President Putin consolidated this trend, subsidizing the creation of mosques and Islamic education, which he called an "integral part of Russia's cultural code",[2] encouraging immigration from Muslim-majority former Soviet bloc states and condemning what the Russian state considers criminal anti-Muslim hate speech, such as caricatures of the Prophet Muḥammad.[3]

Indeed, Islam is deeply rooted in Russia (Sect. 10.2) in which we can see the seeds of the first unprecedented experiences in history of Islamic economics. The "Muslims of Russia", or simply "Muslims",[4] have contributed greatly to Islamic economic thought (Sect. 10.3). Their efforts led to the appearance of the first known journal dedicated to the Islamic economy (Sect. 10.4) and developed theoretical and practical models of Islamic banking (Sect. 10.5).

10.2 Islam's Deep Roots in Russia

The development of Islamic finance in Russia is motivated by historical Islamic presence and local Muslim communities in Tsarist Russia. The position of Islam as a major Russian religion, alongside Orthodox Christianity, dates from the time of Catherine the Great, who sponsored Islamic clerics and scholarship through the Orenburg Assembly.[5] So, Russian Muslims differ from Muslims in EU countries by their origins, they are part of Russian historical heritage, and the Russian government

[2] Melina Delkic: "Putin says Islamic Schools can help stop destructive ideas", online on: https://www.newsweek.com/putin-pledges-support-islamic-schools-russia-791561 (seen on June 2018).

[3] Vladislav Davidzon: "Why Russia is no place to be Charli", online on: https://www.tabletmag.com/scroll/188502/why-russia-is-no-place-to-be-charlie (seen on June 2018).

[4] Despite being published in Tatar with Arabic script, the magazine constantly uses the notion of "Russian Muslims" and "Muslim", and almost never the word "Tatar", neither as a noun nor as an adjective.

[5] Azamatov, Danil: "The Muftis of the Orenburg Spiritual Assembly in the 18th and 19th Centuries: The Struggle for Power in Russia's Muslim Institution", in Anke von Kugelgen; Michael Kemper; Allen J. Frank, *Muslim culture in Russia and Central Asia from the 18th to the early 20th centuries*, 1998, vol. 2: Inter-Regional and Inter-Ethnic Relations, Berlin: Klaus Schwarz Verlag, pp. 355–384.

subsidizes Islam.[6] That's why Islam is recognized under the law and by Russian political leaders as one of Russia's traditional religions.[7]

Given the Early Muslim Conquest, it is hard to determine when Islam really arrived in Russia because the lands that Islam entered early in its expansion were not part of Russia at the time.[8] In mid-seventh century, Islamic conquest of Persia helped spread Islam into the Caucasus countries, which later became permanently part of the Russian Empire.[9]

Dagestani people in Derbent region became the first Muslim people within current Russian territory. The first Muslim state in the future Russia lands was Volga Bulgaria.[10] Later, the Lesghiens (who were located in the north of Dagestan and the south of the current Azerbaijan) embraced Islam followed, in 737, by the Tatars of the Khanate of Kazan who inherited the population of believers from that state. Later most of the European and Caucasian Turkic peoples also became followers of Islam.[11]

The Tatars of the Crimean Khanate, the vassal of Ottoman Empire and last remaining successor to the Golden Horde, kept its dominion on southern Russia and burned down Moscow in 1571.[12] Crimea was conquered by the Russian Empire in 1783.

Between the early sixteenth century and the course of the nineteenth century, the region of South Caucasus (Transcaucasia) and southern Dagestan was controlled by alternate Iranian empires (the Safavids, Afsharids, and Qajars) and their main rivals, the Ottoman Turks. Shia Islam and Sunni Islam were spread all over Caucasia leading to constant conversion even in the neighboring territories.

The era of Russian expansion from Ivan the Terrible (conquest of Kazan in 1552) to Catherine the Great (ascented in 1762) always resulted in oppression of the Muslim community throughout discrimination and unjust treatment and exclusion, as well as the destruction of Muslim

[6] Imogen Bell: *Eastern Europe, Russia and Central Asia 2003*, Europa Publications, 3rd edition 2002, p. 47.

[7] Ibidem.

[8] Shireen Tahmasseb Hunter, Jeffrey L. Thomas, Alexander Melikishvili: Islam in Russia: The Politics of Identity and Security. Routledge, 2004, p. 3

[9] Ibidem.

[10] Mako, Gerald: "The Islamization of the Volga Bulghars: A Question Reconsidered", in *Archivum Eurasiae Medii AEVI. 18 (2011)*, pp. 199–223, see p. 208.

[11] Shireen Tahmasseb Hunter, Jeffrey L. Thomas, Alexander Melikishvili: "*Islam in Russia*", Routledge, 2004.

[12] Solovyov: *History of Russia from the Earliest Times*. AST. 2001, pp. 751–809.

culture by the elimination of outward manifestations of Islam such as mosques.[13] To appear as tolerant towards Muslim communities, particularly on Kazakhs towards whom they have a great aversion, the Russians first allowed Muslim clerics to preach to their people. However, they made sure to introduce pre-Islamic element of collective consciousness[14] such as praising pre-Islamic historical figures, diminishing and belittling Kazakhs, and sending them to high élite military institution to be humiliated.[15] In response, Kazakh religious leaders attempted to bring religious fervor by espousing pan-Turkism, although many were persecuted as a result.[16]

The Cossack institution recruited and incorporated Muslims from different ethnic groups in Russian Empire, Non-Muslim and Siberian Muslim could have the same military status.[17] Even Muslim Cossacks in Siberia requested an Imam.[18] Muslim soldiers, especially Baskirs and Kalmyks, fought bravely against Napoleon's army[19] and were engaged in the war of France.[20]

While total expulsion, as practiced in other Christian nations such as Spain, Portugal, and Sicily, was not feasible to achieve a homogeneous Russian-Orthodox population, other policies such as land grants and the promotion of migration by other Russian and non-Muslim populations into Muslim lands displaced many Muslims, making them minorities in places such as some parts of the South Ural region and encouraging emigration to other parts such as the Ottoman Turkey and neighboring Persia, and almost annihilating the Circassians, Crimean Tatars, and various Muslims of the Caucasus. They were given a choice as to where to be resettled: in the Ottoman Empire, in Persia, or in Russia far from their old lands.

[13] Frank, Allen J. *Muslim Religious Institutions in Imperial Russia: The Islamic World of Novouzensk District and the Kazakh Inner Horde, 1780–1910*, Vol. 35. Brill, 2001.

[14] Hunter, Shireen: *Islam in Russia: The Politics of Identity and Security*, Routledge, 2004, p. 14.

[15] Ibidem, p. 14.

[16] Farah, Caesar: *Islam: Beliefs and Observances*, Barron's Educational Series Inc., 5th édition, 1994, p. 304.

[17] Allen J. Frank: *Muslim Religious Institutions in Imperial Russia: The Islamic World of Novouzensk District and the Kazakh Inner Horde, 1780–1910*, BRILL, 2001, p. 87.

[18] Ibidem, p. 122.

[19] John R. Elting: *Swords Around a Throne: Napoleon's Grande Armée*, Perseus Books Group, 1997, p. 237.

[20] Dominic Lieven: *Russia Against Napoleon: The True Story of the Campaigns of War and Peace*, Penguin Publishing Group. 2010, p. 504.

The ideological opposition between Islam and Christian-Orthodox widen with the Caucasian wars, ended in 1864, when Circarsians leaders endorsed a loyalty oath. However, many of them refused to be ruled by a Christian monarch and decided to leave for Ottoman Empire. Many other Caucasian Muslims ended up in neighboring Iran—sizeable numbers of Shia Lezgins, Azerbaijanis, Muslim Georgians, Kabardins, and Laks.[21] Many historians agreed on a number of 500,000 residents of the highland Caucasus behind deported in the 1860s. A large proportion of them died in transit from disease. Those who stayed loyal to Russia were allowed to settle into the lowlands. The Russian nationalist politics carried on for many years at different levels, during Tsarist and Soviet periods. In 2014, Tatars lived outside the Republic of Tatarstan than inside it.[22]

In the same way, traditional and conservative Islamic education school with Islamic ideology were willingly imposed by Russians in order to keep Muslim communities under control, destroy any kind of opposition, and prevent them from taking power.[23]

Communist rule oppressed and suppressed Islam, like other religions in the Soviet Union. The communist atheist Soviet laws reinforced this control and gave the occasion to destroy over 25,000 mosques between 1917 and 1991, leaving the number at 500 of which 27 in the Republic of Dagestan. Many mosques (for some estimates, more than 83% in Tatarstan[24]) were closed. For example, the Märcani Mosque was the only acting mosque in Kazan during the communist era.

Islam in Russian Federation is the nation's second most widely professed religion. According to a nationwide survey conducted in 2012,[25] Muslims in Russia numbered 9,400,000 or 6.5% of the total population. However, the populations of two federal subjects with Islamic majorities were not surveyed due to social unrest, which together had a population of nearly 2 million, namely Chechnya and Ingushetia,[26] thus the total number of Muslims may be larger.

[21] A. G. Bulatov. *Laktsy (XIXe-début du XXe siècle). Essais historiques et ethnographiques*, Makhachkala, 2000.

[22] Shireen Hunter, Jeffrey L. Thomas, Alexander Melikishvili: *Islam in Russia*, op. cit.

[23] Andrew D. W. Forbes: *Warlords and Muslims in Chinese Central Asia: A Political History of Republican Sinkiang 1911–1949*, Cambridge University Press, 1986, p. 16.

[24] For more details, see: I.A. Zaripov, M.A. Safarov: *Akhmetzyan Mustafin: Extrait de l'histoire de l'islam en URSS*, Medina, Moscou, 2017.

[25] Arena: *Atlas of Religions and Nationalities, Russian Federation*, Среда (Sreda). 2012, realised in cooperation with the All-Russia Population Census 2010 (Всероссийской переписи населения 2010) and the Russian Ministry of Justice (Минюста РФ).

[26] Ibidem.

As for their actual repartition, Muslims form a majority of the population of the republics of Bashkortostan and Tatarstan in the Volga Federal District, and predominate among the nationalities in the North Caucasian Federal District located between the Black Sea and the Caspian Sea: the Circassians, Balkars, Chechens, Ingush, Kabardin, Karachay, and numerous Dagestani peoples. Also, in the middle of the Volga Region reside populations of Tatars and Bashkirs, the vast majority of whom are Muslims. Other areas with notable Muslim minorities include Moscow, Saint Petersburg, the republics of Adygea, North Ossetia-Alania and Astrakhan, Moscow, Orenburg, and Ulyanovsk oblasts.[27]

This large Muslim community reflects no doubt the large potential market for Islamic financial products. However, the large repartition of Muslims in different parts of the vast Russian territories, through different republics, marks another difficulty for presenting Islamic financial solutions. Islamic products launched and distributed in Volga-Ural region remains unknown in Caucasian regions, as we will see below.

10.3 Contribution of Tatar Theologians in Islamic Economics

In the late nineteenth and early twentieth century, theoretical and practical experience took place in Tsarist Russia. The Tatar scholars were in fact the "pioneers" of the revival of the economic thinking of the entire Islamic world.

It was precisely during this period that the economic treatises of Habdel-Hallyam Faizkhanov (1850–1910) and Moussa Akegetzade (1864–1923) appeared. Religious figures, such as Moussa Bigiyev (1875–1949), Galimdzhan Baroudi (1857–1921), Rizaetdin Fahretdin (1859–1936), Zakir Ayukhanov (1889–1961), and so on, did not stay away from economic problems: in their publications, they call upon Muslims to a dynamic economic activity, the development of industry and financial institutions, implementing the Coranic prohibition of *ribā* and conceptions of the organization and functioning of an Islamic bank.[28]

The Tatar press has made a huge contribution to the publication of economic works. In the pages of the many pre-revolutionary newspapers

[27] Arena: *Atlas of Religions and Nationalities, Russian Federation*, *op cit*.

[28] I. Zaripov: "Review of publications of Tatar theologians on the Islamic economy", *Journal of the Russian Islamic Institute "Minbar"*, 2011, N°1 (7), pp. 33–44.

and magazines, various issues relevant to the Tatar community of the period are discussed. One of the main themes was economics. In various periodical collections of social or religious inspiration, such as “Shuro” (the “Council”), “al-Din wa al-Adab” (“Religion and morality”), “Al-Islah” (“Reformation”), and so on, they published various articles on economic questions, and opened economic rubrics.[29]

10.4 First Known “Islamic Economic Journal” in History

In addition to the diverse writings of the Tatar scholars, a particular journal is in a leading position in this theme. The magazine *Iqtisad* (literally “Economy”) became the first economic magazine for Muslims in Russia and seems to be the first Islamic economic journal throughout the Muslim world. Indeed, no peer was found in the Arab and Turkish press of that period.

The magazine *Iqtisad* was published from 1908 to 1913. Its founder, chief editor and publisher, was Imam in the city of Samara, Muhammad-Fatih Murtazin (1875–1938). He had received his religious education in the *madrassa* “Marjaniyya” in Kazan.[30] In addition to his religious teaching and writing-editing activities, Mr. Murtazin has been a member of the Samara Credit Bank Board of Directors.[31]

The magazine, published in Tatar language with Arabic script was widely distributed, from Kazan to Chistopol, Simbirsk, Astrakhan, Ufa, Sterlitamak, Orenburg, Troitsk, Guryev, Kokand, and Makaryevskaya Fair.[32] The editorial office was located in Samara, but lacking a printer suitable for Arabic writing, the edition was done in typolithography at “Karimov, Khusainov and Co.” in Orenburg.[33]

The structure of the journal remains unchanged throughout the six years of its publication by carrying the following sections: economy, trade, production (crafts and industries), agriculture, public affairs, letters, and ads. More than half of the articles in each issue have been devoted to different issues of the economy.

[29] Ibidem.

[30] I. Zapirov: ““Iqtisad” – The first Russian magazine on Islamic Economics”, *ФИЛОЛОГИЯ И КУЛЬТУРА. PHILOLOGY AND CULTURE.* 2013. N°1(31), pp. 193–197, p. 193.

[31] Gazizullin F.G.: *Tatar economic thought on the way to Marxism, 1880–1917*, PhD thesis in history, Kazan, 1980, p. 36.

[32] I. Zapirov: ““Iqtisad” – The first Russian magazine on Islamic Economics”, *art. cit.*, p. 193.

[33] Ibidem, p. 194.

In their contributions to this magazine, Tatar scholars have witnessed a vast culture. They presented to readers the opinions of ancient Greek philosophers, such as Aristotle, Plato, and Xenophon, but also European economists of the eighteenth–nineteenth centuries, such as Adam Smith, John Stuart Mill, David Ricardo, Jean-Baptiste Say, and others. The themes of the magazine were examined in the light of the peculiarities of Tatar life and the precepts of Islamic Law. Thus, the magazine constitutes in its own way a new economic doctrine, based on a synthesis of classical economic theory and Islamic Law.

The main purpose of the publication of the magazine, as stated in the programmatic article of the first issue,[34] is to "*make Muslims aware of their economic situation, equipping them with scientific knowledge in commerce, agriculture, production, and industry, demonstrate economic methods for allocating national wealth, and thus serve to achieve their happiness and progress*".[35] In the same programmatic article, the editorial staff notes that the magazine does not represent the views of any political party and will look at all the issues from the point of view of the economy and "*weigh them in the balance of the sharīʿa*".[36]

In his article analyzing the magazine *Iqtisad*, I. Zapirov rallied the articles of the magazine dealing with economic subjects according to the following sections[37]:

- Relations between the Islamic religion and the economy (e.g., the article "Islam and economy", 1909. N°1 – pp. 1–2).
- A description of the economic situation of Muslims in various regions of Russia and throughout the country (e.g., the article "Islamic wealth bursts in Russia", 1909, N°7, pp. 195–196).
- A description of the economic situation of Muslims in other countries (e.g., the article "Muslims of China" 1911, N°8 – 9 – 10 – p. 294).
- The questions of the Bank and the problem of the creation of a Muslim bank (e.g., a series of articles, "banking issues", 1909, N°6 – pp. 169–171; N°7, pp. 203–205, N°9, pp. 266–267).

[34] Cet article fut intitulé "Maqsad wa-maslak" ce qui signifie "Objectif et méthodologie".

[35] "Objectif et méthodologie", *"Iqtisad" Magazine*, 1908, N°1, p. 1.

[36] Ibidem.

[37] I. Zapirov: ""Iqtisad" – The first Russian magazine on Islamic Economics", *art. cit.*, p. 195.

- The position of Islam on shares, bonds, debt securities, loans, and promissory notes (e.g., the article "Types of Credit", 1910, N°3, pp. 74–75).
- Insurance (e.g., the article "Insurance [of trading companies]", 1910, N°5, pp. 133–134).
- The ethical issues of the Islamic economy ("Influence of the profession on the moral life" 1913, N°1, pp. 13–14).
- The religious and legal justification of the lawfulness or prohibition of new products, materials, and technologies in the industry (e.g., the article by Minushev Mirzagabdrahman "Manufacture of horn and bone articles", 1912, N°8, pp. 243–246).
- The creation of credit unions (e.g., the article by Iskhakov Mahmoud "Opening companies for small debts [Bugulma district, Almetyevsk village]", [the author of this article is the imam in a village called "Shirdan Kbir"] 1912, N°3, p. 88).
- Education issues (e.g., article "Program for Muslim Schools", 1911, N°3 – pp. 94–95).

A special place in the magazine is given to banking and credit issues. *Iqtisad* writes that "banks are the heart and the most important blood vessels of economic life".[38]

The present lines highlight the need to study this journal as a remarkable initiative in the history of Islamic economic thought and in the history of Islamic Law. Finally, we can say that all the ideas proposed by the magazine have not been implemented. The 1917 revolution stopped the development of the economic and theological thinking of the Tatar people and destroyed the national bourgeoisie, the main target audience of the magazine, which alone could bring these ideas to life.[39] However, *Iqtisad* was not limited to theoretical reflections; some of the ideas mentioned in this journal were an analysis of the mutual banking practice that began to appear in Russia before the Bolshevik revolution, which gave rise to an unprecedented Islamic banking activity.

[38] Ibidem.

[39] Ibidem.

10.5 Pioneer Islamic Banking Initiatives

As we have already mentioned, the magazine *Iqtisad*'s authors made sure to study the subject of banks in Islam. They pushed their reflection to the limit, evoking, for the first time, the notion of "Islamic bank".[40]

In addition, an author has particularly developed the idea of the Islamic bank. The famous theologian Musa Bigiyev, known in the Muslim world under the nickname Musā Jārallah and as having the title of "Last Shaykh al-Islam of Russia", wrote an interdisciplinary book entitled *Zakāt*. This book was published in Petrograd in 1916 in Tatar language with Arabic script.[41] The author of this book was the first scholar (not only in the Russian Empire but also worldwide) who described the concept of Islamic bank.

This theoretical activity was parallel to a practical activity that took place in Tsarist Russia. At the beginning of the twentieth century, mutual credit societies spread to Russia. Their owners are the member-borrowers themselves; they are bound by mutual accountability. The purpose of these companies was to provide cheap loans to their members, mainly in the short term (six months) and to meet the needs of businesses. Some authors of the magazine *Iqtisad* attest the legitimacy of these mutual banks in Islamic Law and encouraged Muslims to participate.[42] Others challenged this legitimacy by proposing the constitution of an "Islamic bank" and using perhaps this notion for the first time.[43]

According to the articles of *Iqtisad*, it is obvious that Russian Muslims have been present in this banking model. For example, M. Murtazin, an imam working in Samara and chief editor and publisher of the magazine *Iqtisad*, was a member of the board of directors of one of these banks. He has repeated this again and again in the pages of the magazine *Iqtisad*.[44]

[40] For example:

"Issues related to the Islamic Bank", *"Ikatisad" magazine*, 1909, N°6, pp. 169–171.

"Issues related to the Islamic Bank", *"Ikatisad" magazine*, 1909, N°7, pp. 203–205.

"Issues related to the Islamic Bank", *"Ikatisad" magazine*, 1909, N°9, pp. 266–267.

[41] M. Bigiyev: *Zakāt*, published by Muhammad Alim Maksudov, Petrograde, 1917.

[42] For example: "Mutual bankers [loan association – cooperation]", *Magazine Iqatisad*, 1911, N°3, pp. 73–74.

[43] Comme Mahmoud Iskhakov: "Issues related to the Islamic Bank", *Magazine Iqatisad*, 1913, N°5–6, pp. 141–143.

[44] Par example:

"Mutual loaning Bank in Samara", *Magazine "Iqatisad"*, 1913, N° 3, pp. 74–75.

"How we organized the Bank", *Magazine "Iqatisad"*, 1913, N°4, pp. 104–105.

On the other hand, other evidence indicates the constitution of an "Islamic bank". One author mentions sources that an "Islamic bank" was established in 1912 in St. Petersburg.[45] However, we have no other indications about this banking experience or whether it adopted as a model the mutual banks known at the time.

Thus, several Islamic banking experiments took place at the time: the Islamic version of the mutual banks like that of the city of Samara and the "Islamic Bank" founded in St. Petersburg in 1912. However, no analysis can be made because we do not have sufficient data.

These experiences and writings have fallen into oblivion of history and are not mentioned in the writings concerning the history of Islamic banking and financial activity because of the barrier of time, space, political situation, and language. These succinct lines are intended to highlight the need to study them as a remarkable initiative in the history of Islamic economics and in the history of Islamic Law.

10.6 Conclusion

The Islamic banking activity in Russia dates back well into Tsarist Russia where the scholars of the Tatar Muslims developed an unprecedented intellectual reflection on economic fields. Their theoretical writings in Islamic economics were disseminated in the Tatar press of the time, a large number of newspapers had columns dedicated to the Islamic economy. In addition, a journal dedicated to the Islamic economy, named *Iqtisad*, was published and was published for six years from 1908 to 1913. Moreover, this theoretical reflection was parallel to a practical experience, the mutual banks appeared in Russia Tsarist and the Muslims have adopted this banking model. An inedited experience remains little known and unclear, a so-called Islamic bank has emerged. This trans-historical experience from the Tsarist era deserves deep reflection and recognition as a pioneering activity in the history of Islamic economics, Islamic banking, and Islamic Law.

[45] Gazizullin F.G.: *Tatar economic thought on the way to Marxism, 1880–1917*, PhD thesis in history, Kazan, 1980.

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"Mutual bankers [loan association – cooperation]", *Magazine Iqatisad*, 1911, N°3, pp. 73–74.
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CHAPTER 11

Islamic Finance in Spain

Germán Rodríguez-Moreno

11.1 Introduction

Islamic finance, as a modern viable industry, is barely 50 years old with some of its components, such as *Takāful*, not even reaching 40. This industry is even younger in Europe, and its development is uneven. Luxembourg and the United Kingdom have constituted themselves as the hubs outside the Islamic world. Other countries have followed, including France, Germany, and, more recently, Ireland. Spain, however, is not yet among them.

Iberia (Spain and Portugal) is the only region in Western Europe with a rich Islamic heritage encompassing 800 years. Madrid is the only capital city in Europe founded by Muslims.[1] Today, almost 2 million Muslims (four per cent of the Spanish population) live in Spain,[2] and Islam, after Catholicism, is the largest religion in the country. And yet Islamic finance

[1] La Fundación de Madrid in De Mayrit a Madrid (2015), pp. 24–39.

[2] Estudio Demográfico de la Población Musulmana, UCIDE (2018). All figures in this section come from this timely study.

G. Rodríguez-Moreno (✉)
IE Business School, Madrid, Spain
e-mail: grodriguezm@faculty.ie.edu

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remains an esoteric niche not only among the Spanish population at large but also among the Muslim population itself.

As discussed in Sect. 11.2, Spain was once a majority Muslim country where Islamic institutions such as *waqf* flourished and developed, becoming vital for financing the social, economic, and cultural infrastructure of Al-Andalus. *Waqf* survived the rise and fall of the Umayyads of Cordova, three Taifa periods, the Almoravids and the Almohad, and, indeed, the beginning of Catholic Spain, only ceasing when a final expulsion happened of the several thousand Muslims, which endured a century of forced conversion. The reason to make this history *detour* in this section is twofold: (1) Sheer justice as 800 years of history and rich cultural legacy cannot possibly be ignored and (2) to compare and put in context present-day Spain and the Muslim population within it. It is estimated that Muslims accounted for four per cent of the population at the time of their final expulsion, and by coincidence, the Muslim community today represents four per cent of the Spanish population. I will just add at this stage that they have issues of their own with which to contend.

Section 11.3 deals with the current situation of the Islamic banking and finance sector in Spain today. The short answer is that it does not exist. Nevertheless, the reasons for this are discussed putting it in a wider context, looking at several potential players (the sponsor, the facilitator, the provider, and, finally, the consumer), concluding that there is neither offer nor demand at present or in the foreseeable future.

All analyses of opportunities open for the development of Islamic finance in Spain to date have concentrated almost exclusively on the banking sector (and, to a lesser extent, *ṣukūk*), coming to similar conclusions: Spanish legislation is not Islamic-finance friendly. However, I seriously believe that *Takāful* offers a more fertile ground. Section 11.4 deals with this discussion, looking in some depth at the mutual insurance structure as the most likely vehicle for its implementation and also looking at *Takāful* in crisis as an opportunity precisely to implement a mutual model as being both commercially viable and *Sharīʿa*-compliant.

Finally, Sect. 11.5 deals with the one Islamic finance development indicator which has seen the greatest growth in Spain in the last few years: Education. Just one proviso: Its growth is still fragile and remains heavily dependent on external finance.

11.2 Interaction Between Islam and Society

Of the 1.94 million Muslims living in Spain, 43 per cent are Spanish and 57 per cent are immigrants. Of the 834,058 Spanish Muslims, almost 63 per cent are Spanish-born. The remaining 37 per cent (309,708) became Spanish by naturalisation between 1968 and 2016. On the other hand, non-Spanish Muslims are made up largely of nine different nationalities.[3] Unsurprisingly, perhaps, Moroccans are the largest group (almost 750,000 or 38 out of 57 per cent). More surprisingly, however, Pakistanis are the second largest group, representing over seven per cent (80,003) of the total immigrant Muslim population.

Forty-one per cent (808,106) of the Muslim population live in Madrid and Catalonia, Barcelona being the city with the largest concentration of Muslims in Spain (328,840). If we add Andalusia (314,980) and Valencia (206,315), we can see that these four regions are home to over 68 per cent of Muslims in Spain.

What is today Spain was once a majority-Muslim territory. Thomas F. Glick argues that Muslims represented the majority of the population in Spain in the tenth century, when it is estimated that the Hispano-Muslim population was 6–7 million.[4] The Arab and Berber Muslims were numerically[5] always a minority; Arabs were a minority within that minority. However, by the time of their eventual expulsion (1614), it is estimated that the size of the Muslim population was but four per cent of the Spanish population.[6] Given that this followed a century of forced conversion from

[3] Algeria, Bangladesh, Gambia, Guinea, Mali, Morocco, Nigeria, Pakistan, and Senegal. Each one of these nationalities is at least 10,000 strong. There are a further 20 nationalities represented in the Islamic community, none of which, however, reach the 10,000 mark.

[4] Islamic and Christian Spain in the Early Middle-Ages (1979). Thomas F. Glick refers to the Hispano-Muslims quite correctly as Neo-Muslims since the Arab and Berber population was Muslim prior to their arrival in the Iberian peninsula.

[5] Numerically, but certainly not militarily, where Berbers gained a stronghold; or culturally, where Arabs, “a ruling, bureaucratic and landholding elite,” became hegemonic.

[6] Muslims in Spain 1500 to 1614 (2005), see pp. 12–21. Harvey uses the “prudent approximation” of Sir John Elliot, who calculated that the population of Spain in the sixteenth century increased from 7.5 to 8.5 million. Elliot himself calculated the figure of 275,000 for the Muslim population at that time. This, Harvey warns us, apart from being “guesswork” (prudent, but guesswork nevertheless) may represent an underestimate. However, the Muslim population might not have exceeded five per cent by the end of the sixteenth century.

Islam into Christianity, the remarkable thing is, perhaps, that a few hundred thousand were prepared to stand their ground openly[7] until the end.

11.2.1 Islamic Finance in Medieval Spain

It may be difficult to establish when a dominant[8] *Sharīʿa*-compliant[9] economy developed in Spain. However, what we do know is that *awqaf*[10] were very much part of Islamic Spain. In her book on charitable endowments (*waqf khayrī*) and family trusts (*waqf ahlī*) in Al-Andalus (IV/X–VI/XII centuries), Ana María Carballeira[11] states that throughout this period: (1) The legal system was in permanent evolution on these matters; (2) *waqf* heavily impacted on several aspects of daily life; (3) the history of *waqf* (particularly *waqf ahlī)* was linked to the transfer of property; (4) there was a great deal of social prestige to be gained in the establishment of *waqf*, particularly *waqf khayrī*; (5) *waqf khayrī* was of utmost importance in the development of cities in Al-Andalus, financing the social, economic, and cultural infrastructure; (6) charitable endowment and public well-being were intimately associated; (7) *waqf* was a factor for change; and (8) the depth of the economic impact of *waqf* on society was considerable.

The document known as the Capitulaciones, signed on February 26, 1501, included a clause that made it clear that *habices*[12] were to continue to be available for local use and not for private benefit.[13] Said clause called to devote the income of charitable foundations for the relief of the poor, ransoming of captives, highway repairs, and any other charitable purpose in perpetuity.[14] In the Capitulaciones, the Spanish crown respected the

[7] I deliberately use the word "openly" as those numbers did not include what Harvey has denominated "crypto-Muslims." See Harvey (2005).

[8] We can speak of "dominance" but not of "exclusivity" as the Christian and Jewish communities remained autonomous. That said, Harvey (1990) remarks that Islamic Granada largely evolved "towards being a purely Islamic state with only small *dhimmi* elements, and in particular, scarcely any Christians." p. 14.

[9] At least to the extent that it was free of *riba* (usury) and commercial transactions were done on the basis of Islamic instruments and/or custom.

[10] I largely agree with Çizakça (1998) that *Waqf* "stands as one of the major achievements of Islamic civilization."

[11] Carballeira Debasa, A.M. (2002). See in particular her general conclusions (pp. 347–355).

[12] In Arabic of al-Andalus, waqf is referred to as *habis*; and awqaf as *habices.*

[13] Harvey (2005), pp. 46–47.

[14] "*y les dexaran y mandaran dexar en sus casas, haçiendas y bienes muebles y rayses, agora e en todo tiempo para siempre jamas.*" Cited in Espinar Moreno (2009), p. 62.

right of the alfaquíes (*mutawalli*) to manage and deal with *habises* freely without the intervention of outsiders, including the Crown or any other authority. However, throughout the sixteenth century *waqf* property was progressively confiscated as Muslims converted to Catholicism so that by the time of their final expulsion said property had ceased to exist.

11.2.2 Starting from Scratch

What is clear is that there is no connection between the Muslim population that lived in Spain for many centuries until the beginning of the seventeenth century and today's Muslim population. There is no denying that the Muslim legacy in Spain is unique in Western Europe and yet it is as if we have to start from scratch. Over 900 years elapsed between Alphonse VI of Castille taking over Madrid in 1085 and the establishment of the first *aljama* mosque (the Abu Bakr mosque) in 1988. It was followed, four years later, by the opening of the Omar Mosque, which is today the *aljama* mosque in Madrid.

11.2.3 Freedom of Religion

The Spanish Constitution, approved in 1978, guarantees religious freedom. Article 16 provides:

> 1. Liberty of ideology, of religion, and of worship, are guaranteed to all individuals and communities…
> 3. No religious denomination will be designated as the religion of the state…

Under Article 27.3, the Spanish Constitution further guarantees "the right of parents to ensure that their children receive religious and moral instruction in accordance with their own convictions."

However, in its report the Union of Islamic Communities (UCIDE) states that only 8[15] out of the 17 autonomous regions that make up Spain meet the legally minimum requirements regarding Islamic religious education. Neither Catalonia nor Murcia meets the said requirements despite

[15] Andalusia, Aragon, Canary Islands, Ceuta, Melilla, Castille and Leon, Basque Country (Euskadi), and Madrid. In Spain the provision of education is the responsibility of the autonomous regions.

the fact that Barcelona and Murcia city have, together with Madrid city, the highest concentration of Muslim students. Two conclusions in the report are worth highlighting in this context: 95 per cent of Muslim students do not have access to Islamic religious education, and, by coincidence, 95 per cent of Islamic religion teachers are unemployed. Finally, 13 per cent of the Islamic community does not have access to a mosque,[16] whilst 95 per cent of the different Muslim communities does not have access to an *almacbara* (Muslim cemetery).

11.2.4 Religious Freedom at the Workplace

The interaction between religious freedom and the world of work is the arena that best reflects the daily reality of Muslims in Spain. This interaction is dealt with under Art. 16 of the Constitution and regulated under Organic Law 7/1980 (Religious Freedom Act, known as LOLR) which provides that "no religious reasons will be alleged to impede a person from performing a job"[17]; and "a person has a right to commemorate religious festivities."[18] Under a Cooperation Agreement entered into between the Spanish State and the Islamic Commission of Spain in 1992 (Law 26/1992), Muslim workers are granted certain religious rights,[19] all of them, however, subject to reaching prior agreement with the employer. This is the key as it potentially gives the employer a very effective right of veto. On the one hand, the employer is not permitted to ask (direct) questions on religious affiliation at the time of the job interview; on the other hand, however, the employer may be entitled not to grant certain rights to the employee if the employee failed to mention her religious affiliation prior to entering into an employment contract.[20] Regarding the use of the *hijab*,[21] the issue is whether or not the employer requires the use of a

[16] And the report remarks that different Islamic communities have not always been able to open a mosque and/or a cemetery.

[17] Art. 1.2.

[18] Art. 2.1 b.

[19] Including, for example, leaving work an hour before sunset during the month of *ramadán* (Art. 12.1 of the Cooperation Agreement).

[20] See Serrano Falcón, C. *Musulmanes y libertad religiosa en el trabajo asalariado en España* in Carballeira y González (2016), p. 88.

[21] The reference to the hijab should be understood as referring generally to the use of any garment or object with a religious connotation; however, the hijab has, perhaps, become the most symbolic garment.

uniform.[22] In the case that wearing a uniform is not required, the employer may not stop an employee from wearing the *hijāb* without incurring in discrimination. It would be disingenuous not to admit, in the light of the above, that the *hijab* may not survive the interview process. As Carolina Serrano Falcón[23] states: “expressions of religious freedom become heavily eroded in the labour market, confirming the irrelevance of religious believes.”[24] She adds that “we cannot yet state that the presence of cultural and religious diversity has been implemented in the Spanish workplace.”[25]

Last but not least is the invisibility of Muslim women not only in Spanish society at large, but also within the Muslim community itself. We do not appear to know even the basics: (1) The number of women in the Muslim community (both Spanish and immigrant); (2) levels of education; and (3) levels of integration in the workplace. This lack of data may just be symptomatic of what Pilar Rivas Vallejo[26] has referred to as “the common invisibility of the female in the work and social worlds…historically mutating between absence and irrelevance.”[27]

Undoubtedly, there is a great deal of work to be done to ensure that: (1) The Constitutional guarantees become a tangible reality and (2) a multicultural society becomes an intercultural one. As Pedro Martínez Montávez states:

> The difficult search for an intercultural society does not just mean an obligation to interact with the other, it means too an obligation to interact among ourselves; it is not just an issue regarding the outside, but also an issue regarding the inside, as necessary and inevitable one and the other.[28]

For this, stereotypes, ethnicity, religion, cultural identity, immigrant condition, and, indeed, gender have to cease to be social segregation and workplace discrimination factors.

[22] This assumes that the Muslim candidate has already been successful at the job interview stage and is now fully employed.

[23] Ibidem. pp. 85–105.

[24] Ibid. pp. 101–102.

[25] Idem.

[26] Sesgos de género en el trabajo de las mujeres musulmanas en España in Carballeira and González (2016), pp. 107–128.

[27] Ibid. p. 107.

[28] Prologue to Carballeira and González (2016), p. 13.

11.3 The Current Situation of the Islamic Banking and Finance Sector

Spain, despite its history, has not so far been a fertile ground for the growth of Islamic finance. According to the Islamic Corporation for the Development of the Private Sector (ICD)—Thomson Reuters Islamic Finance Development Report 2016, Spain is ranked 103 out of 124 countries. Spain scores 0.22 in the Islamic Finance Development Indicators (IFDI),[29] whereas Malaysia, which is ranked first, scores 123 points, and the United Kingdom, which is the highest European country in the ranking, scores 15 points. The Quantitative Development Indicator reflects the Islamic finance activity in a country: Islamic Banking, *Takāful*, Other Islamic Finance Institutions (OIFI), *Ṣukūk*, and Islamic funds. Spain does not score here. The only activity is limited to Coophalal, a small financial services cooperative established in Barcelona in 2015.

Spain has remained peripheral to the development of Islamic finance until recently. Nevertheless, an important change has occurred since 2015. The Islamic Financial Services Board (IFSB), with the support of the Bank of Spain, and the collaboration of the IE Business School organised a major conference in Madrid in May 2016. The then-Governor of the Bank of Spain pointed to the need to bring Islamic finance into the fold of the Spanish financial services. In the same manner, the Spanish Observatory of Islamic Finance in conjunction with Casa Árabe and the presence of members of the National Securities Commission (CNMV) welcomed Dr. Omar Ansary of the AAOIFI in February 2018. Further interaction at high level between the mentioned entities needs to be encouraged and efforts need to be made to establish said interaction at structural level on a regular basis. This is a necessary part of any strategy to put Islamic finance on the map; however, it is by no means sufficient.

The Islamic community in Spain has so far not been active in lobbying relevant institutions such as the Bank of Spain, the CNMV, and/or political parties as their counterparts in the UK so effectively did, nor has there been any tangible interest to accommodate Islamic finance in Spain on the part of any of these entities. Islamic finance is on nobody's radar at present or, indeed, in the foreseeable future.

[29] There are four individual indicators: Qualitative Development, Knowledge, Governance, Corporate Social Responsibility, and Awareness. The sum of these individual indicators gives the final indicator: IFDI Global Indicator.

11.3.1 Offer or Demand-Led?

In light of the above, one may be entitled to reach a partial conclusion at this stage: There is no tangible demand for Islamic finance products in Spain. This somewhat pessimistic statement needs to be put into a proper context.

According to a report on Improving Saving Culture,[30] Spain "suffers from a widespread lack of understanding regarding both basic financial concepts and financial products and investment." Fifty-three per cent of individuals "do not have a basic level of financial literacy." "More alarmingly," says the report, "45% of investors" (i.e., people who do actively invest) "lack the minimum financial knowledge to invest."

Therefore, the lack of a saving and investing culture in Spain may be an inhibitor for the development not only of Islamic finance but also of conventional finance. Paradoxically, however, it may also afford an opportunity. The Report identifies certain inhibitors for investment: "financial corruption scandals, severe economic crisis, and a general sense of distrust in financial entities and products...."[31] It has been said more than once that Islamic finance products need to find a niche to enter the European market and that said niche may well be the social impact, ethical solution in the financial investment/product sector.[32] Many large European financial services providers (such as Allianz, Zurich, FWU, Swiss Re, and others) are heavily engaged in the Islamic financial services sector in Asia. These providers have, therefore, the necessary experience and know-how. The fact that they have so far chosen not to introduce these or similar products into the European market may suggest that they do not see a sufficiently large market for them.

The European Islamic (retail) banking sector has so far not made use of the opportunity afforded by the "European passport." Unfortunately, with Brexit happening,[33] said opportunity may be lost for UK-based Islamic banks. To be fair, the retail Islamic finance sector in Europe as a whole is not working. The reasons for this may be many, but one possible explanation is that the potential market is, wrongly in my view, identified solely (or at least primarily) with the Muslim community. The cry that

[30] Nuñez Letamendia, et al. (2017). The report is worth reading altogether but the key findings (p. 94) give a very good insight into the problem.

[31] Ibidem.

[32] See Rodríguez-Moreno (2017).

[33] At the time of writing, the prospect of a "no deal" Brexit is by no means remote.

"these are products for all" may become a reality only if said products are identified as a social impact solution sufficiently differentiated to whatever else there is in the market.

It would not be a matter of re-inventing the wheel, if the will was there. Right now, however, there is neither offer nor demand in Spain.

11.4 The Legal Framework of the Islamic Banking and Finance Sector

The few analyses on the prospects and opportunities of Islamic finance in Spain to date have almost exclusively concentrated on the banking sector; to a lesser extent, mention is made of opportunities for the issuance of *ṣukūk*, whilst no mention (or just a passing mention) is made of *Takāful*.[34] The conclusions have almost invariably emphasised that, while there are clear opportunities in Spain,[35] Spanish legislation does not allow financial entities to offer Islamic products.[36] In the same manner, and without fail, every analysis mentions the fiscal challenges which, with the exception of Luxembourg, have been faced by every European jurisdiction in trying to create a level-playing field for Islamic finance.

Islamic finance is not on the radar of Spanish political parties at present; to date, there has not appeared a powerful sponsor championing Spain as a hub for Islamic finance as was the case in the UK and France. Therefore, this section will deliberately shy away from yet another analysis about the banking sector. I will only add that little or no mention, never mind analysis, has been made of the opportunities afforded by the European passport to Islamic banks in other European jurisdictions to enter the Spanish market and of the possible reasons why no advantage has been taken of it to date.[37]

This almost exclusive focus on the banking sector has meant that the one pillar of Islamic finance that may be established in Spain with relative legal ease has been ignored. The establishment of an Islamic insurance sector, prima facie, would not offer a material challenge to Spanish legislation.

[34] See Garrido, I. et al. which is one of the very few that mentions *Takāful*, however briefly.

[35] See García-Herrero, A. et al. (2009), p. 128.

[36] See Garrido, C. and Rodríguez-Monroy, C. An Approach to Islamic Finance in Spain (2015), p. 7.

[37] See Canalejo. G and Alfredo Cabellos (2009), who are amongst the very few (1) to remark on the possible use of the European passport by UK-based Islamic banks and (2) to ask themselves: "when will we see Islamic windows in Spanish banks"?

In its definition of *Takāful* Undertaking,[38] the Islamic Financial Services Board (IFSB) states:

> The underwriting in a *Takāful* is…undertaken on a **mutual basis, similar in some respects to conventional mutual insurance**. A typical *Takāful* undertaking consists of a two-tier structure that is a hybrid of a mutual and a commercial form of company – which is the *Takāful* operator (TO) – **although in principle it could be of a pure mutual structure.**

It then adds in a seldom-cited footnote[39]:

> There are two reasons why pure mutual structures are not normally used for *Takāful* undertakings. First, cooperative o mutual forms of companies are not recognised in a number of countries' legal systems. Second, and more fundamentally, a newly formed mutual insurance company would hardly be able to meet the capital adequacy requirements that are now standard….

In light of the above, the IFSB crucially (for our analysis) accepts that a *Takāful* undertaking may be structured as a conventional mutual insurance company (or indeed, as a cooperative society). As for the two reasons adduced as to why pure mutual structures are not normally used, we can readily dismiss them: (1) Mutual insurance companies are very much a part of the insurance landscape in Spain, and (2) the "real life" experience of mutual insurance companies in Spain is contrary to the second reason.

11.4.1 Mutual Insurance Companies[40]

A mutual structure is one of the legal forms foreseen in Spanish legislation for an entity dedicated to the insurance activity.[41] Mutual insurance companies may be either fixed premium or variable premium.

11.4.1.1 Fixed-Premium Mutual Insurance Companies

Fixed-premium mutual insurance companies[42] (**"FPMs"**) are not-for-profit private entities dedicated to insure the risks of their members (mutualistas)

[38] See Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings (2009), p. 2.

[39] Idem. p. 2. footnote 4.

[40] To a very large extent, any reference here to mutual entities could easily apply to cooperative societies.

[41] Art. 7 Ley de Ordenación y Supervisión de los Seguros Privados.

[42] Art. 9 idem.

for which the latter pay a fixed premium at the commencement of the relevant period. In addition to the not-for-profit motive, they must have at least 50 members. The condition of member is inseparable from the condition of insured and vice versa. The liability of the member is limited to the premium paid in any given period. Any losses or gains will be dealt with by way of payment of an extra premium or the return of part of a premium, as the case may be. In the event of the latter, said return will not be regarded as profit and hence it will not be subject to capital gains tax.

FPMs will have to credit permanent mutual funds from member contributions and/or out of surpluses retained from previous fiscal years.[43] The minimum capital will depend on the risks covered, as follows:

(a) €9,015,181 for life, public liability lines, and reinsurance;
(b) €2,103,542 for accident, health, legal assistance, and death

In addition, FPMs will have a guarantee fund[44] which will be equal to at least a third of the minimum amount of the solvency margin which will not be less than three quarters of €3.2 million for an entity covering life or any public liability risk. Otherwise, the minimum capital will be three quarters of €2 million. If an FPM does not cover public liability or reinsurance, and its annual premium income does not exceed €5 million in three consecutive years, the guarantee fund will be at least €800,000 if it covers life; €200,000 if it covers damage to goods, death, and legal assistance; and €300,000 if it covers any other risk. An FPM will be exempted from the above minimum levels provided that its annual premium income does not reach €750,000 and it does not operate in life, public liability, or is engaged exclusively in reinsurance.

11.4.1.2 Variable-Premium Mutual Insurance Companies

Variable-premium mutual insurance companies[45] (**"VPMs"**) are not-for-profit entities established on the principle of mutual help to protect, on a common basis, their members through the payment of extra premia following the occurrence of an insured event, for which liability is several. A VPM will charge an initial membership fee and must constitute a fund which will allow the VPM to cover claims and costs as they arise without

[43] Art. 13 idem.
[44] Art. 18 idem.
[45] Art. 10 idem.

waiting for the members to pay the extra premia. Managers will not receive any remuneration for their services and the production of insurance products will be direct, without mediation, and without retribution. A VPM will operate in only one other commercial line different from life save for public liability.

A VPM will have a permanent mutual fund, the minimum capital of which will be €30,050.[46]

Finally, the benefits or surpluses generated in the first three whole years of operation as well as in the initial year of operation will not be distributed and will be applied in full to the legal reserve. Any insurance entity that does not have fully covered its technical provisions or its margin of solvency or guarantee fund does not reach the legal minimum will not distribute any benefits or surpluses, otherwise, nor will it extend its activities to cover other risks.[47]

*11.4.2 "***Takāful** *Is Not Working"*[48]

Contrary to Islamic banking, which is working, *Takāful*, on the other hand, is not. A simple glance at any statistic confirms this. While the Islamic banking sector represents 73 per cent of the Islamic finance industry, *Takāful* accounts for only two per cent of it.[49] The projected growth of the industry up to 2021 makes this story even more stark: *Takāful* is expected to represent a poultry 1.5 per cent of the Islamic finance industry.

11.4.2.1 Tabarruᶜ *Is Not Fit for Purpose*

This quantitative analysis, however, reflects a deeper qualitative problem. *Tabarruᶜ*, arguably the cornerstone[50] upon which *Takāful* is based, is not fit for purpose. The system is built on a fiction which predicates that, unlike conventional insurance, in *Takāful* the participants make their contribution by way of donation.[51] This is not the place to make a review of

[46] Art. 13 idem.

[47] Art. 19 idem.

[48] So stated Omar Ansary, AAOIFI Vice-Secretary, at a meeting organized by Casa Árabe, Madrid, on January 24, 2018.

[49] Thomson-Reuters-ICD, Islamic Finance Development Report 2016, p. 29.

[50] The IFSB describes *Tabarruᶜ* as **fundamental** to *Takāful* schemes (Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings, p. 5).

[51] Article 2 of the Malaysia *Takāful* Act 1984.

the debate surrounding this fiction, that is, when a donation is not a donation? Suffice it to say that said fiction has been heavily questioned by leading Islamic scholars and Islamic standard-setting entities. One such leading Islamic scholar, Mufti Muhammad Taqi Usmani, has argued that the system of *tabarruʿ* fails to prevent the existence of r*iba* and g*harar,* rendering, therefore, the whole transaction void.[52]

The AAOIFI may not go as far as Mufti Taqi Usmani. Nevertheless, there is a recognition that there are certain *Takāful* models which are not *Sharīʿa* compliant, namely the *muḍāraba* and the *muḍāraba-wakālā* models. In future, the AAOIFI will propose exclusively the *Wakālā* and the *Waqf* models as being *Sharīʿa*-compliant.[53]

The cry that "*Takāful* is not working" may for some represent a system in crisis. And yet, it may represent an opportunity for the mutuality model to be added as a *Sharīʿa*-compliant alternative. El-Gamal has argued that mutual organisations can provide a simple juristic solution to problems of *riba* and *gharar*.[54] In addition, and once the *Sharīʿa* credentials are certified, mutual organisations offer regulatory advantages to governance issues raised by the other *Takāful* models discussed by the IFSB in its governance paper. In particular, mutual organisations overcome the uneven relationship between the *Takāful* operator and the participants that characterise all other *Takāful* models, with the important exception of the *Waqf* model.

The above discussion is relevant to help us elucidate a viable *Sharīʿa* and regulator-compliant model to develop in Spain. Just as in other European jurisdictions, the Spanish regulator would not be concerned with the *Sharīʿa*-compliant aspects of the products offered. This would require the development of the necessary human infrastructure, including the development and education of potential members of *Sharīʿa* supervisory boards and any other person involved in the design, development, and sale of *Sharīʿa*-compliant products.

In addition, the development of *Takāful* by way of mutual insurance entities would not create tax issues potentially discriminatory to *Sharīʿa*-compliant products. Neither would there be any legal/contractual dis-

[52] See the review of this debate in Nana, Abdullah (2016) particularly pp. 70–75.

[53] I refer to that said by Omar Ansary at the meeting previously referred to.

[54] El-Gamal, M., **Mutuality, reciprocity and justice within the context of a unified theory of *ribs* and *gharar***, in S. Nazim Ali (ed), *Takāful* and Islamic Cooperative Finance (2016), pp. 48–61.

criminatory practice in terms of generating a document-heavy sale process. This could be an incentive or at least not a disincentive to develop a *Takāful* industry in Spain.

11.5 The Academic Situation of Islamic Banking and Finance

This is the area of greatest growth in Spain in the last few years. Today, there are a number of universities and business schools in Spain offering courses at degree and postgraduate levels. It is no coincidence that the two criteria in which Spain does relatively well are the Knowledge and Awareness indicators.[55] The best way to appreciate this is to look back at the last 20 years.

Islamic finance was introduced as an academic course by the single-handed efforts of Professor José Collado Molina at the Universidad Nacional de Educación a Distancia (UNED)[56] in 1996. However, it is the creation of Casa Árabe, a public institution, in 2006 and the establishment of the Saudi-Spanish Center for Islamic Economics and Finance (SCIEF) in Madrid by the IE Business School and the King Abdulaziz University[57] in 2009 that marks a watershed in the growth of academic interest in Islamic finance in Spain.

Casa Árabe, dual headquartered in Madrid and Cordoba, is a public consortium formed by the Ministry of Foreign Affairs and Cooperation, the Spanish International and Cooperation Agency (AECID), the regional governments of Madrid and Andalusia, and the municipal governments of Madrid and Cordoba. Since 2009, Casa Árabe and the Spanish Diplomatic School offer a course titled "Islam and Muslims Today" which includes modules on Islamic finance.

Initially, Islamic finance was only one of the 80 elective courses at IE Business School's Master in Finance. In 2015, however, IE Business School, in collaboration with the Islamic Corporation for the Development of the Private Sector (ICD),[58] established its own Master in Islamic Finance

[55] As per the Global Islamic Finance Development Indicator developed by ICD-Thomson-Reuters. See ICD-Thomson Reuters Islamic Finance Development Report 2016.

[56] The Distance Learning National University.

[57] A Saudi university based in Jeddah.

[58] ICD is a multilateral development financial institution and is part of the Islamic Development Bank (IDB).

(MIF). The programme attracts students from around the world. The MIF is organised around three pillars: Technical financial foundations, skills workshop and Islamic finance technical skills, and legal aspects. It has a blended format, combining on-site periods in Madrid and Jeddah with interactive online-modules. In addition, IE Business School now offers a number of elective courses in Islamic finance.

In 2014, Universitat Oberta de Catalunya (UOC)[59] and the Hamdan Bin Mohammed Smart University (HBMSU)[60] launched a two-year long Executive MBA in Islamic Banking and Finance. There is a clear division of labour whereby UOC offers conventional finance and management courses during the first year and HBMSU offers the Islamic finance units during the second year, with each institution making use of its own virtual campus to deliver the course.

The University of Almeria and the Almeria School of Finance jointly offer an online specialist course on Islamic finance. Each school issues its own certification. In addition, the students are encouraged to study for the Islamic Finance Qualification (IFQ) offered by the Chartered Institute for Securities and Investment. This is a 250-hour course, 100 of which relate to the IFQ.

SCIEF, King Abdulaziz University, and the Islamic Research and Training Institute (IRTI)[61] offer an Executive Program in Islamic finance which takes place over four days in Jeddah. The course, in addition to lectures, includes a visit to a number of leading Saudi enterprises located in that city.

The Centro de Estudios e Investigación en Economía y Finanzas Islámicas (CEIEFI)[62] offers a three-day introductory course to Islamic finance: The Barcelona Certified in Islamic Finance (BCIF), and a more advanced five-day course: The Certified Islamic Banker Barcelona (CIBB). Both courses are offered either on-site or online in any of three languages: English, Spanish, or Arabic.

The undoubted growth in the institutional offering of Islamic finance has to be tempered by the fact that Islamic finance remains an esoteric subject. Only one provider offers Islamic finance at degree level (as

[59] UOC is located in Barcelona.

[60] HBMSU is an e-university based in Dubai.

[61] IRTI is an entity within the Islamic Development Bank (IDB) which serves as research centre of the IDB Group.

[62] CEIEFI was established in Barcelona in 2013.

opposed to 27 providers in the UK, e.g.).[63] Courses are attended by small numbers; these are overwhelmingly male and Muslim. The academic growth has been offer-led. The demand has yet to crystallise in sufficient numbers to make the offer-led growth viable and sustainable.

In terms of research and publications, around 60 papers were published in Spanish publications between 1998 and 2017.[64,65] Academic research in Islamic finance is still limited.[66] Few out of those 60 publications came out of universities or higher education institutions.

Nevertheless, special mention needs to be made of the creation of the Observatorio de Finanzas Islámicas (Islamic Finance Observatory) in June 2017. It aims to bring together the main experts in Islamic finance in Spain with the objective of joining forces to generate interest, disseminate knowledge, and create awareness of Islamic finance, as well as lobbying influential public and private entities to embrace Islamic finance and make Spain an alternative hub for ḥalāl investment. The IE Legal Clinic and SCIEF joined forces in 2018 to put together a comparative study which will be delivered by way of a series of reports over the prevailing situation of the applicable law and regulations in several European jurisdictions regarding Islamic finance. The results will be made available to the different members of the Observatorio with a view to benefit from lessons learnt in other jurisdictions which may facilitate the way forward in Spain.

11.6 Conclusions

To the extent that Islamic finance has a future in Spain, it will have to be based on an ambitious and daring agenda, one that cannot be based simply on competing in the same market with conventional finance or on emulating other European countries where Islamic finance has been a feature for some time. Islamic finance has to present a value proposition which clearly differentiates itself not only from conventional finance but also from much of what passes today for Islamic finance.

[63] ICD-Thomson Reuters Report 2016.

[64] See the rather comprehensive list of publications published by the Observatorio de Finanzas Islámicas in Las finanzas islámicas en España 2017.

[65] Compared to the 160 research papers produced in the UK in three years (2013–2015).

[66] It is important to distinguish between research and publications on Islamic Finance and Arabic Studies. Spain is rich in research and publication regarding the latter. My remarks here refer exclusively to Islamic Finance.

As Mufti Muhammad Taqi Usmani, one of the leading contemporary Islamic jurists and experts in the Islamic finance, states:

> Islamic financial institutions wish to compete with their conventional counterparts in all respects, and restrict themselves to the debt-based products. In their zeal to compete [with] conventional banks, they are trying to invent *Sharīʿa* compliant [equivalents] for each and every financial product available in [the] conventional capitalist market, regardless of whether or not they are in [accordance] with the ethos of the Islamic economy.[67]

It will not be easy as a great deal of groundwork at different levels will have to be undertaken. In the medium term, the offer-led route will have to be transformed into a demand-led movement. A great deal of "lobbying" is yet to be done to convince potential (heavy-weight) sponsors, intermediaries, and, eventually, final-consumers that Islamic finance is a social impact solution different from whatever else is there in the "market."

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CHAPTER 12

Participative Banking in Turkey

Ibrahim Zeyyad Cekici

12.1 Introduction

From the Beginning to Nowadays Modern Islamic finance has been existing for more than 30 years in Turkey. Indeed, Ottoman Empire had imposed that all kinds of financing must be compliant with Islamic Law.[1] But, the secular Republic of Turkey has ended up, since 1923, with the application of Islamic Law (*Sharīᶜa*) and had forbidden all shapes of religious reference, above all the Islamic reference, a movement that matched during decades with religious freedom restrictions[2] and coup d'état against governments that are potential threats to the secular State.[3]

[1] H. Tünç, *Katilim Bankaciligi, Felsefesi, Teorisi ve Türkiye uygulamasi* (in Turkish, our translation: Participative Banks, Their Philosophy, Their Theory and Their Regulation in Turkey), Nesil, Istanbul, p. 175 et s; H. Döndüren, *Delileriyle Ticaret ve Iktisat Ihmihali* (in Turkish, our Translation: Encyclopedia of Islamic commercial Law and Islamic Economy with Their Legal Sources), Erkam Yayinlari, Istanbul, 1424/2003, pp. 362–366.

[2] For example, Turkish authority had closed many Mosques, Koranic schools (madrassa), Sufi places (zawiya) and had forbidden the Appeal for Prawyer (Athan), holding at home Koran, obligating the former Sultans and Scholars to leave the country.

[3] The last coup d'état dated 28 February 1997 was against the coalition government headed by the Prof. Dr. Necmettin Erbakan. Regarding the figures, the Islamic economic

I. Z. Cekici (✉)
Paris, France

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However, for several years, the government has allowed Turks to draw in their "glorious" past. This return to the authentic sources has allowed the establishment of an even stronger legal base to Islamic financings. The first Islamic finance activities began in 1985 with the setting of *Albaraka*. After, *Kuveyt Turk* began its activities in 1989. The Islamic banks were created with local capital like *Anadolu Finans* in 1991, *Ihlas Finans* in 1995 and *Bank Asya* in 1996.[4]

For several years, the Turk authorities have sustained the Islamic finance development. The former prime minister had set up in 2015 a coordination committee for interest-free finance that always depends on Public Revenue Office and aims to fulfill the development of Islamic finance in Turkey. He invited all the concerned public authorities to make their contribution to this development.[5]

Former Legal Environment Islamic financing found a legal base with the Law of 1983 which named participative banks as "Special Finance Institutions" (*Özel Finans Kurumlari*)[6] in line with the Turks' expectations[7] Thanks to the Law, many banks had got the authorization to become an Islamic bank.

The Banking Law n° 4389 of 1999 set all the banks under control of the same regulator "without any religious distinction". Then, the Law imposed the setting of the Special Financial Institution Association and a Warranty Fund of Islamic deposits.[8]

New Legal Environment However, the publication of a Bank Law[9] on 19 October 2005 (hereinafter the "Bank Law") marked a new turning point. Indeed, Specialized Financing Institutions are now named as *participative*

activities had registered a loss of around several billions of dollars: see N. Erbakan, *Davam* (in Turkish, our translation: My Involment), Milli Gazete Ankara Kitab Kulübü, 2013.

[4] Undersecretariat of Treasury of Republic of Turkey, Prime Minister, *Turkey Participation (Islamic) Finance Country Report*, November 2016, p. 15.

[5] Circular of Prime Minister Services, n° 2015/17.

[6] Law n° 83/7506 of the 19th December 1983 on Specialized Financial Institutions; completed by two Decrees of the Economy Minister and one circular of the Central Bank of Turkey in 1984. The Government published more than 20 texts between 1984 and 2004.

[7] Undersecretariat of Treasure of Republic of Turkey, Prime Minister, prec., p. 19.

[8] Idem.

[9] Law n° 5411 of 19 October 2005, OJ p. 25983.

banks, whereas the Law never refers to the Islamic Law or to the forbidden interest. Participative and traditional banks are now considered to be equal. By the way, this Law defines some Islamic credit operations and Participative Investment Account referring to the principle of loss and profit sharing.

Definition of the Participative Bank The Banking Law defines participative banks as *fundraising structures using Current Accounts and Participative Investment Accounts and which distributes credit to the clients.* However, this definition does not admit the legal nature of the Islamic bank operations except to the fact it refers to the definition of the participative accounts. It is important to highlight that this activity is also open to foreign banks which have agencies in Turkey.

Underlying Islamic Contracts According to the Sub-secretary of the Treasury of the Republic of Turkey, participative banks use under Islamic contracts in order to structure credit operation and deposits whose name and the terms of contracts are indicated in Table 12.1.[10]

It would be judicious to study the figures of the Market of Participative Banking (1) as well as the various factors which could contribute to this development (2) which is largely bound in the conditions of implementation of the participative banks (3) and to the legal framework of its activities (4).

Table 12.1 Islamic contracts use in Turkey's Islamic Banks

Asset *Nature of the underlying Contracts*	*%*	*Liability*	*%*
Mourabaha	90	Capital	15
Ijāra	5	Participative Investment Account (*moudaraba*)	70
Istiṣnā[c]	2	Current Account	15
Salam	1		
Mousharaka	1		
Moudaraba	1		
Total	**100**	**Total**	**100**

[10] Undersecretariat of Treasure of Republic of Turkey, Prime Minister, prec., p. 30.

12.2 The Figures of the Participative Banks Sector

Size in the Global Market According to the Islamic Financial Services Board, the part of Turkish Participative Banks in the global Islamic bank market represents 2.9% in 2016. It increased to 9% in 2007.[11] However, other structures estimate that Participative Banking industry represents at least between 4.5% and 5% of the global market.[12]

Nationwide Figures In August 2017, there were five participative banks in Turkey, with two of them being public banks called *Ziraat Katilim Bankasi* and *Vakif Katilim Bankasi*. The three other banks are private banks: *Türkiye Finans, Albaraka* and *Kuveyt Turk*.[13]

They represented only 4.71% in April 2017 compared to the Turkish banking sector, whereas this rate was 5.32%[14] in 2016 and 6% in 2014, respectively.[15] The decrease can be explained by the liquidation of two participative banks (*Ihlas Finans* and *Bank Asya*): contrary to this, the rate could have reached 10%.[16] Nevertheless, the creation of two new participative banks is expected: the first will be a public bank named *Halk Katilim Bankasi* and the second will be a private sector bank.

Dynamic Growth In 2016, the asset of participative banks was around US$41.417 million compared to the US$813.412 million representing the total amount of the assets of all banks in Turkey. Those assets represented 5.1% of the total bank assets. During the same period, they raised a fund of US$25.567 million (for a total of US$427.778 million), and they provide US$24.576 in the form of Islamic loan[17] (for a total of US$512.333).

[11] Islamic Financial Services Board, *Islamic Financial Services Industry, Stability Report*, 2017, pp. 7–10.

[12] Turkey Participative Banks Association, *Katilim Finans*, Revue, June–July 2017, p. 3 and Ernst & Young, *World Islamic Banking Competitiveness Report 2016*, p. 12.

[13] www.tkbb.com.tr

[14] Katilim Dünyasi, *Katilim bankalarinin bankacilik sisteminde payi yuzde 4.71'e geriledi*, Journal of 31 May 2017, https://katilimdunyasi.com/2017/05/31/katilim-bankalarinin-bankacilik-sistemindeki-payi-yuzde-4-71e-geriledi/

[15] Ernst & Young, *World Islamic Banking Competitiveness Report 2016*, p. 12.

[16] Idem.

[17] Undersecretariat of Treasure of Republic of Turkey, Prime Minister, op. cit., p. 10.

In fact, participative banks succeeded less than traditional banks because they first have displayed a growth rate of 4.5% of the funds raised and, second, they practically doubled this rate reaching 8.2%. This lag is also present in the repartition of the credits where participative banks increased the allocated funds to 14.1%, whereas traditional banks realized a growth of 19.9%.[18]

Growth of Assets, Profits and Agencies The financial assets of participative banks grew up to 21% between 2011 and 2015, with 2.5% in four months, passing from 132,874 million of Turk lira, hereafter "TL" (in December 2016) to 136.210 million TL (in April 2017), whereas their own funds also topped up from 11,494 million TL to 11.986 million TL, which means an increase of 4.3% (for the same period).

It is surprising that for the same period, the profits significantly increased with a growth rate of 254% starting from 130 million TL to 461 million TL. In the same period, the staff employed in the banks expanded from 14,465 to 14,594 employees which means an increase of 0.9%.[19]

Otherwise, the number of agencies topped up from 959 to 978 with a growth rate of 2%.[20] Yet, in 2015, 1080 participative bank agencies were mapped—990 agencies in 2014, while the total number of bank agencies in Turkey was 12,269 in 2015 and 12,210 in 2014.[21]

Raised Funds Concerning the funds raised by the participative banks, they also augmented from 85,283 million to 92.502 million TL in five months, which is an 8% increase. However, these banks have injected 86.705 million TL in December 2016 and 91,148 million TL in May 2017. It is important to highlight that the fundraising is made with both local and national currencies (the last representing about 10% of the total of the funds raised).[22]

[18] Ibidem, p. 11.

[19] For example, the number of employees of Albaraka was 400 in 2001 and 3800 in 2017 (Turkey Participative Banks Association, *Katilim Finans*, préc., p. 32).

[20] Ibidem, p. 12.

[21] Undersecretariat of Treasure of Republic of Turkey, Prime Minister, prec., 11.

[22] Ibidem, p. 12.

Growth Rate Expected The Secretary of the Turkey Participative Banks Association (*Türkiye Katilim Bankalari Birligi*) has declared that the growth rate expected for the 2017 exercise is about 20%.[23] The rate is due by a state credit support policy: participative banks should have increased the amount of the credits from 20 billion TL to 160 billion TL this year.

Individualized Growth Rate Among the public participative banks, *Vakif Katilim* began its activities in February 2016. In just a year, this bank achieved a growth rate of 27% allocating loans which the total amount matches with 5.92 billion TL, with 25 million TL of profits, and raised 4.43 million TL of funds for the first quarter of 2017.

For the following year, *Vakif Katilim* will open agencies in all the 81 cities of Turkey. For the moment, the bank has 46 agencies based in 26 cities of Turkey. Its CEO explained that if participative banks represent 5% of the market, it will be a serious challenge to reach 15% by 2025, and he will be delighted to contribute to it.[24]

The first public participative bank of Turkey, *Ziraat Katilim*, has just celebrated its two-year anniversary. The bank has relocated 11 billion TL of funds and collected 8 billion TL, dealing at the same time several syndicated loans backed by the *Murābaḥa contract* for a total of US$500 million and a *ṣukūk* issuance of US$500 million. This bank has only 7% of the parts of the participative banks sector.

Kuveyt Turk increased its profits to 21.3% with 152 million TL during the first quarter of 2017. The total of the assets cumulated is now equal to 49 billion TL. The bank frequently issued *ṣukūk*.

Türkiye Finans achieved a profit of 91.4 million TL which means its profits increased to 9% at the first quarter of 2017 and have disclosed that 695.5 million TL will be relocated under the principle of profit and loss sharing.[25]

Albaraka has set up a network of 132 agencies in the country, whereas *Kuveyt Turk* has got 338. The first bank has participated to syndicated financing based on the *Murābaḥa* (the last of these unions is dated on this current year for an amount of 213 million TL) and frequently issued *ṣukūk*.

[23] Ibidem, p. 13.
[24] *Katilim Bankalari Dergisi* (Revue of Participative Banks), n° 2, avril 2017.
[25] Turkey Participative Banks Association, *Katilim Finans*, prec., p. 17.

Profit Rate Participative banks propose for their clients Participative Investment Accounts. The beneficiaries fulfilled a very good deal for their savings because the profit rate of their accounts averaged 8.18% in 2017, whereas this rate was around 7.59% last year.[26]

Growth of the Chief Executives' Wage Logically, participative banks which have realized profits consequently have well-paid their chief executives which is reflected by an increase of 32% of their wages representing an additional amount of 20 million TL. This figure shows the good health of this field, in the same time pulling critics up vis-à-vis the figures of the profit rate really relocated.

Bank Innovations Several bank innovations can be highlighted. These banks offer accounts based on gold starting from 50 g of gold. For example, *Albaraka* distributed 2.34 g of gold of profits on the first quarter for 100 g deposed, *Türkiye Finans* 1.96 g, *Kuveyt Turk* 1.92 g and *Ziraat* Katilim has distributed 0.6 g of gold.[27]

The *Kuveyt Turk* bank offers credit cards cumulating points which will be transformed into gold after purchasing with the card.

Also, in order to support the Turk economy, *Ziraat Katilim* issues securities (*ṣukūks*) when clients deposit gold in the bank. It should be better to enlighten that *Vakif Katilim* and the Turk Post Mail office signed an agreement for facilitating the fund transfer.

FinTech (which means a designed technology to serve finance) is expected to contribute to the development of the Islamic finance in Turkey. It uses robotics, *Blockchain* mechanisms and also the *Bitcoin*. For example, *Kuveyt Turk* set up an R&D committee in FinTech. The committee keeps an eye on the finance innovations on the markets and the start-ups alleged to add a plus-value in the bank field as the "Open Bank". In fact, all the participative banks watch over the news about the evolutions of the sector.[28]

[26] *Katilim Dünyasi*, Journal of the 1st August 2017: https://katilimdunyasi.com/2017/08/01/katilim-bankalarinin-ortalama-kar-payi-orani-yuzde-8-18-oldu/

[27] Katilim Dünyasi, Journal of 12 may 2017: https://katilimdunyasi.com/2017/05/12/altin-hesaplara-en-cok-kar-payi-veren-albaraka-en-az-vereni-ziraat/

[28] Turkey Participative Banks Association, *Katilim Finans*, p. 59.

The Contributions of the Participative Banks in the Economy According to the figures displayed above, the contribution of the participative banks to the economy of Turkey should be admitted. These banks have not only supported the small and medium firms but also, according to the former Prime Minister's words, Mr Nurettin Canikli, prevented these firms from going into bankruptcy.

So, the amount of the allocated credits to the firms, supported by public authorities, reached 140 billion TL in just a year, particularly by financing companies evolving in the real economy sector.[29] For example, the first industrial group specialized in robotics has benefited from the principle of profit and loss sharing.[30] The same example is applicable for the Ertemeller group specialized in the real estate and tourism sectors.

Moreover, traditional banks have contributed to the development of the Islamic finance sector. Indeed, the CEO of HSBC, Turkey, has declared that his bank played an important role in the syndicated financing and the issuance of *ṣukūk*.[31]

Takāful Except the participative banks, other structures are taking part in the development of the Islamic finance in Turkey. For example, the Islamic insurance is gaining momentum in Turkey. According to the former Vice-Prime Minister Mehmet Simsek, the sector is expected to collect 180 billion TL by 2023 to reach 10% of the market share.[32]

Istanbul Stock Exchange and IsDB The Islamic Development Bank (IsDB), localized in Saudi Arabia, wants to buy equities of Istanbul Stock Exchange. The exchanges between the two actors have already begun and reportedly passed through public offer of securities of which a part should be reserved to the IsDB.[33]

Stock Exchange of Real Estate Securities During the meeting of the Member-States of the Islamic Organization, the former Vice-Prime Minister, Mr. Canikli, announced that Turkey will set up an Islamic Stock Exchange for real estate securities, when the technical works are completed.[34]

[29] Ibidem, p. 25.
[30] Ibidem, p. 38.
[31] Ibidem, p. 22.
[32] Ibidem, p. 20.
[33] Ibidem, p. 21.
[34] Ibidem, p. 25.

Application in the Implantation of the "Islamic Mega-bank" For several years now, Turkey and Indonesia have been racing for hosting the "Islamic Mega-bank" headquarters in their respective country. However, the two states show a concerted action because the IsDB has decided that the two countries should collaborate to find a solution soon.[35]

Academic Works For a harmonious development, the help of university lecturers is obvious. In Turkey, the multiplication of academic works is important. For example, the "Islamic economy workgroups" conducted at Sakarya University has hosted a great number of speakers from different countries.[36]

In addition, the Turkey Participative Banks Association decided to publish a book titled "The Development of Participative Banks". This book has 12 chapters lightening its report on juridical matters and regulatory issues.[37] After obtaining the authorization of the Organization of Higher Education, the Social Sciences Institute of the Technical University of the Black Sea allocated a grant for a PhD student of up to 1,80,000 TL a month for a duration of four years.[38]

A Cross-Border Standardization The university lecturers will bring in their experience for translating Islamic rules published by the *Auditing and Accounting Organization for Islamic Financial Institutions* (AAOIFI). Both the last and the Turkey Participative Bank Association have signed a memorandum of understanding on 26 April 2017 aimed to translate the 58 *Sharīᶜa* standards. This work is supported by the Bank Control Authority of Turkey and managed by the University of Sabahatin Zaim.[39] The group will be composed of 17 experts and translators.

Weakness of Participative Bank System Nevertheless, all the political actors, economic sector and scholars have highlighted the weakness of this activity which matches with ignorance, and furthermore suspicion from the

[35] Ibidem, p. 22.
[36] Ibidem, p. 21.
[37] Ibidem, p. 29.
[38] www.ktu.edu.tr/sbe
[39] Turkey Participatives Bank Association, *Katilim Finans*, Revue, préc., p. 28.

population.[40] They want the communication about it to be simplified and better-axed forward to all the sections of the population because Turkey is a country with a very high rate of banking system usage and the needs of financing are becoming more and more significant.

12.3 Participative Banks Setting Conditions

Supervisory of Participative Banks Traditional and participative bank activities are watched over by the same independent authority (*Bankalar Düzenleme ve Denetleme Kurulu*) which is called "Bank Control Authority" or "BCA".

This BCA has the power to control and regulate. This institution can define the significance of the legal rules.[41] Except all the traditional aspects linked to power,[42] participative banks are watched over in order to make enough profits for meeting their commitments about their clients' return on investment, in particular, to remunerate Investment Participative Account beneficiaries.

Moreover, participative banks are subjects of a specific supervisory consisting of the quality of the assets in the achievement of a credit operation. For example, if participative bank meets financial difficulties, the BCA is empowered to increase the capital, to suspend profit distribution, to reduce credit loan or to suspend long-term investments.[43] To solve the deficit position of a bank, the BCA is able to set one or several preventive measures such as the liquidation of their positions on raw material market, the liquidation of fixed assets, the suspension of payments and/or the replacements of managers.

Turkey Participative Bank Association has published a recommendation with principles governing the fees of the Islamic banks. This text completes[44] the previous texts defending clients who can be considered as consumers for the following operations: Investment Participative Accounts, payment and credit cards, fund withdrawals, funds transfer and so on.

[40] Ibidem, p. 25.

[41] Ibidem, p. 25.

[42] Classically, the supervisory of banks consists of accountability and financial reports in order to reduce the market risk, credit risk, liquidity risk and rate risk.

[43] Article 68 of Banking Law.

[44] Law n° 6502 of 7 July 2013 on the protection of consumers.

Among these rules, the bank must reimburse the funds when the client requests after a conviction by a court.[45]

Authorization Obviously, a bank either traditional or participative needs an authorization from the BCA to provide its services (Articles 6–14 of Bank Law). As a result, the bank must have a public limited company with a capital of up to 30 million TL and owning shareholders under thorough transparency obligation. Indeed, Article 8 of the Bank Law defines the conditions shareholders of a bank have to fulfill: to not have been the subject of a bankruptcy or of criminal condemnation, to have a sound finance background, to have sufficient reference and competent staff. They must be upright and skillful in carrying out banking operations.

Establishment Bank by Foreign Shareholders Article 9 of the last Bank Law does not limit in any shape the opening of a participative bank to nationwide shareholders. On the contrary, it allows banks and foreign shareholders to enter into the domestic bank market. This means that every foreign Islamic bank willing to be established in Turkey requires an authorization that follows a specific procedure (Articles. 16–21 from the Bank Law).

Threshold Crossing Regarding Article 18 of the Bank Law, if the shareholder crosses over 10%, 20%, 30% or 50% of the capital of a bank, he must ask the BCA for authorization. In the same way, a shareholder must ask for authorization when he wants to decrease the rates presented above.

Indeed, both the BCA and the bank customers and partners will be notified about capitalistic operations on a participative bank notably for reasons linked to financing terrorism, money laundering or corruption. This obligation of transparency should ensure the markets or "stress" them moreover. We can take the example of the judicial liquidation of a participative bank whose shareholders owned privileged shares representing more than half of the capital, whereas their identity and their actual rights on the capital securities was not comprehensive.

[45] The Law n° 6361 du 13 décembre 2012 on the financial leasing, the factoring and others financing companies is applicable to participative banks. For example, the client who has the quality of a lessee has the same right imposed by Islamic Law.

Board of Directors A participative bank must have a board of directors composed of a CEO and four other members. This means that the board of directors cannot be composed of less than five members.[46] Nevertheless, a foreign bank willing to implant in Turkey requires to set an ad hoc board composed of at least three members aimed to implement all the proceeds to assure the domestic control, risk management and the compliance of the operations with the laws and regulation of the country.

Skills of Directors The CEO must be a graduate with at least an MBA degree in Law, in Administration or in Management. Also, he/she must have an experience of ten years in the banking sector. The other members of the Executive Board must have a graduate diploma and at least seven years of experience. Before embodying their functions, they have to declare their identity, diplomas and CV to the BCA. All the directors must be free from any court penalty and not be a subject of any personal bankruptcy.[47]

Audit Committee The participative bank must set up a three-member audit committee who are not part of the managing team of the bank. The committee has the responsibility to establish an activity report linked to internal control, to risk management and the compliance of the operations with laws and regulation.[48] Nevertheless, it is regrettable that the bank law does not respond to the expectation of the setting up of a *Sharīᶜa* audit committee.

The same remarks must apply to the designation of a *Sharīᶜa audit board*. Indeed, none of the participative banks have implemented this type of Committee, which will lead to, thereafter, shape critics about the Islamic validity of different operations.

Accountable and Financial Reports Participative banks are obliged to have a sound accountability. They must publish accountable and financial reports every year.[49] Concerning a banking group, it should be better to do a consolidated report.[50] However, none of these measures

[46] Article 23 de la loi bancaire.
[47] Articles 25 to 27 of the Bank Law.
[48] Articles 29 to 31 of the Bank Law.
[49] Articles 37 to 42 of the Bank Law.
[50] Article 38 of the Bank Law.

specifically administrate the case of the participative banks. This means the participative banks in Turkey are not under any particular accountable or financial constraint although the AAOIFI published standards proper to Islamic banks.

Own Funds Following the own funds requirements of the Committee of Basel, Article 45 of the Bank Law has determined the rate of 8%. The method of calculation of this rate is set by the BCA which also has the responsibility to define the liquidity rate.[51]

Banking Secrecy It is totally logical for customers to expect their bank to get utmost secrecy on their account It is interesting to note the fact that the staff of a participative bank is also obliged to keep bank secrecy on bank operations but also on equity participation in another bank or which is aimed to have control of a company.[52] The duty of bank secrecy also spreads to the BCA, particularly in administrative and legal matters, including in the case of judicial investigations, when the collected information is not public.

Protection of the Reputation Article 74 of the Bank law forbids all information that affects the reputation of a bank. This is a core point in Turkey because a number of individuals convey a bias that participative banks carry out inconsistent operations with Islamic Law and fraudulent transactions because Turkey has been shaken up with several financial and industrial scandals. This article refers to the Press law which requires the providing of sufficient evidence to accuse a financial structure of unlawful achievements.[53] The journalists have to adopt a specific ethic.

Ethical Principles The lawmaker has asked the banks to respect the principles of justice, righteousness, probity and the ones referring to social responsibility. These principles are detailed by the associations and control authorities.

Dissolution and Liquidation Participative banks are under general rules of dissolution and liquidation of the companies in Turkey. In this case, management and control of the different steps are devolved to the “Deposit

[51] Article 46 of the Bank Law.
[52] Article 73 of the Bank Law.
[53] Law n° 5187 on the media.

guarantee fund" (*Tassaruf Mevduat Sigorta Fonu*).[54] Several participative banks have been already placed under the authority of this organization.[55] The budget of this institution is raised from all the banks, including participative banks.

Allowed Transactions Article 4 of the Bank Law has listed more than 20 transactions that are beyond the simple bank area because all the banks can, for example, achieve financial transactions concerning capital securities, raw material (gold, platinum, etc.) and also derivatives. They have the ability to allocate all types of guarantee, to provide advice to customers on a securities portfolio. This means, by the diversity of the transactions, that Turkey has made the choice of a very liberal legal framework for either traditional or Islamic banks.[56]

12.4 Legal Framework of Participative Bank Transactions

A participative bank can have numerous banking transactions. Among these transactions, there are the investment participative accounts (1), the credit cards (2) and the credits (3). But, we will finish by an explanation of the different measures for the purification of incomes, taxation and penalties (4).

12.4.1 Investment Participative Accounts

Definition of the Investment Participative Accounts Based on the *Muḍāraba* contract, the investment participative accounts are regulated by legal texts. Indeed, the Bank Law defines, in preamble, those accounts as *accounts on which the clients of participative banks deposit funds in order*

[54] Articles 106–110 of the Bank Law and Articles 111–143 which are established through the principle of independence.

[55] The last case is Bank Asya which was accused of financing a terrorist organization led by Fethullah Gülen who has tried to bring down the Turkish government on 15 July 2016. The preparators of putsch have tried to occupy the Istanbul Stock Exchange after bombing the Parliament. The coup d'état did not succeed thanks to the resistance of Turkish People. However, there were about 148 dead and more than thousands injured.

[56] It is forbidden to offer banking and financial services to a person who does not furnish his name, address, tax identity and all information imposed by the regulation (Article 76 of Bank Law).

to share the profits and losses of those banks so that the profit is not fixed ex-ante and so that the reimbursement of these funds is not guaranteed. This definition resumes completely the most characteristic condition of the Islamic banks, knowing the fact that customers participate in the losses and profits realized by the bank which has invested their funds. The customers thus take the risk of losing their funds, even if the participative banks limit this risk and distribute profits higher than the interest rates.[57]

Investment Participative Account Holders The Bank Law allows the natural person and the legal entity to hold one or several investment participative accounts. This type of account permits to save or to put the cash flow of a company from 1 to 12 months, or from one to several years.

Nature of the Payments The funds can be paid in Turkish Lira or in currency (generally in USD or in Euros). The participative account can also be fed with precious metals such as gold or silver. In case of profit distribution, they can take the shape of either paper money or precious metals.

Nature of the Funds Raised The funds paid by the clients to the participative bank are not considered as a debt or a claim, but a capital contribution which is structured, thanks to the *Muḍāraba* contract. The rate of profit and loss sharing is fixed in the contract, for example, if the rate is 5%, the client would receive 5% of the profits or would suffer losses with the same rate.

However, the bank never sets in advance a rate or an amount of money to give to the client and does not warrant the initial fund put in the account. But, the risks of loss are lowered thanks to the setting of reserve account or the payment of bonus to the Warranty Deposits Fund.[58]

Investment of the Raised Funds Participative banks invest the raised funds according to the Islamic Law. For example, they enter into *Murābaḥa* contracts on raw materials to finance the needs of the firms or lease agreements based on the *Ijāra*. In contrast, they are not allowed to invest these funds in traditional banks or financial institutions. The profits issued by

[57] I. E. Aktepe, *Investment Participative Accounts in Participative Banks*, in Association of Participative Banks of Turkey, *Katilim Finans*, prec., p. 64.

[58] Idem, p. 65.

these transactions will be shared between the bank and its client; the profits paid to the client will be deposited in his/her participative account.

Separate Accounts, Authorized Accounts According to Article 60 of the Bank Law, participative banks and the other banks have the obligation to clearly distinguish the accounts. They have to distinguish between the deposit accounts, the short-term deposits and the investment participative accounts.

The conditions of using these accounts are supervised by the Central Bank. In addition, Article 60 of the Bank Law forbids all financial institution to open investment participative accounts for clients without being allowed by the BCA.[59] If the client becomes the holder of this type of account, he/she has to obtain a document or a contract testifying the opening of this account. None of the participative banks have the authorization to raise funds for foreign banks, foreign credit agencies or foreign financial institutions. If participative banks have proceeded to this type of transaction, the Bank Law would consider these raised funds as non-authorized, which can lead to administrative and criminal penalties.

Obligation to Provide Information A decree from the Central Bank of the Republic of Turkey outlined the nature of information to communicate to the clients.[60] This information includes the profit and loss rate applicable to participative accounts. The decree refers to the legal-form principle[61] following which the interest rates are freely set by the banks which open short-term accounts. These rates can differ based on classical economic indicators (interest rate performed by the Central Bank, consumption index, Istanbul Stock Exchange, etc.).

This liberty to freely set the interest rate naturally spreads to credit operations (particularly to consumer credit). Article 3 of the decree exposes the same principle of liberty in terms of investment participative

[59] This article excludes from its scope the participation of the moral or physical persons in the share capital of a private or public company, the payment of sum of money in a waqf, the contributions were paid in the bodies of Social Securities. It's the same for funds paid in development or investment banking or for funds paid for the operations in financial markets.

[60] Decree of the Central Bank of Turkey, 9 December 2006, O.J. 26,371.

[61] Article 144 Of Bank Law.

accounts. These rates need to be known by the Central Bank and available to the clients in the bank agencies.

Permanent Calculation Participative banks have to set up the amounts of the profits and losses every day because the term of the accounts differs from one client to another and needs a daily update from the bank. If the funds are withdrawn before the term of the account, none of the profits can be paid to the client even though a potential profit could have been generated. That is why it is better to wait for the terms of account to expect to gain profits.[62] If the participative bank had invested its own liquidities, no profit will be shared with its clients who will however not suffer from any loss.[63]

Unconditional Withdrawal of Funds Under the provisions of Article 61 of the Bank Law, participative banks do not have the right to impose conditions to their clients that would limit the withdrawal of their funds on their participative accounts. Nevertheless, it is no longer possible to withdraw the funds that are present for ten years in an account that has not registered any transaction during this time (Article 62 of the Law).

Guarantee Funds The existence or not of a guarantee fund is a core aspect in the Islamic qualification of a participative account. Generally, the participative account is backed to *Muḍāraba* contract where the capital of the partner (*rabb al-māl*)—the client in the case of a participative account—has not been guaranteed. This means that an Islamic bank does not pay bonus to warrant the funds poured in a participative account. Also, the client must neither reclaim nor perceive any amount of money from a guarantee fund in case of bankruptcy of his/her bank according to the rules that manage the *Muḍāraba* contract and the principle of the profit and loss sharing. However, the Turkish regulation imposes on the participative banks to subscribe to an insurance by paying bonus to the Guarantee Fund of Deposits. Nevertheless, the Bank Law foresees that the amount of the bonus cannot surpass 20 per 1000 per year.

[62] I. E. Aktepe, *Investment Participative Accounts in Participative Banks*, in Association of Participative Banks of Turkey, *Katilim Finans*, prec., pp. 64–65.

[63] Idem.

12.4.2 The Credit Cards

Application of a Profit Rate All participative banks offer credit cards. Some of them have the originality to apply a profit rate when these credit cards allow their owner the right to pay his purchasing at once or at installments. If the reimbursement of this loan exceeds beyond three months after the purchasing day, a profit rate is applicable because it is the counterpart for the bank to the allocation of credit it made, like, a consumer credit.

It is not about an interest-bearing loan, what the general conditions explicitly indicate, but it is about a loan backed by the *Murābaḥa mechanism* This profit rate is generally fixed. For example, *Turkiye Finans* applies a profit rate of 2.02%. However, in its general terms of sale, there is a penalty clause with a rate fixed at 2.52%.[64]

Fluctuation of Profit Rate The profit rate is subject to fluctuate from a year to another in function of the indicators communicated by the Central Bank. In this case, the client is made aware of it in earliest convenience (generally 30 days before). In a contract, the terms suggest that if the profit rate has changed and the client has paid his loan by the 60th day of this change, this rate gap is not applicable. If the rate becomes excessive, the client is allowed to cancel the contract, as appropriate, after paying his debt which becomes immediately payable.

Cash Advance and Withdrawal Such a credit card can offer to its owner the possibility to demand for a cash advance from his bank adviser. If the cash advance is available, a rate of profit will also apply while knowing that it has the power to modify both the rate as well as the amount of the advance.

Charging the Participative Account The credit card allows, throughout the fund withdrawal, the client to use his money from his participative account or from his current account.

Prohibitive Rates? There are necessarily several types of credit cards (classic, gold, platinum) offered by the banks, which price is changing in function of the rights they allow and the fees they generate for the user. It is

[64] We refer to the Master Agreement of definitive contract proposed by *Turkiye Finans*.

worrying to note that payments and withdrawals over 1000 TL generally lead the bank to perceive commissions which rate is fixed at 1.5%. This rate is considered as prohibitive for many customers.

12.4.3 Islamic Credit Operation

A participative bank provides fund to their clients through different means (1). In order to control the participation to the capital of a corporation, there are different kinds of thresholds (2). Finally, we will study the terms of an Islamic mortgage contract (3).

12.4.3.1 The Different Categories of Islamic Credit

No Legal Definition Article 48 of the Bank Law does not define credit transactions. Nevertheless, it establishes a list of operations from which we understand that credit transactions are direct or indirect provisions of fund to the customers. There are customer credit, credit to professional matter, bills of exchange, endorsements, letter of guarantee, sale of assets on credit, as well as financial instruments opening the right to the bank to demand a claim.

Participative Credits The list of credit transactions is stretchable because the legislators added to the list “similar operation”, what opens the way to any shape of banking innovation. However, it looks like Article L. 313–1 of the French Monetary and Financial Code, with the difference that Article 45 of the Turkish Bank Law also includes participative credit. So, are considered as being credits:

- the provisions of fund backed in movables or real property;
- the payments of the financial services related to the credit transaction;
- the investments applying the principle of the profit and loss sharing;
- the operations on the real estate, on the professional equipment and on the raw materials;
- the financial leasing;
- documentary credits backed in a good;
- the participative investments and
- similar operations.

Variety of Credit Operation It emerges from this list that the Turkish Law took into account the diversity of the Islamic financing. The characteristic feature of these operations is to back a good which reassures (secures) from an Islamic point of view the financing. To be able to include all transactions of Islamic financing, the Bank Law has taken care of considering as being a credit any similar operations realized by the participative banks.

This flexibility of the Turkish Law will allow to include the Islamic banking innovations, given that the criticisms focus essentially on the credits which are backed by the *mourabaha* which is a sale contract where the bank buys cash for the asset and which resells it to its customer on credit, matched by a profit margin.

Banking Innovation To develop credits by applying the principle of the sharing of the profit and the loss, the Association of the Participative Banks of Turkey decided to promote the credit transaction which combines the decreasing *mousharaka* (partnership contract) and the *ijāra* (lease agreement). In reality, the source of this credit is in Article 19 of the Decree applying Bank Law.

This operation aims to finance the real estate projects (residential or professional) by sharing funds bought by the bank and the customer in a participative structure, having the characteristics of a *mousharaka* (company) among which the parts of the bank decrease as the customer pays off funds moved forward by the bank. The customer has the status of a lessee of the company and which pays rents corresponding to the amount of the reimbursement. Finally, the customer stops paying rents because he acquired all the parts of the bank which withdraws by leaving the property title to the customer.

12.4.3.2 *The Rules of Participation of a Bank in the Capital of a Company*

Thresholds to Be Respected It is obvious that the participative bank has to determine the financial capacity of its customer to honor its commitments. The scoring became, in reality, by virtue of the Article 52 of the banking law, a legal obligation following the example of the follow-up of a customer. To limit default risks, the bank can require various categories of guarantees (mortgage, personal guaranty, etc.) according to the quality of

the financed assets. The providing of credit is besides limited to ceilings as mentioned in the following:

- The amount of a single credit cannot exceed 25% of the own funds of a participative bank if the borrowers are their managers or their shareholders.
- The amount of the credit cannot exceed 50% of the own funds of a participative bank if the borrowers hold at least 1% of share capital.
- For a "big credit" when the amounts for a single borrower exceed 10% of the own funds of the bank, the total amount of this kind of credit cannot exceed eight times its own funds.

Limit to the Participation in the Capital of a Project? Article 56 of the Bank Law limits the participation in the capital of another credit institution. Indeed, a participative bank can hold no more than 15% of the shares of a credit institution or a financial institution, and the total amount of its participation cannot exceed 60% of its own funds.

This provision does not have to be read as a limit in providing funds which are based on the principle of the sharing of the losses and the profit. It limits the exposure to the risk of the bank in the financial sector.

Not Absolute Limit Article 57 of the Bank Law gives us more precision on this matter. The principle is that no bank can hold securities valued at amounts exceeding 50% of its own funds. Nevertheless, this article discharges the participative banks of this upper limit when the operations concern securities, equipment, raw materials, including financial rent and all kind of operations applying the principle of the sharing of the losses and the profits.

So, the Turkish Legislation has taken into account specificities of the Islamic bank. But, it is necessary to indicate the risks bound to this exception as far as the banking market and the financial markets seem porous which can lead to unexpected variations on the price of certain products.

12.4.3.3 The Islamic Mortgage

Classical Islamic Operation Generally, mortgage serving to finance the acquisition of an apartment or a house is subject to the law relative to the protection of the consumers. For the participative banks, this kind of

credit is called “financing of the residential property matched by a fixed profit rate”,[65] which is the mechanism of the *mourabaha* that we kept in order to explain below the specificities of this type of financing.

Cost of Credit First, it is important to note that the cost of the credit is going to include not only the profit margin of the banker but also numerous expenses (inspection fees, expertise expenses, all other fees for structuring the mortgage, etc.). So, the credit agreement determines the amount of the funds provided, the rate of profit, the duration and so on.

Then, the bank takes care of including a clause according to which it is not the seller of the asset, but it is an intermediary chosen by the customer to facilitate the financing transaction. However, the bank has the right to inspect the asset, and the customer makes a commitment to pay off expenses engendered by this check. Here, the bank has to make sure that the customer really acquires a real estate which corresponds to the specifications which were communicated to the bank.

A Doubtful Arrangement? In the *mourabaha* credit, the bank is going to acquire the asset from the hands of the seller by paying in cash. Then, he is going to resell on credit the aforementioned asset to it customer, by applying a profit margin. The customer will pay it off by installments. However, another point which must support our critic is the fact that the bank considers that the customer got into debt toward it from the signature of the contract of *mourabaha* even though the customer does not have the ownership of the asset.

Indeed, during the first stage of this financing, the signature of the sale contract in cash concluded between the seller and the bank. After the signature of the contract of *murābaḥa* between the bank and the customer, the latter becomes the owner of the asset. In reality, we observe that these stages and the rules which are governing them were adapted regarding the Islamic Law. It is also necessary to note the practice of the indexation of the funds offered to a currency. It is a very controversial point by the Muslim Scholars because they consider that the indexation is similar to an interest rate.

[65] In this section, we refer to the mortgage proposed by *Turkiye Finans*.

A Doubtful Qualification (or Not): Affected Credit (or Not?) It is interesting to note that the bank specifies in the contract that the credit so granted is not an affected credit but a credit backed on an asset. The bank does not so qualify the contract in order to not support the consequences bound to an affected credit while it exposes, in the contents of the convention, the rules governing this kind of credit.

Thus, it takes care of indicating that the customer has the right to retract, to ask for a discount if the asset presents some defects, to ask for the repair of the asset or to change the asset with an equivalent one. It is rather strange to read that if the customer exercises a right previously expressed, the bank and the seller are jointly responsible. The bank underlines the principle of collective responsibility, that is, responsibility is time-limited and is valid for only one year from the delivery of the good to the customer and for the amount of credit. This obligation seems to be in compliance with the Islamic Law and in compliance with the national law.

But the contract pushes even further by specifying, on the one hand, the address and phone number of the seller and the specifications of the asset under an article entitled *Name and Address of the Seller and the Specifications of the Good, the subject of an affected credit* and, on the other hand, the right of retraction of the customer following the signature of an Agreement entitled "Agreement of cash sale" between the seller and the customer, this agreement producing its effects after the expiration of the deadline of retraction.

Here, we wonder about the reasons which urged the bank not to qualify this financing by affected credit, and the reasons of the signature of an Agreement of cash sale was concluded between the seller and the customer, while this agreement must be concluded between the seller and the bank according to the Islamic Law.

Private Life? There is another point in the credit agreement concerning the documents and information that the customer in case of changing the situation has to supply. Among the quoted cases, the bank requires to be informed if its financial situation has changed, if he is pursued or if he is the subject of a foreclosure.

Reimbursement of Provided Funds and Fees The participative bank sets up a "reimbursement schedule" and it is indicated that part of capital will be payed off by the customer and a part of the profit awarded to the bank every term.

Yet, it is specified well that the rate of profit cannot be changed. This fixed rate indeed has to remain fixed according to the Islamic rules.

Furthermore, the customer has to pay off solicitor's expenses and all the expenses moved forward by the bank to realize the operation. We wonder if the bank should not take in charge some expenses as far as it acquires the asset to resell to the customer. By the majority of the terms of the contract, the participative bank requires that all the expenses relative to the mortgage are supported by the customer.

Indexation It is completely interesting to read in the contracts that the provided funds can be indexed in a foreign currency (generally the USD or the euros). Nevertheless, most of the Muslim Scholars consider that the indexation on a currency is forbidden because it leads to the produced interest. But, in our case, the bank takes care of indicating that funds will be indexed the day when the funds will be reimbursed.

Anticipated Reimbursement When the customer decides to pay off in an anticipated way the funds provided to him, the bank makes a commitment to propose him a discount which will be naturally weighted on the profit margin which is due to the bank.

Restructuring of the Debt The bank and the customer can make a commitment to restructure the debt by modifying the number of term, the rate of profit and/or the conditions of the Agreement. The parties take care of it indicating that this restructuring is not a new financing and that the banker can demand a fee for restructuring where the fee cannot exceed the amount of the discount which would be granted to the customer.

Delay Penalty The contract determines the payment of delay penalty in the case of the customer not honoring one or several terms. The contract fixes the rate of penalty which has not to exceed 30% of the amount of the profits.

In Islamic Law, delay penalties are considered as interests which must be given to charity on behalf of the bank. Unfortunately, this point upsets the specialists of the Islamic finance who judge that this kind of conditions soils the Islamic validity of the contract.

Failure of the Customer If the customer is lacking and cannot pay any more, he has to find with the bank the means to pay off his debt. Generally, there is a personal guarantee or a mortgage to limit the risk of the bank.

Naturally, they can also activate the precautionary measures (restructuring of the debt) or the procedure of liquidation of the financed house. Besides, the bank grants itself the right to preempt all the securities, all the funds and all other convertible goods quickly in liquidity to recover its claim.

Disputes In order to solve the disputes which can arise from the contract of credit, the customer can request the mediation of a body specially dedicated to this objective or start a particular procedure behind the "Court of the consumers". The problem is that there is no provision in the Bank Law in case of violation of the Islamic Law. Given that the Turkish Courts do not apply the Islamic Law, the participative banks insist that the customers and their litigation services request the implementation of a court of arbitration.

12.4.4 Miscellaneous

Adapted Tax System Following the examples of numerous countries which welcome the Islamic finance, Turkey exempted the financing transactions of certain taxes. Such are the cases of double registration fee and fixed taxes which burden the property deals which would come to weigh down the Islamic financing. These exemptions apply in the same way to *ṣukūk*.

Criminal Penalties: Prison and Fines In case of breach of trust imposed by the Bank Law, the authors of these breaches may be condemned to 5 years of prison and a sum equivalent to 5000 "legal days" which have to multiply by 20 or 100 times regarding the nature of breaches. Also, the authors of breach of retention of the funds of the holders of the investment participative accounts can be condemned to 2 years of prison and in a sum of equivalent money in 500 legal days. The penalty is 3 years of prison and a sum of money equivalent to between 1000 and 2000 legal days in case of breach of the bank secrecy.

Rate of Purification The Islamic banks have to purify their income when a part of the income is generated by an operation which is not complied with the Islamic Law. So, the impure income has to be given to a charity. Article 59 of the Bank Law fixed the maximum amount to 4 for 1000 of

the own funds of the bank. It means two things: on the one hand, the participative bank has to manage its activities regarding Islamic Law, and, on the other hand, the Bank Law limits the process of purification.

Finally, Turkey, due to its geographical situation, its population and its economy, can become, in the next decades, the center of the Islamic finance on the condition of well applying the requirements of the Islamic Law, whereas the legal framework is clear enough and precise which permits a reasonable growth of the participative banks during the last decade. Supported by the government, they have an objective to reach 15% of the banking market before 2023.

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CHAPTER 13

Ṣukūk Market in Turkey

Dorsaf Matri

13.1 Introduction

With its unique geostrategic position as a bridge between Europe, the Middle East and Asia, Turkey is ideally positioned for becoming one of the most important players in the global *ṣukūk* market industry.

If Islamic finance has not always been very popular in the country, this sector has grown steadily, and *ṣukūk* are enjoying a steady success.

According to Standard & Poor's, the Islamic finance market currently accounts for nearly 10% of Turkey's banking activity. The emerging Islamic finance industry is referred to as "Participative banks" in order to respect the institutional neutrality of the country.

Having recently implemented major regulatory and infrastructural reforms in the banking sector, the Turkish government has set itself the goal of tripling the proportion of participative banks in the country by 2025.

In its medium-term program for the years 2016–2018, the Turkish government has announced its willingness to continue strengthening the legal and regulatory framework for participative financing and to promote the development of interest-free financial products. In this context, the

D. Matri (✉)
World Bank (IFC, IBRD), Washington, DC, USA

Attorney at Law, Paris, France

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regulator has undertaken to consolidate *ṣukūk* regulation through a major reform adopted in August 2016 to minimize market barriers and increase liquidity.

Encouraged by sovereign issuance and public authorities' enthusiasm, Turkish issuers and investors are now showing growing interest in *ṣukūk*.

In this context, Standard & Poor's[1] stated that the prospects for *ṣukūk* in Turkey were very promising as the market was likely to exceed US$100 billion, especially thanks to investors from the Middle East.

The Turkish government is therefore determined to make Istanbul a financial hub for Islamic finance on a regional and global scale. With a GDP of US$769 billion in 2017,[2] Turkey ranks 18th among the world's largest economies and appears in this context well positioned to become one of the leading players in the global *ṣukūk* market industry.

Despite this potential, there are still many legal and financial hurdles, limiting the development of *ṣukūk* in the country.

It will therefore be necessary to study the particularity of the *ṣukūk* market in Turkey and more precisely the characteristics of this sector and its prospects for evolution (Sect. 13.2), then to analyze the legal and regulatory framework implemented by the public authorities (Sect. 13.3) to better understand what are the major obstacles to the growth of these financial instruments and how to overcome them (Sect. 13.4).

13.2 The *Ṣukūk* Market in Turkey: State of Play and Prospects for Evolution

13.2.1 The Introduction of Ṣukūk *in Turkey*

The market for *ṣukūk* is growing alongside the Islamic finance industry. The global *ṣukūk* outstanding reached an all-time high of US$300.9 billion as of end of 2014, recording a resounding post-financial crisis double-digit compound annual growth rate (CAGR) of 19.56% between 2009 and 2014.[3] This growth had been boosted by the increase of activity in the

[1] D. DEY, "Building the Turkish *ṣukūk* market: One step at time", White & Case, 31 August 2016.

[2] International Monetary Fund (IMF), "Turkey: 2016 Article IV Consultation-Press Release; Staff Report; and Statement by the executive director for Turkey", IMF Country Report n° 18/110, April 2018.

[3] World Bank Group (IBRD), "Turkish *ṣukūk* Market Report", 2016–2017.

primary *ṣukūk* market where annual issuances had surpassed the milestone of US$100 billion mark for three consecutive years between 2012 and 2014.

However, over the recent years, the *ṣukūk* market is experiencing a slowdown due to weaker economic growth and drop in oil prices. From an 11-month total in 2015, the global primary *ṣukūk* market issuances amounted to nearly US$59 billion, with approximately 70.0% of the funds raised by sovereign and government-related entity issuers, and the remaining 30.0% by corporate issuers. The global *ṣukūk* outstanding in November 2015 were valued at US$290.58 billion, a 3.4% contraction as compared to the record value as of end of 2014. This drop in the outstanding volume is attributable to a combination of factors, including a decline in issuances activity in 2015 as well as currency exchange rate movements where local currency *ṣukūk* outstanding are now valued lower in USD terms.[4]

The global *ṣukūk* market witnessed in 2016 a rebound after three consecutive years of decline and increased to a record of US$349.1 billion as of December 2016 (8.7% increase in comparison with end-2015). For instance, in 2016 the global *ṣukūk* issuance posted a growth of 13.2% from the previous year to reach US$74.8 billion.

Despite a predominantly Muslim population and a long presence in the international financial markets as an issuer of conventional bonds, Turkey did not have a significant presence in the *ṣukūk* market before 2010, mainly due to the lack of a legal framework which complies with the requirements of *Sharīʿa*-compliant financings.[5] Thus, the *ṣukūk* market has gradually developed as part of the emergence of the Islamic finance industry in Turkey.

Ṣukūk were introduced for the first time on the Turkish market in April 2010, in the form of secured debt instruments, known as the "lease certificate". These lease certificates enabled the issuance of a *ṣukūk ijāra*. Following this first operation, changes to the tax legislation were implemented to introduce exemptions in order to make *ṣukūk* more attractive for foreign investors.

In order to strengthen investor confidence, the Public Finance Act n°4749 was amended to allow the issuance of sovereign *ṣukūk* in June 2012.

[4] White & Case, "Building the Turkish *ṣukūk* market: One step at time", 2016.

[5] I. CHAPELLIERE, "Le modèle Turc: une référence pour l'implantation de la finance islamique en France?", *La Revue du Financier n°182*, May–June 2010, p. 114.

Following this legal reform, the Turkish treasury issued US$1.5 billion *ṣukūk* in September 2012.

Thus, between 2011 and September 2015, nearly eight sovereign issuances with an approximate total value of US$7.714 billion, and numerous private issuances with an approximate total value of US$4.071 billion have allowed the *ṣukūk* market to stabilize and ensure its sustainability in the country. In 2016, Turkey recorded a notable rise of *ṣukūk* issuance at US$4.1 billion for the year, supported by a number of sovereign issuances with maturity ranging from one to five years (Table 13.1).

13.2.2 The Ṣukūk *Market and Its Prospects for Evolution*

However, if we study in detail the economic structure of the country, we can notice that the *ṣukūk* market contributes only slightly to the overall bond market.

While sovereign *ṣukūk* issues are significantly higher than the private market, they are still quite low compared to the overall bond market in Turkey (Tables 13.2 and 13.3).

Based on the figures below, the total debt securities market (conventional and Islamic) is small compared to Turkey's gross domestic product (GDP). In 2013, Turkish bond market comprised only 25% of the country's GDP. In comparison, the Malaysian bond market in 2013 comprised 103% of the country's GDP.

Therefore, the conventional as well as the Islamic bond markets in Turkey remain in a nascent state and require significant development (Table 13.4).

This fragility of the Turkish bond market is partly explained by the omnipresence of the banks in the financial fabric of the country which is currently hampering the development of financial markets.

This point is especially true for *ṣukūk* where it is again the participative banks that monopolize the market, leaving little room for private issuers.

Participative banks were introduced in 1985 with the establishment of the banks Kuveyt Türk and Albaraka Türk. In the 1990s, two additional participative banks were established: Türkiye Finans and Bank Asya, which increased the market share of participative banks in the Turkish banking market to 5% in 2010.[6]

[6] I. CHAPELLIERE, "Le modèle Turc: une référence pour l'implantation de la finance islamique en France?", *La Revue du Financier n°182*, May–June 2010, p.114. E. BRACK, *Systèmes Bancaires et Financiers des pays arabes: vers un modèle commun?*, L'Harmattan, 2012.

Table 13.1 Recent *ṣukūk* issuances

Ṣukūk name	*Türkiye Finans Participation Bank*	*Albaraka Türk Participation Bank*	*Turkey 2024*	*Turkey February 2017*	*Turkey August 2017*	*Albaraka Türk 2025*	*Kuwait Finance House Turkey 2026*	*Kurveyt Türk 2018*	*Turkey 2021*
Structure	*Muḍāraba*	*Wakālā/ Murābaḥa*	*Ijāra*	*Ijāra*	*Ijāra*	*Murābaḥa* (Tier II)	*Wakālā* (Tier II)	*Wakālā*	*Ijāra*
Currency	US$	US$	US$	TRY	TRY	US$	US$	TRY	US$
Tenor (years)	5	5	10	728 days	2	10	10	729 days	5
Closing date	16/4/2014	1/7/2014	18/11/2014	18/2/2015	19/8/2015	30/11/2015	17/2/2016	25/4/2016	8/6/2016
Issue size	500 m	350 m	1bn	TRY 1.8bn	TRY 16bn	250 m	350 m	TRY10m	1bn
Issuer name	Tükiye Finans ALC	Bereket ALC	Treasury ALC	Treasury ALC	Treasury ALC	Albaraka *ṣukūk* Ltd	KT *ṣukūk* Company Ltd	Kuveyt Türk ALC	Treasury ALC

Source: The Capital Markets for Board of Turkey: publicly available sources

Table 13.2 Sovereign *ṣukūk* Issues (2011–2015)

	Issue amount (USD Billion)	*Average maturity (Years)*
Domestic	3964	2.14
Cross-border	3750	6.83

Table 13.3 Private *ṣukūk* issues (2011–2015)

	Issue amount (USD Billion)	*Average maturity (Years)*
Domestic	1402	0.78
Cross-border	2669	5.01

Source: IIFM (2016), 5th Edition Sukuk Report

Table 13.4 Bond market in Turkey

In billions of USD (USD)	*2011*	*2012*	*2013*	*2014*	*2015 (Q3)*
Domestic issues					
Total debt securities	252.7	297.7	286.4	294.6	255.5
Financial institutions	11.2	27.5	37	49.8	46.2
Non-financial institutions	0.3	2	5.2	8	7.8
General government	241.2	268.2	244.3	236.8	201.5
Domestic debt	202.2	232.6	205.6	198.1	159
Financial institutions	7.3	15	15.1	16.4	12.6
Non-financial institutions	0.1	0.6	1.8	3	2.5
General government	194.8	216.9	188.7	178.7	143.9
International debt	54.7	70.9	90.2	111.3	112.2
Banks	6.5	15	25.6	40.9	41.9
Other financial institutions	0.9	0.7	0.8	1.3	1.3
Non-financial institutions	0.4	1.6	4.6	6.5	6.8
General government	46.9	53.5	59.3	62.5	62.1
National issuers					
International debt	61.3	74.3	90.7	106.6	107.1
Banks	10.5	15.5	24.1	35.8	36.8
Other financial institutions	3.3	3.7	3.6	3.5	3.2
Non-financial institutions	0.6	1.6	3.8	4.7	5

Source: www.bis.org

The Turkish government is currently working to increase this market share to 15% by 2025. It is expected that new participative banks such as Vakif Participation and Ziraat Participation will take part in the *ṣukūk* market.

For instance, in 2016, Kuveyt Türk Bank issued a Level 2 *ṣukūk* compliant with Basel III and with a maturity of ten years for US$350 million. This transaction is currently the first issuance of *ṣukūk* investment grade by a Turkish Participative Bank. The amount of this issuance is the highest ever issued abroad.

This *ṣukūk* was issued by KT *ṣukūk* Company, an SPV established specifically to carry out the operation. This issuance has been rated BBB− by Fitch Rating and is listed on the Irish Stock Exchange.

However, despite the viability of the *ṣukūk* market in Turkey, we can notice that there is currently only few corporate *ṣukūk* issuance in the country.

In June 2016, the participative banks were the only corporate *ṣukūk* issuers in the country. However, efforts have been made, and some participative banks have attempted to fill these gaps by allowing leasing companies (LACs) to play a part in the issuance of *ṣukūk*.

In addition to the numerous sovereign issuances made by traditional players in the Islamic finance industry (such as Turkey, Indonesia, Malaysia, the United Arab Emirates and some Middle Eastern countries) and new issuing countries (such as the UK, South Africa, Hong Kong and Luxembourg), numerous international corporate *ṣukūk* issuance, mainly from issuers located in the Gulf Cooperation Council (GCC) countries and in Southeast Asia, have been achieved in recent years.[7]

On a global scale, corporate *ṣukūk* issuance accounted for 36% of total international *ṣukūk* issuances in 2014 and 39% of volume in 2015.

However, things have changed over the past years and in contrast to historical trends where issuance was driven by sovereigns, corporate issuers dominated the market in 2016, producing a volume of US$47.3 billion, representing a share of 63.2%.

The participation of new issuers (in particular, the UK and Luxembourg, both rated AAA by Standard & Poor's) has been warmly welcomed by other market players as sovereign issuance in these countries opens the way to companies' participation to the *ṣukūk* market.

[7] M. YEGIN, "The emergence of the Turkish *ṣukūk* market", *YEGIN CIFTCI Law Firm*, January 2015.

However, corporate *ṣukūk* are not limited to issuers from GCC or Southeast Asia. Between 2012 and 2014, two corporate *ṣukūk* issues were carried out in France, one in Germany and one program was approved by the Turkish government.

Of the *ṣukūk* issued by companies in GCC and Malaysia, 49 are listed on the London Stock Exchange, 29 are listed on the Irish Stock Exchange, 16 are listed on the Luxembourg Stock Exchange and 13 are listed on the Frankfurt Stock Exchange.

While providing an alternative source of financing for Turkish companies, this variety of *ṣukūk* can also be useful in bridging the funding gap for some projects, particularly for infrastructure construction and the establishment of private-public partnerships (PPPs).[8]

13.3 Analysis of the Existing Legal and Regulatory Framework

The legal and regulatory framework for *ṣukūk* has been gradually established in Turkey through a number of reforms in the public and private sectors.

The initial legislative act relating to the introduction of *ṣukūk* in Turkey was a communiqué (statement) issued by the Capital Markets Board of Turkey in April 2010 entitled *Communiqué on the Principles pertaining to Lease Certificates and Asset Leasing Companies*. This communiqué which has now been repealed, concerned only *ṣukūk* al-*ijāra*.

This initial communiqué introduced an onshore special-purpose entity called an asset leasing company ("ALC") to act as the issuing entity of the lease certificates (*ṣukūk*).

Following the issuance of this Communiqué, amendments to the tax laws were introduced in February 2011 by Bucket Law N°6111 (the "Bucket Law").[9]

The purpose of these reforms is to create a taxation regime closer to Conventional Instruments through a set of exemptions. Bucket Law N°6111 has introduced exemptions from notary fees, taxes on the land registry and some registration fees relating to the transfer of property and

[8] For instance, since December 2015, Turkish companies have been seeking US$350 billion to complete a backlog of planned projects until 2023, most of which could be provided by Islamic funding.

[9] Tax Amnesty Law n°6111 of 25 February 2011.

intangible assets to ALCs.[10] The legal structure of the contemporary *ṣukūk* market in Turkey was established in 2012 and 2013 with the adoption of the new Capital Markets Law in December 2012, including Article 61 which regulates *ṣukūk*.[11]

In June 2012, the Public Finance Law No. 4749 was amended to facilitate the issuance of sovereign *ṣukūk*.[12] In April 2013, Article 7/A of the Public Finance Law was amended to allow the issuance of *ṣukūk* by the Turkish Treasury and public institutions.

Article 7/A states that leasing companies are authorized to buy, sell, redeem, lease and transfer securities of tangible assets (including movable and immovable property) and intangible assets belonging to the state.

In order to facilitate the issuance of *ṣukūk*, Article 7/A of the Public Finance Act also authorizes the Deputy Prime Minister for Economic and Financial Affairs to establish a leasing company ("ALC") and to transfer to an ALC some property assets belonging to the State.

In order to support the efforts of the Capital Market Board to promote the issuance of *ṣukūk* in Turkey, tax legislation has been amended to introduce certain exemptions for *ṣukūk ijāra* issuers.

In this context:

- profits from the sale of a portfolio of assets by a lender to an ALC are now exempt from corporate income tax;
- *ṣukūk*'s settlement-delivery to *ṣukūk* holders is exempt from value-added tax (VAT);
- The sale of portfolio of assets is exempt from the payment of certain fees, such as registration fees of the property deed and other fees; and
- Income of *ṣukūk* holders holding *ṣukūk* with a maturity of five years or more is exempt from withholding tax;

  Documents relating to the transfer of assets and leases executed by and between lenders and ALCs are exempt from the payment of the tax stamp.

[10] These exemptions were introduced by the amendment of Article 123/4 of the Tax Law n° 492. Changes were also made to Article 15/C of Law n°5520 on the taxation of enterprises and Article 75 of the Income Tax Law n°193.

[11] See Article 61 of the Capital Market Law n°6362.

[12] Cf. see Law n°4749 on Public Finances; Law on Public Financing of December 2014 and Law n°5393 on Municipalities.

Despite these initiatives, exemptions were applied mainly to *ṣukūk ijāra*, and did not sufficiently cover other *ṣukūk* structures, which created uncertainty among potential issuers and sellers. To remove this uncertainty and encourage other *ṣukūk* issuance, the Turkish bill on improving the investment environment (the "Omnibus Bill") was promulgated on 9 August 2016, introducing tax exemptions for all the types of *ṣukūk*. In this regard, the omnibus bill amended stamp duty, value-added tax and royalty laws. This reform notably introduced an exemption from the payment of the stamp duty for all the documentation related to the issuance of a *ṣukūk* as well as the exemption from customs duties unlike the old regulation that provided this type of exemptions only for *ijāra ṣukūk*.

In addition, the Omnibus Bill amended the Corporate Tax Law, introducing corporate income tax exemption to the income derived from sale and purchase back of all assets and rights by and between ALCs and originators. This exemption ensured originators and ALCs (issuers) that no corporate income tax would be levied on the income derived from sale and purchase back of *ṣukūk* assets.

Nevertheless, it should be noted that Article 7/A of the Public Finance Law No. 4749 only covers the structuring of *ṣukūk* al-*ijāra*.

While, since 2013, the law on capital markets now allows the issuance of various forms of *ṣukūk* including *ṣukūk Wakālā*, *Murābaḥa*, *Mushāraka* and *Istiṣnāᶜ*, we note, however, that the majority of *ṣukūk* that have been issued in recent years in the country rested on the *Ijāra* structure.

Under *ijāra ṣukūk*, the most common *ṣukūk* structure in Turkish practice, the entity seeking to raise funds through an issuance of *ijāra ṣukūk* establishes a special-purpose vehicle (SPV) for the sole purpose of issuing lease certificates, and then transfers the underlying assets to the SPV. The SPV then leases these assets back to the entity and issues lease certificates based on the proceeds of the lease. Lease certificates representing the ownership share in the underlying asset entitle their holders to a pro rata share of the proceeds generated by the asset.

The SPV is established as a joint stock company upon approval by the CMB. The lease certificates may be sold through either public offering or private placement. The CMB does not require a prospectus for a private placement sale.[13]

[13] White & Case, "Building the Turkish *ṣukūk* market: One step at time", 2016.

The development of *ijāra-ṣukūk* is mainly due to the existence of a more favorable tax regime for *ijāra*-type structures even though similar exemptions are not provided for the *Wakālā*, *Murābaḥa*, *Muḍāraba*, *Mushāraka* and *Istiṣnāʿ* structures. Thus, it is now more profitable for an investor to issue *ṣukūk* in Turkey using the *Ijāra* structure.

In its report on the development of participative finance in Turkey, the World Bank recommended amending Article 7/A of the Public Finance Act No. 4749 to also promote the issuance of other categories of *ṣukūk*.[14]

Following the regulatory changes implemented pursuant to the Communique on Lease Certificates (III-61.1) in 2013, the CMB introduced new permitted *ṣukūk* structures (in addition to the *ijāra* structure covered under the previous regulation), including *muḍāraba*, *murābaḥa*, *mushāraka* and *Istiṣnāʿ*.

Under the Communique, originators must conduct *ṣukūk* issuances via ALCs, which may only be established by certain entities such as banks, intermediary institutions, mortgage financing institutions, real estate investment trusts listed on a stock exchange, first- and second-group public companies listed on Borsa Istanbul, companies maintaining a long-term investment-grade rating and companies owned 51% or more by the Turkish Treasury.

Entities listed under the last three categories above may establish ALCs only for issuances in which they also act as originator. In other words, only ALCs established by banks and intermediary institutions may issue *ṣukūk* for an originator other than its founder corporation. Originators seeking to issue *ṣukūk* must liaise with a bank or intermediary institution in order to conduct *ṣukūk* offerings, unless they obtain a long-term investment-grade rating or are ranked among the first- or second-group public companies listed on Borsa Istanbul. This obligation and its associated expenses may prove too burdensome for some corporations.

It follows, therefore, that Law No. 4749 does not allow other entities including municipalities to establish an ALC for the purpose of issuing a *ṣukūk*.

Thus, while there is already a favorable legal and regulatory framework for *ṣukūk* in Turkey, many reforms are still needed to broaden the range of issuers and allow for a more diversified category of Islamic financial instruments.

[14] World Bank Group (IBRD), "Turkish *ṣukūk* Market Report", 2016–2017.

In addition to the existence of legal issues, other economic and financial obstacles currently prevent optimal development of the *ṣukūk* market in Turkey.

13.4 Major Barriers to the Growth of the *Ṣukūk* Market in Turkey

Certain conditions are required to develop a viable financial market a fortiori when one wishes to market products such as *ṣukūk* that require the establishment of an environment adapted to Islamic financial instruments.

However, several essential elements are currently lacking on the *ṣukūk* market in Turkey, such as the absence of liquid instruments in the short term or the impossibility of using *ṣukūk* as collateral in a financing transaction.

The structures necessary for the development of this market are also not organized enough. For example, rating agencies have not been sufficiently present and intervene on too few transactions. There are currently two credit rating agencies on the Turkish market, Fitch Ratings (Fitch) and JCR Eurasia Rating (JCR). Fitch has been present in Turkey since 1999 and has registered 70 companies in the country—45 banks and non-bank financial institutions and 25 private and local enterprises.

Although Fitch is considered reliable by investors, the agency applies a severe rating to companies it evaluates in Turkey, especially private companies. JCR has been present in Turkey since 2007 as a subsidiary of Japan Credit Rating Ltd. To date, JCR has evaluated (47 financial institutions and (83) private enterprises (non-financial institutions). Overall, the figures for both agencies are quite modest, considering the size and scale of the Turkish market.

At present, the supply in the *ṣukūk* market in Turkey remains limited and few issuers offer Islamic financial products to investors. We also see the same problem in the conventional bond market.

Overall, the range of issuers includes the government and some private companies (mainly financial institutions). Clearly, an environment conducive to the bond market is lacking, and therefore, the *ṣukūk* market remains hampered by structural problems such as the cost of operations and a lack of underlying assets. These elements ultimately have a negative impact on the growth of the *ṣukūk* market.[15]

[15] D. DEY, "Building the Turkish *ṣukūk* market: One step at time", *White & Case*, 31 August 2016. See also A.CEYLAN and A.BUYUKATAK, "Country Report: Turkey. Islamic Finance continues rising in Turkey", *IFN: Islamic Finance News*, 2016.

The lack of liquidity is evident in secondary markets, which discourages investors from investing in *ṣukūk* because of liquidity problems. In addition, the majority of *ṣukūk* on the market are held to maturity by investors, especially participative banks because of the minimal supply on the market.

In addition, the Turkish market (conventional as well as *ṣukūk*) lacks a diversified investor base, thus reducing the global demand for these instruments and resulting in an underdeveloped bond market. The *ṣukūk* investor base consists mainly of participative banks. Obviously, there is a need for investors in the medium and long term to generate interest in this type of product.

Despite these shortcomings, the Turkish market still offers strong infrastructures for clearing and settlement procedures. Takasbank and Markezi Kayit Kurulusu (MKK) operate under the supervision of the Turkish Capital Markets Board and provide, respectively, the central clearing and settlement infrastructure and the securities register. This infrastructure provides a comprehensive *ṣukūk* database (as well as conventional debt securities) and greatly facilitates access to the secondary market through the benchmarking of instruments on Bursa Istanbul.

Other factors also hinder the growth of the *ṣukūk* market in Turkey.

The Turkish financial market must put in place a suitable legal framework for *Sharīʿa* governance. Such a framework would establish standards (e.g., standardized documentation) in the Islamic financial industry while ensuring the protection of investors and ensuring the Islamic conformity of products. The essential elements for the establishment of good Islamic governance are[16]:

(a) establishment of a *Sharīʿa* board/committee within participating banks and financial institutions marketing *ṣukūk*;
(b) increased risk control on Islamic financial products; and
(c) audit of *Sharīʿa* Committees.

Indeed, there is evidence in the Turkish *ṣukūk* market, few standardized standards in Islamic finance necessary to ensure the integrity of financial transactions. These standards are essential to protect investors.

In addition to this point, the country has a low level of savings. Turkey has a low level of savings resulting mainly from the absence of a compul-

[16] World Bank Group (IBRD), "Turkish *ṣukūk* Market Report", 2016–2017.

sory pension scheme. At present, there are several pension funds in Turkey. However, they remain optional and are reluctant to invest in *ṣukūk* as they seek shorter-term investment instruments.

Volumes to date in the *ṣukūk* market are quite modest and, as a result, the few investors seeking such instruments (mainly the participative banks) generally buy and hold their securities. There is also very little *ṣukūk* on the secondary market. These elements as well as the lack of major market players currently discourage investors from investing in these products.

The majority of *ṣukūk* on the Turkish market are based on an *Ijāra* structure. The offer is therefore not diversified enough and should therefore be developed to attract more investors.

The lack of awareness and knowledge of the *ṣukūk* market is another problem for Turkey. It would be useful for intermediaries such as investment banks and asset management companies to take the time to inform investors about the nature of Islamic financial products and advise them in their choices.

Finally, conventional and Islamic financial markets remain embryonic in Turkey. As is the case with other emerging financial markets, the *ṣukūk* market in Turkey may have difficulty developing alongside the conventional bond industry due to higher issuance costs and regulatory requirements heavier for Islamic transactions. Therefore, the country's authorities should ensure a level playing field for these two sectors.

13.5 Conclusion

While there is no doubt that *ṣukūk* will assume an increasingly important role as a financial instrument for economic development, it is clear that Turkey will be one of the countries that will shape the future of the *ṣukūk* market on a global scale.

Although *ṣukūk* issuance in the country is still at a preliminary stage, the desire to grow the industry is strong from both the government and private sector issuers.

Yet, despite the stated willingness of the government to develop the *ṣukūk* market, many structural problems remain and the supply remains limited for investors.

Efforts still need to be made to ensure a stable environment conducive to the development of this promising market.

Undoubtedly, Turkey will meet this challenge brilliantly in the years to come.

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