CHAPTER 2

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

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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.

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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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-compliant investment funds.

[16] Eleanor de Rosmorduc, Florence Stainer (2013), Luxembourg: a leading domicile for *Sharīᶜa* 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 *Sharīʿa*-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 *Sharīʿa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-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 *Sharīᶜa*-compliant financial undertakings as ethical businesses is easily inferred from the sources of *Sharīᶜa* law. By contrast, the comparison between Islamic finance and socially responsible enterprises may be explained by referring to *Sharīᶜa* 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 *Sharīᶜa*-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 ͨ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 ͨa* rules and implies that Islamic financial undertakings, based upon *Sharī ͨ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 ͨa* is something other than *fiqh*: while *Sharī ͨ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 ͨ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 ͨ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 apotictically 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 *Sharīʿa* 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 *Sharīʿa* 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 *Sharīᶜa* (according to a large number of *Sharīᶜa* 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 *Sharīᶜa*-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 *Sharīᶜa* 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 *Sharīᶜa* compliant, but the bank's unrestricted investment accounts (being contractually 'capital certain') were not themselves *Sharīᶜa* 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 *Sharīᶜa*-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.

– *Sharī*ᶜ*a*-compliant activity is comparable to the legality control performed by a company's auditors, where the legal order to comply with consists of *Sharī*ᶜ*a* rules and principles. This type of control prevents any financial undertaking claiming to be *Sharī*ᶜ*a* -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, *Sharī*ᶜ*a*-compliant activity highlights the so-called *Sharī*ᶜ*a* 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 *Sharī*ᶜ*a* 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 *Sharī*ᶜ*a* defence" is often used to mitigate *Sharī*ᶜ*a* 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 *Sharī*ᶜ*a* principles. Additionally, such a contract clause may often provide for an "explicit statement on *Sharī*ᶜ*a* compliance, pursuant to which the parties agree to follow the interpretation of the bank's own *Sharī*ᶜ*a* board as far as the transaction is concerned".[80]

[77] See: Kilian Bälz (2008), *Sharī*ᶜ*a* risk? How Islamic finance has transformed Islamic contract law, Harvard Law School: Occasional Paper, n. 9, p. 23. Mr. Bälz referred to *Sharī*ᶜ*a* risk, adding that "[l]aw provides transaction security. In Islamic finance, the role of *Sharī*ᶜ*a* is reversed. *Sharī*ᶜ*a* 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 *Sharī*ᶜ*a* 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 *Sharīʿa* 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 *Sharī ͨa* rules may influence how Islamic finance is accommodated within the EU-based framework.

At the moment, three regulatory options may be addressed:

(a) *Sharī ͨa* 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) *Sharī ͨa* 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^ca*-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^ca* 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 *Sharīᶜa* 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 *Sharīᶜa* 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 *Sharī*[c]*a* 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 *Sharī*[c]*a*-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 *Sharī*[c]*a* 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 *Sharī*[c]*a* 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 *Sharī*[c]*a* 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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[111] Gabriella Gimigliano (2013), Islamic banking in the European Union legal framework, in Cattelan, V. (ed), Islamic finance in Europe. Towards a plural financial system, Edward Elgar publishing: Cheltenham, Glos, UK, pp. 143–156.

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