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FIRST EUROPEAN MOVERS IN REGULATION OF ISLAMIC FINANCE

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─Abstract ─

Before the crisis, for the most of European decision makers, Islamic finance was an exotic issue. Nowadays more and more European governments are interested in set up Islamic part of their financial system.

We have researched the latest developments in EU member countries which made opportunity for this financial market segment with making special regulation for that. A comparison was made between the European regulatory examples and countries which have dominating Islamic finance segment in their financial sector.

Key Words: *Islamic finance, conventional finance, regulation*

JEL Classification: G28

1. INTRODUCTION

Before reviewing the latest regulatory issues of the Islamic financial segment, we shortly summarize the historical, religious and moral foundations that will help to understand this topic in more depth. "Render therefore unto Caesar the things which be Caesar's, and unto God the things which be God's." [Luke 20:25]

To understand the world of Islamic finance, let us briefly look at how monotheistic religions relate to economy and money. Ancient people felt completely vulnerable. They found the forces of nature and their life environment uncontrollable. This situation was fundamentally changed by The Old Testament. According to Jewish social and economic teachings, we are responsible for our actions. An important task on Earth is to preserve and transmit human dignity to the next generations. The Jewish doctrine places great emphasis on co-operation, seen in institutions which form basic social units such as the family or religious communities. [Botos, 2009]

The obligation to accumulate, preserve and pass on knowledge greatly contributed to the survival of the Jewish community and to the foundation of the successes in the past centuries of the “Western world” based on the Judeo-Christian culture.

Another pillar of Jewish teachings is the principle of correct and equitable lifestyle, leading to the emergence of the obligation of “charity”. This stated that no one was allowed to remain without their basic needs being satisfied; those, to who God gave more, are obliged to help those who are unable to satisfy their needs even at the minimum level. [Botos, 2009]

Christianity is deeply rooted in the teachings of the Old Testament. A new element appeared, the commandment of love, especially towards God but also the love of neighbours, even if our neighbour is also our enemy. Christianity places great emphasis on learning about the world and holds that God created people equal and to his own image. Being the children of God, we have a special property called logic that helps us learn about and influence the world around us.

Further basic values of Christian teaching are individual dignity and the respect for private property. Equality before God was also a foundation for the democratic nature of the “Western” social development. Like Jewish teachings, Christianity believes that we can preserve the world and sustain our lives with our responsible actions. [Botos, 2009]

The Catholic Church expresses its opinion in a large number of economic issues (perhaps Papal encyclicals about this topic should deserve more attention, as from an economic point of view the Roman Catholic Church is the world's oldest economic operator, and, consequently, the most successful organization (too)). These, from an economic viewpoint scholarly, statements all rely on the above-mentioned fundamental grounds and give very up to date (of course, non-technical) answers to today's economic and social challenges.

Islam is the second largest religious community in Europe and America and an estimated 20% of the world’s population is Muslim. Islam has the same roots as the Judeo-Christian cultural sphere (the three monotheistic religions are collectively referred to as Abrahamic religions).

In Arabic, the word Islam means submission, i.e. to submit ourselves to God's (Allah's) will, to entrust ourselves to God's will. It is not only a religion, but also a lifestyle and way of thinking. Muhammad began preaching Islam and its essence, monotheism in Mecca in 610, when angel Gabriel first conveyed to him Allah's final revelation, the Qur'an (the holy book of Islam). According to Islam, the Christian Holy Trinity assumes three divine persons; therefore, it cannot be a monotheistic religion. Muhammad (prophet founder of Islam) left Mecca in 622, and preached Islam as a final and universal divine teaching to the whole world until his death (632) in Medina. Islam requires that six basic tenets be accepted: faith in Allah, his angels, writings, delegates, afterlife, and predestination. It commands respect for several biblical personalities, including Noah, Abraham, Moses and Jesus (who is not considered a divine person). It agrees with a lot of Biblical statement, however, believes that only a part of the Bible comes from God. In Islam, the Qur'an is God's ultimate revelation. This religion is also characterized by the belief in the supernatural life and accepts that God will judge everyone on the day of resurrection. These beliefs strongly pervade the everyday life of the Muslims in the 21st century as well. [Bernard Lewis –Buntzie Ellis Churchill, 2009]

Islam views the world as connections in a network. The changes that are essential elements of economic activity (may) interfere with these connections. For many social scientists dealing with this topic, this is one of the reasons why the competitiveness of Islamic countries is not necessarily at the top of such rankings. Islam accepts the existence of individual interests, but does not embrace market fundamentalism. Islamic people have the right to private enterprise and private property, but religion sets moral limits to individuals. The supreme command to Muslim believers is to respect justice. All human activities must comply with a moral minimum, which may not be overridden by the business rationalities of today's Western world.

3. THE FUNDAMENTAL DIFFFERENCE BETWEEN ISLAMIC FINANCE AND THE CONVENTIONAL MODEL OF FINANCE

Following a brief review of the historical and religious roots it is worth exploring the meaning of Islamic Finance, and the content that this expression carries. „In the fact, the expression „Islamic Finance" two competition forces at work. The noun "finance" suggests that Islamic financial markets and institutions deal with the allocation of financial credit and risk. Thus Islamic finance must be essentially similar to other form of finance. On the other hand the adjective "Islamic" suggests some fundamental differences between Islamic finance and its conventional counterpart. Observes of the theory and practice of Islamic finance sense this tension between attempts to be essentially similar to conventional finance (emphasizing competitiveness and efficiency) and attempts to preserve a distinctive Islamic character (emphasizing Arabic contract names and certification by religious scholars)." [Mahmoud A. El Gamal: Islamic finance, economics, and practice, Cambridge 2006].

Under conventional finance we here understand the classic European economic model, the financial, economic structure developed through historical evolution, and the principles, motivations and individual elements constituting such.

The fundamental difference between Islamic Finance and the conventional model of economics and finance, manifesting also in practice is one of the important principles derived from the Qur'an and applied in Islamic Finance which declares that „Islam forbids interest" (Riba). Naturally, this simplified principle in itself only enhances the understanding of the differences between the two financial systems together with the underlying content; the mere referral to the mentioned principle would be insufficient for the proper understanding.

The difference lies on the most part in the expenditure elements appearing in the individual transactions and processes, the role of such elements, the form and manner of financing, but to even higher extent in the diversification of bearing risks and the risks themselves, profit sharing and the joint bearing of losses. The „Islam forbids interest" principle and the religious and moral message carried thereby probably enhance the distinguishing to the largest extent based on these characteristics. Of course there is a long list of principles that influence Islamic Finance, e.g. „the Islamic economic model emphasises fairness" or "the contractual certainty" or "the prohibition of excessive risk undertaking".

The above principles and characteristics are such that may make Islamic Finance attractive not only for the followers of Islamic faith, but also for those who – in the present situation of world economic crisis - are searching for alternatives of the renewal of the economic and finance systems of the world presently in a crisis.

The renewing power of the Islamic Finance as a finance model – among others – is that in comparison with the economics of European and non-European countries, mostly Christian based, but during history distorted in values (conventional economics), through the values carried by the Islamic faith, it is able to properly enforce these moral and religious norms, and by such to establish a uniform financial practice.

There are two substantial issues and tasks to be emphasised in this respect. On one hand it is necessary to examine and ensure that the already evolved products and processes of Islamic Finance are implementable to the established legal system and practice of a certain country; on the other hand it is necessary to provide such institutional frames which guarantee that the products and processes worked out in this manner are entirely in full compliance with Islamic law, the prescriptions Qur'an (Shariah compliant products and transactions).

In the „Islamic Countries" the development of the Islamic Finance and the Islamic law has been parallel, as both have evolved based on the prescriptions of the Qur'an.

However, regarding the European countries the case is that the fundaments of Islamic Finance had to be laid down within the framework of a legal system based on a different religious, cultural and historical foundations, in such manner that there are substantial differences also between the individual European countries, namely in the first place the differences between the Anglo-Saxon precedent oriented legal system of the United Kingdom having established the legal frames required for Islamic Finance, and the continental legal systems of other European countries not belonging to the United Kingdom.

4. ISLAMIC FINANCE AND ITS REGULATION IN EU COUNTRIES

4.1. United Kingdom

The UK is the largest Islamic Centre in Europe, with $19bn out of global assets of $1,7trn and is home to fully Sharia-compliant banks.

The fact that the united Kingdom is the international central scene of financial life, and that approximately 4.6 % of its population that is around 2,869,000 persons are of the Islamic faith – in our view – have together resulted that the United Kingdom has taken prominent role in the European regulation of Islamic Finance, and that as of today London has become one of the centres of Islamic Finance.

"Most of the growth of the Islamic Finance in the UK has taken place in the last ten years, but the existence of Sharia-compliant transactions in the London financial markets goes back to the 1980s. Commodity Murabaha (which is a mechanism used to create a Sharia-compliant form of short term deposit/placement by way of transactions in commodities, usually metals) type transactions trough the London Metal Exchange were used, in significant volumes, to give liquidity to Middle Eastern institutions and other investors that fostered the development of a wholesale market in the UK. This did not, however, cater for retail Muslim consumers, as the products developed at the time were aimed exclusively at wholesale and high-net-worth investors. These products were relatively uncomplicated in structure and fell outside the scope of the regulators. Retail Islamic products first appeared in the UK in 1990s but only on a very limited scale. A few banks from the Middle East and South East Asia began to offer simple products such as home finance. The growth of the retail market remained slow throughout the 1990s and early 2000s. Much has changed since then. Both of the wholesale and the retail side, the quality of the products has improved, a wider range of products has become available; and more players have entered the market." [Financial Services Authority, Michael Ainly and co-authors: Islamic Finance in the UK: Regulation and challenges, 2007]

"Since the early 2000s the government, for reasons of wider public policy, has introduced a series of tax and legislative changes specifically designed remove obstacles to the development of Islamic finance. The first significant change came in the Finance Act 2003 which introduced relief to prevent multiple payment of Stamp Duty Land Tax on Islamic mortgages. The Finance Acts 2005 and 2006 contained further measures aimed at putting other Islamic products on the same tax footing as their conventional counterparts. The Finance Act 2007 clarified the tax framework further, in case of Sukuk (bonds). The banking regulators, the Bank of England and, from 1998, the Financial Services Authority (FSA) have been open to the development of Islamic Finance in the UK for some time" [Financial Services Authority, Michael Ainly and co-authors: Islamic Finance in the UK: Regulation and challenges, 2007]

„The FSA operates under a single piece of legislation that applies to all sectors, the Financial Services and Markets Act 2000. The FSA's policy towards Islamic banks, and indeed any new or innovative financial services company, can be summed up simply as "no obstacles, no special favours". One of the most important issues for the FSA is that of Islamic deposits. The UK legal definition of a deposit is: "a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties". In other words, money placed on deposit must be capital certain. For a simple non-interest bearing account there is no problem. The bank safeguards the customer's money and returns it when the terms of the account require it to do so. However with a savings account there is a potential conflict between UK law, which requires capital certainty, and Sharia law, which requires the customer to accept the risk of a loss in order to have the possibility of a return. Islamic banks resolve this problem by offering full repayment of the investment but informing the customer how much should be repayable to comply with the risk-sharing formulation. This allows customers to choose not to accept full repayment if their religious convictions dictate otherwise. [Financial Services Authority, Michael Ainly and co-authors: Islamic Finance in the UK: Regulation and challenges, 2007]

Currently 22 such banks operate within the UK, which are licensed to conduct Islamic finance products. In the first terminal in 2012 the Abu Dhabi Islamic Bank (ADIB), the second largest Islamic lender in the United Arab Emirates, opened its first branch in London. ADIB is the first UAE-based financial institution to receive a banking operation licence from the UK Financial Services Authority. Britain's largest standalone sharia bank, Bank of London and the Middle East (BLME) (is awaiting regulatory approval to move in the reverse direction to tap into the close ties between the Gulf and the UK.)

"Anyone seeking to conduct a regulated activity in the UK is required to apply to the FSA for a permission under Part IV of the Financial Services and Markets Act 2000. All financial institutions authorised by the FSA and operating in the UK, or seeking to do so, are subject to the same standards. The FSA also has to consider the role of the Sharia Board (SSB). The industry defines the key objective of SSB scholars as ensuring Sharia compliance in all entity's products and transactions. The FSA is in no position to assess the suitability of the scholars consulted by Islamic firms. [Financial Services Authority, Michael Ainly and co-authors: Islamic Finance in the UK: Regulation and challenges, 2007]

4.2. Germany

Despite the fact that almost 9.3 % of the European Muslim population, about 4,119,000 people live in Germany, the major European players, Germany remains reluctant to embrace Islamic finance within its legal and tax systems though the globally-thriving industry is already making inroads into its economy.

In Germany Islamic finance as a professional area is under continuous movement, as the German market carries huge potential. It is sufficient merely to take into account the large number of the Muslim population – half of which originates from Turkey – and the fact that Frankfurt is among the most important financial centres of the world, and the German industry holds numerous opportunities for private equity investments.

Federal Agency for the Supervision of Financial Services („BaFin") has been responsible for the German regulation since 2002.

„BaFin sent two representatives on a World Islamic Finance Conference held in London, March 28/29. The World Islamic Finance Conference is set up to be an opportunity to forge closer ties between the European Islamic finance industries with its partners in Islamic countries. The conference is not the first effort undertaken by the BaFin to jump start Islamic Banking in Germany. In October 2009, BaFin, even hosted its first own conference on Islamic Finance. It was the first event of this sort and a major break-through in public awareness on the subject. BaFin officials, including its president Mr. Jochen Sanio, repeatedly signalled their willingness to support Islamic banking. The conference was seen as the starting point to build up a regulatory framework for Islamic banking in Germany. Mr. Sanio again stressed his willingness for cooperation in a lecture held at the Euro Finance Week in Frankfurt in November 2010. Nevertheless, so far no Islamic bank has settled for the German market. Asked why, Juergen Dreymann another BaFin representative in June 2010 stated at a panel discussion in Frankfurt that until then the BaFin had simply not received any applications for the opening of an Islamic Bank. The Kurveyt Türk Bank, announced in the press as the first Islamic Bank to open in Germany, started only by operating a representative office which will collect the money in Germany but administrate and invest it through their home offices in Turkey. The way to a full banking licence for a Sharia-compliant institution in Germany is expected still to be long even though Mr. Dreymann's further remarks clearly showed sound interest. The framework of the German banking regulations still either does not allow trade based Islamic transactions or does not consider them to be banking transactions at all. Besides some of the tax regulations such as VAT constitute a disadvantage for Islamic banking customers who would be charged twice.

The BaFin is willing to react to claims by various Muslim institutions in Germany stating that the demand for Sharia-compliant banking is high and therefore adjustments must be undertaken to meet the demand." [http://www.citizentimes.eu/2011/03/04/an-overview-of-islamic-finance-in-germany/]

4.3. France

France,, the biggest Muslim minority in Europe, currently does not offer Islamic banking services. With regard to the fact that almost 10.7 % of the European Muslim population, approximately 4,704,000 people live in France it is worth touching upon the French situation of Islamic Finance.

France has announced plans to adjust its economic and legal frameworks to accommodate Islamic banking activities in the near past. In 2007, the Economy

Minister Christine Lagarde has briefed Gulf investors on steps "to make (their) activities as welcome in Paris as they are in London and elsewhere." “The government is expected to announce fiscal and legal adjustments to accommodate the Shari`ah-compliant industry before the end of July. The modifications will facilitate the issuance of Islamic bonds (Sukuk) and structured real estate transactions. Lagarde's address to the Gulf businessmen was "the first time that a representative of the state has said publicly that she is favorable to the development of Islamic finance.” [http://www.onislam.net/english/news/3341/420439.html]

Other developments that took place in the last couple of years: 2008: The French Securities Commission (AMF) recommends Islamic investment funds. 2009: Investment products and wholesale banking somewhat active in France. 2011: Al Baraka group will launch its first French Islamic Bank by first half of 2012. Its paid up capital will be 100 million Euros.

4.4. Other countries

The foregoing well demonstrate the tendency that numerous countries have realised the potentials held by Islamic Finance, and generally speaking we can state that all are making efforts by their own unique means to create the economic and legal framework of Islamic Finance, or to express intent towards the same. The examples and endeavours could be listed, but the aim of this presentation is only to demonstrate the general tendencies and not to set forth fully exhaustive listings. Nevertheless, we shall say a few words about Russia, where the creation of the frame of Islamic Finance has become a general demand and a subject of continuous dialogs on a state level, one of the good examples of which is the convention between Russia and the United Arab Emirates on the liberation of investments from taxes. The specialty of this is that practically this has been the first tax release in the history of Russia. But it is also necessary to mention Luxemburg, where the first Islamic Finance House has been established already in the beginning of the 1970s, and also Denmark, where – following this – the Islamic Bank International of Denmark has been founded.

5. CONCLUSION

It might seem a major simplification, but practically the current global financial and economic system built on the foundations of the Judeo-Christian cultural sphere in the last centuries, while the Islamic cultural sphere “was asleep” (the eastern world religions are not discussed here for lack of space and since their “acceptance” is stronger, their global economic impact was smaller in the past centuries). Now it seems that due to worldwide globalization processes and their problematic nature, Islamic finance may be an area where Islam may again inspire the rest of the world (remember that while Europe failed to develop for a few "dark centuries", Islamic scientists carried on the torch of progress in a number of branches of science).

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