Islamic Economic Studies
Vol. 17 No. 2, January, 2010

ISLAMIC FINANCE IN EUROPE: THE REGULATORY CHALLENGE

AHMED BELOUAFI[*]
and
ABDERRAZAK BELABES [+]

ABSTRACT

Over the last few years, Islamic finance has developed and spread quite significantly all over the globe. This development brought with it many challenges and opportunities that industry players, supervisory authorities, and other parties are trying to examine and identify. The regulatory challenge is considered to be among the crucial challenges that need to be properly addressed as a prerequisite for an environment conducive to the development of this emerging industry.
This paper examines the European approaches to overcoming regulatory issues related to the establishment of Islamic finance institutions and the provision of Islamic products and services in these advanced and very sophisticated financial centers. The paper reveals that, despite the fact that cross-country examinations indicate the existence of a variety of models and approaches adopted worldwide to accommodate IF in conventional systems, European countries seem to follow the minimal change approach that relies primarily on tax regimes to achieve level playing field for IF through the policy of "no obstacles, but no special favours" initiated by the UK authorities in their handling of the matter. The paper also reveals that civil law countries in mainland Europe, like Italy, are adopting the policy of "wait and see" by letting market forces decide the future direction of the presence Islamic finance in their domiciles.

1. INTRODUCTION

Islamic finance came into being no more than five decades ago. Its institutional development went through two phases: the first one in the sixties that witnessed the

[*] Researcher, Islamic Economics Research Centre, King Abdul Aziz University, Jeddah, Saudi Arabia, (ambelouafi@kau.edu.sa).
[+] Researcher, Islamic Economics Research Centre, King Abdul Aziz University, Jeddah, Saudi Arabia, (abelabes@kau.edu.sa).

introduction of a local saving bank in the rural area of Mit-Ghamr in Egypt[1], and the second, in the mid-seventies which saw the introduction of commercial private banking and an intra-government initiative[2] at a regional level among OIC[3] countries. From then on, Islamic finance has grown steadily, spreading from one institution in one country to more than 400 institutions in more than seventy countries with total assets reaching the threshold of 1 trillion US dollars (Al-Iqtisadia, 2011). The paper also reported that some experts anticipate that by the year 2020 Sharīʿah compliant assets to be around 4 Trillion US Dollars. In addition, the operations and products of IF have diversified and grown as well.

As a result, Islamic finance (IF) is no longer confined to its traditional Muslim and Arab countries; rather, it has spread, in various degrees, all over the globe. Among the places that have recently witnessed the emergence of IF is Europe. This paper addresses issues relating to the regulatory and supervisory challenges in this locality by discussing the following questions:

- What are the main regulatory issues that the presence of IF in Europe brings with it?
- Is there a variety of approaches adopted across Europe, or are the players following the same path?
- Have Islamic finance operations been taxed on the basis of the legal form of the contact, or on the basis of the economic substance of the transaction?

The paper prosecutes the issues attendant to these queries in four sections. Section I provides an overview of the basic principles of IF and its latest development in Europe. Then Section II touches upon the nature, rationale and objectives of the regulatory process and its relevance to IF. Section III summarizes the different approaches adopted worldwide in accommodating IF into conventional systems, and discusses the route pursued by some European countries within the context of those models. Finally, Section IV draws some concluding remarks from the discussion and analysis carried out in the preceding sections.

[1] The experiment is well known by its founder; Ahmed Al-Naggar and it lasted for four years from 1963 till 1967.
[2] The Islamic Development Bank (IsDB) which has been transformed into a group with many subsidiaries and affiliates.
[3] Organization of Islamic Conference.

2. ISLAMIC FINANCE: BASIC PRINCIPLES & EVOLUTION IN EUROPE

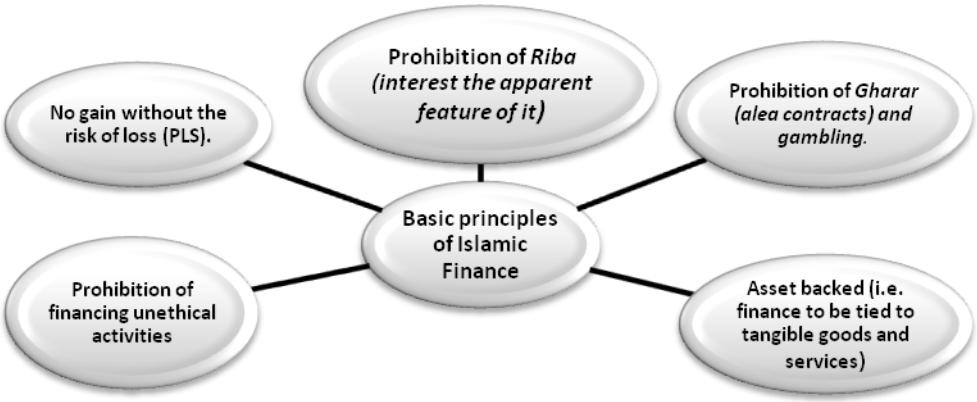
2. 1. Basic Principles of Islamic Finance [4] and their Regulatory Implications

In order to pave the way for the introduction of IF in any conventional legislative body it is important to comprehend fully and properly the basic principles that regulate the operations of this newly emerging industry, the core foundations of which are based upon the ruling of Sharīʿah (Islamic Law) that govern matters of rituals and transaction dealings of the individual and society. This law provides a general framework within which financial transactions can be conducted. Hence Islamic finance, in very simple and general terms, can be defined as "the provision of financial services and products in accordance to the principles of Sharīʿah".

This definition implies that the main difference between the IF industry and its conventional counterpart lies in the "Islamicity" of its operations and products. If so what are then the basic principles that determine this "*Islamicity*"? And what are the legal, regulatory and supervisory implications?

It has been widely accepted that the framework of providing "Islamic" financial services is guided by the following basic principles as illustrated in the chart below:

Figure-1
Basic Principles of Islamic Finance



[4] Some of these principles, such as the prohibition of *Ribā* and gambling, are not alien to the culture of the West, and even to some other cultures and religions (Dar *et. al*., 1999:2-3); (Wilson, 2007b:1); (Chapra *et. al*., 2000:1-2).

Among the elements displayed in the above chart, it can be noticed that the prohibition of *ribā*[5] and the asset-backing norms represent the major principles that have a big impact on the nature of the operations to be carried out by Islamic Financial Institutions (IFIs), especially commercial banks. The prohibition of *ribā* is regarded by regulatory authorities as the overarching principle of the operations of IF industry (FSA, 2006). This is because interest-based dealings constitute the backbone of the operations of conventional finance. On the other hand, the asset–backing norm obliges IFIs to tie the assigned funds for investment purposes to an underlying or very determined and specified asset or service. In conventional finance that is not the case as the provision of funds does not require financial institutions to assume any responsibility of the ownership of the financed assets. In addition, funds pooled for investment purposes have to have guaranteed principals regardless of the outcome of the financed operation.

In order to assess the effect of such principles on the operations of a typical Islamic Financial Institution (IFI), a theoretical structure of assets and liabilities of that institution is examined briefly to identify some of the regulatory and supervisory issues that arise from such a structure:

Table-1: ***Theoretical Structure of Balance Sheet of a Typical IFI and the Policy and Tax Implications of Such Structure***

Assets	Policy and/or tax Implications	Liabilities	Policy and/or tax implications
Inventory: Real estates /automobiles.	Distinct characteristic-ownership of assets.	Investment Accounts: Deposits assigned for investments are accepted on PLS basis. That is neither the principle nor the return is guaranteed. In this category there are two types of products; general or unlimited, to be used as the IFI sees fit, and special or limited, assigned for particular investments based on the customer preference and choice	In prevailing laws, deposits and their fixed returns are guaranteed to certain ceilings through compensation or insurance schemes. How will "Islamic" deposits be treated given the fact that return and principal payments depend upon the performance of the financed assets? - Capital adequacy ratios. - Risk management approach. - Corporate governance issues (e.g. moral hazard).

[5] Interest-based operations represent the apparent and the most significant element of *Ribā* in nowadays financial practices.

Asset backed placements (e.g. *Murābaḥah* (cost plus), *Ijārah* (leasing), etc.): Finance has to be tied to real transactions, be it a plant, a good or a service. The IFI has to acquire such utilities and bear the associated risks by assuming the ownership of the underlying asset at some stage before transferring it to the client. And in providing finance, no predetermined fixed return (i.e. ex ante) can be claimed from the outset of the process. The IFI has to share in profits, if any, and bear part of the losses, if that is the case.	No placement of funds in interest based assets such as bonds and treasury bills. Exclusion of the most widely used instruments for liquidity management, and "safe" investment opportunities. Double stamp duty or registration tax on assets double sale. VAT on *Murābaḥah* mark-up. 100% capital treatment for some Islamic instruments used for mortgage financing. Ownership and illiquidity risks. Rate of return Risk. Displacement Risk. Equity investment Risk.	Current/Demand deposits: similar to conventional ones, but no interest or remuneration of any form to be given to customers.	Have to be fully guaranteed and subject to customer withdrawal at any time.
Profit-sharing Transactions: e.g. *Muḍārabah* (profit-loss bearing), *Mushārakah* (profit-loss sharing).		Profit Equalization Reserves	Distinct characteristic as prudential tool.

Source: Authors & IFSB (2010: 17)

It is clear from the table above that there are sharp contrasts, at the theoretical level at least, between IFIs and their conventional counterparts. However, at the practical level, convergence between IF instruments and their conventional counterparts is dominating the scene through the certification mechanism carried out by scholars and boards (i.e. Sharīʿah Supervisory Boards (SSB)), and in some cases, lawyers are also getting involved in the approval of the IFIs operations (El-Gamal, 2006: xi). In order to understand the nature of risks and regulatory concerns associated with IF instruments and operations, three main questions need to be addressed:

First, does the "*Islamicity*" of financial services and products expose institutions offering this type of arrangements to more, less, or the same sort of risks as conventional industry is exposed to?

Second, is it a must to have an SSB at each and every institution to ensure the "*Islamicity*" of operations?

Third, what are the regulatory implications of such a special nature and a set up?

As for the first question, two views are held (El-Hawary *et. al*., 2004:28); the one that advocates minimal regulation if IFIs operate according to the core risk sharing principles, and the other view is that IFIs must be subjected to the same regulation as their conventional counterparts. There has been a great deal of debate on the related literature. However, the practice of the industry and the attitude of the regulatory authorities in most jurisdictions have adopted the latter approach: requesting IFIs to adopt the norms and standards applied to their conventional counterparts (Chapra *et. al*., 2000:22-25). On the other hand, infrastructure bodies of the industry, like the IFSB[6], are striving hard towards the adoption of some modification of the standards developed by international regulatory settlers, like the Basel Committee, to take into account the special features of IFIs.

As for the second question, the development of the industry over the years indicates that ensuring the "*Islamicity*" of operations is vital for credibility and public confidence. The practice also reveals that the main form for ensuring that is through the appointment of an internal body (SSB) or an individual (scholar) to endorse the "*Islamicity*" of these operations. It is for this reason that Wilson (1999:438) noticed, about the early development of IF in the UK, that some of the conventional institutions offering "Islamic" products could not attract customers to increase their operations in this area until the appointment of an SSB. Having said that, it must be acknowledged that in recent years, Sharīʿah consultancy firms or individuals are emerging as other forms of ensuring the Islamicity of the operations of IF industry. Furthermore, much debate is taking place about the heavy load that many scholars are taking on, which affects the efficiency of their work and may create conflict of interest between their role as independent advisors, and the fact that the managerial committees of IFIs are responsible for their appointments and the remuneration that they get. For instance, Funds@Work (2010:7) organization reveals that the two top scholars are acting in more than seventy boards.

As for the third question, several implications that arose as a result of the aforementioned discussion are identical to those of IFIs counterparts. This may be partly due to the dominance of the fixed income products on the assets side of these institutions through the sales and lease contracts. Some of these issues that have been identified by regulatory bodies are standardization of products and instruments, information disclosure, corporate governance, capital adequacy requirements, and so on. So, almost all prudential matters that stand behind the rationale for regulation of the activities of conventional financial industry are relevant to IF as it is practised nowadays.

---

[6] The Islamic Financial Services Board; a Malaysian based body that was created by a group of Central banks in 2002 with the IMF and BIS support as an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry. **Source:** http://www.ifsb.org, accessed February 27th, 2011.

In this respect, as will be seen in a later section, the UK authorities did not see any need or justification for major changes to the existing legislation, as the policy of "*no obstacles, but no special favours*" is providing good results by sending positive signs to the industry players and the responsible, and as it was also seen as neither appropriate nor legally possible to vary the UK standards for a particular type of institution or industry (Ainley *et. al.*, 2007:11).

2. 2. Evolution of Islamic Finance in Europe

The presence of Islamic finance in Europe can be traced back to the beginning of the eighties of the twentieth century, through the provision of some commodity *Murābaḥah* in the London market (Wilson, 2007b:2), and through the establishment of some financial institutions such as Islamic insurance (*Takaful*) with one in Luxemburg (Krawczykowski *et. al*., 2010), and Al-Baraka International, in London (Wilson, 1999:426).

Since that time IF products and institutions have been introduced in various ways in the UK market. However, the dramatic steps in terms of legislation, the establishment of fully-fledged institutions, and the issuance and listing of some Islamic instruments such as the *Ṣukūk*, have taken place only over the last few years. At the time of writing this paper, the following facts can be cited as indicators of the development of IF in Europe (IFSL Research, 2010:3):

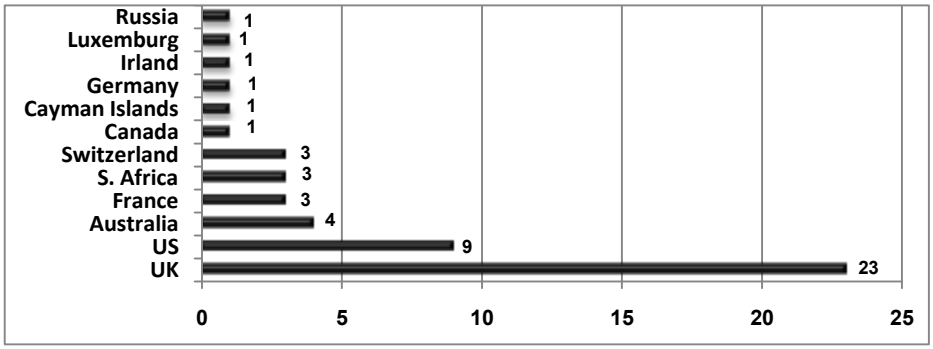
- Europe is a host of five fully-fledged Islamic banks; one is retail and the remaining are wholesale investment banks. All of these institutions are UK based, but they can increase their outreach to the mainland Europe through the European passport[7].
- *Ṣukūk* instruments, or Islamic bonds, as some may prefer to call them, are rapidly expanding too. In the UK, since 2006 which saw the first London-listed *Ṣukūk*, transactions in these instruments have exceeded the value of £9bn through the 26 issues of *Ṣukūk* in the London Stock Exchange (Walmesley, 2011:2). And despite the slowdown of *Ṣukūk* issuance after the financial crisis, last year saw the issues of six *Ṣukūk* in London (Walmesley, 2011:2), while 16 *Ṣukūk* are currently listed on the Luxemburg Stock Exchange (representing approximately 6 billion in notes) in Luxemburg (Krawczykowski *et. al*., 2010). In 2004, Saxony-Anhalt became the first state government in Germany and Europe to issue a sub-sovereign bond under Islamic principles (The Banker, 2004). And in 2008, this time in France, the Autorité des Marchés Financiers (AMF), the French market regulator, gave

[7] In 2009, Gate House Investment Bank used such a tool to apply for the offering of its services in France.

admission to *Ṣukūk* to be listed in the regulated financial market (AMF, 2008).

- Investment funds are also present in some countries of the continent. Luxemburg hosts more than 40 Sharīʿah-compliant investment funds and sub-funds, which makes up around 7% share of the total funds across the world. As a result, Luxemburg is classified among the top five Islamic funds domiciles in the world (Luxemburg for Finance, 2010:7).
- Many European countries have some presence of IF in the form of fully fledged IFISs, or through Islamic Windows offered by conventional institutions, as the chart below demonstrates:

Figure -2: ***Number of IFIs & Islamic Windows in Non-Muslim and Non-Arab Countries***



Source**:** *IFSL Research* (2010) and Islamic Finance (2010)

3. REGULATORY CHALLENGE: NATURE, OBJECTIVES, RATIONALE AND RELEVANCE TO IF

It is widely recognized and accepted that financial systems are the most highly regulated activities of the economy. This is mainly due to the fact that financial products and contracts provided by the financial institutions and markets are significantly different from products and services offered by firms of other sectors of the economy (Llewellyn, 1999:5). This specialness centers on the role of payment system handling and credit provisions and distribution carried out by these establishments. As a result, regulatory authorities in most countries, as noted by Llewellyn, (1999), pay particular attention to this issue, in order to maintain the integrity of the financial system, by affecting the behavior of the regulated institutions and markets in a way that aims to achieve certain objectives. These objectives are considered to be of vital importance to the smooth functioning and stability of the entire economy. Various pieces of legislation as well as the

literature explaining why financial regulation is beneficial, usually state the following objectives as mandates for regulatory authorities to achieve[8]:

- Market confidence – maintaining confidence in the financial system of the country.
- Financial stability - contributing to the protection and enhancement of stability of the financial system.
- Consumer protection - securing the appropriate degree of protection for consumers and users of the financial services and products.
- Reduction of financial crime - reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.

In addition to the above general objectives related to financial activities as a whole, these authorities usually handle carefully the issue of incorporating newly emerging industry or products. Therefore, in dealing with the issue of accommodating IF, regulatory authorities try to achieve the following sub-objectives:

- Lifting uncertainty about the intent of the regulatory authorities to pave the way for level playing field for IF products & institutions. The clarity and intent are required as prerequisites to avoid over- or under –regulation that may respectively either stifle or leave too much room for risk taking (El-Hawary *et. al.*, 2004:28).
- Prudential regulation umbrella for Islamic modes of finance as part of the "*no obstacles, no special favours*" policy.
- Same level of regulatory protection for customers of Islamic products & services to boost confidence in, and stability of the system.

As for the rationale of the regulatory process and its relevance to Islamic Financial Institutions (IFIs), the following points can be made:

[8] These objectives have been drawn from the statutory objectives given to the Financial Services Authority in the UK. Source: www.fsa.gov.uk. On the other hand, the Banking Act 2009, stressed upon the same objectives for the regulation of the banking institutions: Objective 1 is to protect and enhance the stability of the financial systems of the United Kingdom. Objective 2 is to protect and enhance public confidence in the stability of the banking systems of the United Kingdom. Objective 3 is to protect depositors. Objective 4 is to protect public funds (H M Treasury, 2009). Moreover, some other important Central Banks, like the European Central Bank, have concentrated on one aspect of these objectives, like price stability for example: "the overriding objective of [the ECB] monetary policy is price stability". Even for the regulation of IBs almost the same objectives are stated and stressed upon (Chapra *et al.*, 2000:13 & 17).

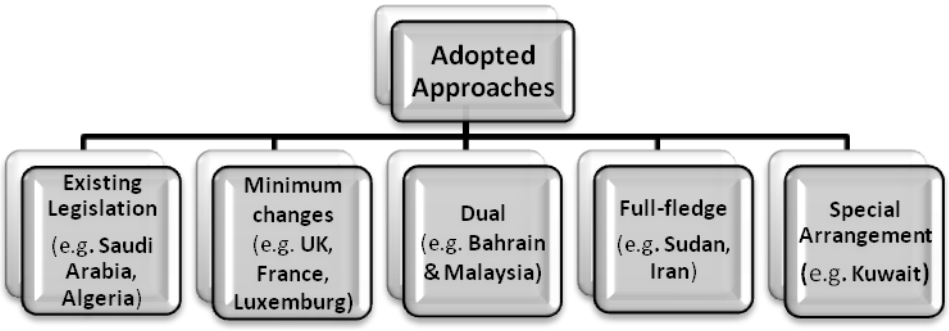
- Financial innovation often brings with it changes in the perception of risk (El-Hawary *et al.,* 2004:3). Merton (1995:462) makes the point that "less apparent understanding of the new environment can create a sense of greater risk even if the objective level of risk in the system is unchanged or reduced".
- Legal: do existing laws in secular jurisdiction allow financial transactions to be governed by Sharīʿah principles (Hesse et al., 2008:179)? The practice reveals that there is no problem in that, as existing laws are flexible enough to accommodate new innovations and products as long as they are well understood, and they do not bring excessive risks that are beyond control. Although this is the case, one must admit that there is a cultural and historical sensitivity linked to the issue of IF operations in Europe; especially if emphasis is given to the inclusion of certain religious laws within the mainstream secular ones (Wilson, 2007a).
- Regulatory: Do Islamic financial institutions & products require similar levels of supervision as their conventional counterparts (Hesse *et. al.,* 2008:179)? We discussed this point in details in the previous section and we concluded that most regulatory authorities, especially European, are of the opinion that IFIs must be subject to the same existing prudential regulations as their conventional counterparts whenever that is possible, without subjecting the institutions of this newly emerging industry to stringent constraints that will penalize their customers or affect the innovation process that is so vital, particularly when the industry is still in its infancy. So, the main point at stake is to strike a balance between over-and-under regulation that may send the wrong signals to interested players, parties and markets.

4. THE EUROPEAN APPROACH WITHIN THE CONTEXT OF THE VARIOUS APPROACHES ADOPTED[9]

Practices and examination of regulatory and supervisory authorities in various countries reveal that there are mainly four approaches, as summarized in the chart below, adopted in accommodating IF in conventional systems. The fifth one, of Kuwait, falls under the auspices of the third approach, i.e. the dual one; however, it has been stated separately to highlight its specialness in two aspects: the first is the fact that the established institution, although depository, has been given the name of a house rather than a bank; and the second aspect is the fact that the institution is regulated by the Ministry of Commerce rather than the Central Bank of Kuwait (El- Hawary *et. al*., 2004:27).

[9] For an in-depth analysis of the variety of models adopted and their progressive nature, see Belabes, (2011).

Figure-3: ***Approaches Adopted Worldwide in Accommodating Islamic Finance***



Apart from the case of Kuwait which has been explained earlier, the above chart is self explanatory in dividing conventional systems in accommodating IF into four categories in a gradual order: the first is the one that preserves the status quo; the second introduces minimum changes to the existing laws; with the third, special laws that go hand in hand with conventional laws are brought in for the regulation of IF activities; and as for the fourth category, which is very limited, it operates the conversion of the full system into an Islamic system. It is clear that so far, the European approach falls within the second category, with minimum changes to the existing laws. In the subsequent sections, we will look at the experiments of three actors in this context: The UK, France and Luxemburg, and then we will briefly account for the latest development in other countries, such as Italy and Germany.

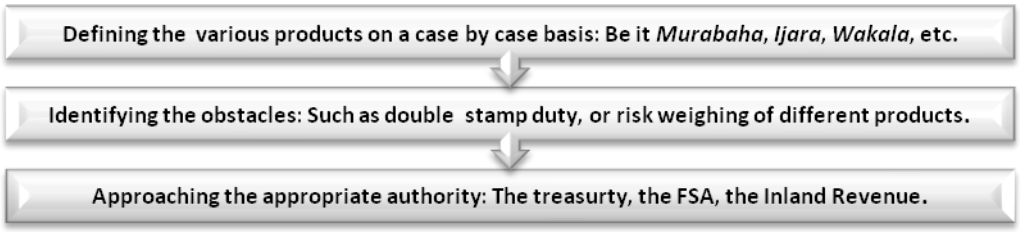
4. 1. The Experiment of the UK

The United Kingdom is by far the most active player in the area of accommodating IF on its territory. Many conventional institutions operating in the London market have been active in the provision of Sharīʿah compliant products since at least the beginning of the eighties in the last century. However, much of the significant development has taken place over the last few years[10]. Among these evolutions are the legislative measures taken by the government to provide level playing field for IF industry. In 1995, the then governor of the Bank of England, Sir Edward George, recognized the 'growing importance of Islamic banking in the Muslim world and its emergence on the international stage' as well as the need to put Islamic banking in the context of London's tradition of 'competitive innovation' (Ainley *et. al.*, 2007:8).

[10] For more details about the latest developments of IF in this country, see Belouafi, **(**2011).

Since that recognition, no significant step had been taken by the UK government until 2001 when a high level working group, chaired by Lord George, was established to identify the barriers that IF faces in the UK (Ainley *et. al.*, 2007:8). According to Lord George (1995:77), the analysis conducted by the working group had been carried out along the following steps**:**

Figure–4: ***Steps Followed by the Working Group that Was Chaired by Lord George***



From the time of the formation of the aforementioned group onwards, the UK government has taken several initiatives before attaining the current status of the development and growth of IF on its territory. Among the measures taken was the formation of more specialized groups, such as the one that looks at tax issues, and the consultation method through various consultation papers[11] in order to get a wider prospect from the stakeholders of the industry; the Treasury, the FSA, the Inland Revenue, the Muslim community, Sharīʿah experts, IF industry and its infrastructure institutions, such as the IFSB and AAOIFI, the City, Lawyers and consultancy firms. In addition, the process was guided by clear principles[12] and objectives[13]. This lengthy work has resulted in the identification of several obstacles. Among them are:

- Definition of a deposit and how to reconcile its legal requirement under the English Law with that of IF principle of the prohibition of taking and giving interest without linking that to the performance of an underlying asset.

[11] A typical example is the consultation paper on "Legislative framework for the regulation of alternative finance investment bonds (*Ṣukūk*)" that was published on December 10th, 2008 and the received summary of responses was published on October 2009.
[12] These are: fairness, collaboration and commitment (HM Treasury, 2008:13-14).
[13] These are: enhancing the UK's competitiveness in financial services by establishing the UK as a gateway for international Islamic finance; and ensuring that everybody, irrespective of their religious beliefs, has access to competitively priced financial products (HM Treasury, 2008:13).

- The double stamp duty land tax (SDLT) on the purchase of the property of the Bank from the seller, and the re-sale of that property to the customer (the purchaser) through the various modes of IF available for home purchase, such as *Murābaḥah*, *Ijārah* or Diminishing *Mushārakah*[14].
- The role of the Sharīʿah advisory board; and if it is going to interfere and overlap with that of the managerial committee, the shareholders and the general assembly of the institution.
- Transparency, clarity, information disclosure and the promotion of products and services.
- Standardization of products and accounting information.

In overcoming the above hurdles and other issues, the practical steps taken by the created groups and the various official entities involved in the process of providing level playing field for IF and derived from the whole exercise can be arranged as follows[15]:

Figure-5: ***Practical Steps derived from the UK Experiment in Regulating IF activities***

It can be noticed from the above encounter that the process has been lengthy and thorough in order to avoid the reach of unintended results or outcome. As a result, the UK authorities started the process of introducing legislation in the Finance Act of 2003 where the removal of the double SDLT on "*Islamic mortgage*" through the *Murābaḥah* and *Ijārah* modes of finance first took place. And in subsequent years, some more legislation was introduced as summarized on the table below:

[14] In this process the bank pays the price in full on spot and adds to it a margin (mark up) and the customer pays the due amount in deferred instalments during the agreed upon period. So it is clear that there is a double sale that requires the double charge of SDLT if tax changes have not taken place.

[15] For a typical example of these steps through the legislation of *Ṣukūk*, see Belouafi, **(**2011).

Table-2: Examples of Some of the Introduced Changes from 2003 to 2010

Date	Introduced Changes
2003	Removal of the double charge of Stamp duty Land Tax (SDLT) for *Murābaḥah* & *Ijārah* contracts that allows individuals to purchase homes. Other measures were introduced as well, to offer Islamic products for Child Trust Fund, asset finance and ISAs.
2005	Extension of the removal to *diminishing Mushārakah* (another mode of alternative finance).
2006	Extension of removal to beneficiaries (i.e. companies) and the introduction of *Wakālah* (profit share agency).
2007	Discussion of applying the same tax rules of conventional debt instruments like bonds to *Ṣukūk* (Islamic Bonds).
2008	Dealing with more issues relating to the issuance of *Ṣukūk*.
2009	Legislation measures for SDLT, Capital Gains Tax (CGT), and capital allowance rules for land transactions involved in the structuring of *Ṣukūk* instruments
2010	The Financial Services and Markets Act 2000 Order 2010 exempts alternative finance investment bonds (AFIBs), a class of debt-like security which includes *Ṣukūk*, from collective investment scheme (CIS) regulations

***Source*:** www.hm-treasury.gov.uk, www.fsa.gov.uk, and www.londonstockexchange.com

On the other hand, in granting the license to the Islamic Bank of Britain (IBB) in 2004, the UK authorities, in collaboration with the IBB responsible came to the following solution with regard to the issue of 'deposit'; 'legally, depositors are entitled to full repayment to fulfill the FSA requirements; however, customers have the right to turn down deposit protection and choose instead to be repaid under the Sharīʿah-compliant risk sharing and profit bearing formula' (Ainley *et. al*., 2007:14). And with regard to the issue of Sharīʿah compliance, the policy adopted was that there will be no central Sharīʿah board at the FSA or at the Bank of England, as applied in other jurisdictions, like Malaysia. This is because the FSA is a secular regulatory entity, and interfering in this area may string up financial innovation in this newly emerging and promising industry (Ainley *et. al*., 2007:14). So, in the end, it was left to individual institutions to choose the appropriate method of ensuring the "*Islamicity*" of their operations. However, the FSA stresses upon the fact that the information given on this respect must not be misleading.

Despite the positive steps and initiatives taken by the British regulatory authorities, there are still deep issues that are of much concern to the customers of IF in the UK. Among these:

- Are Sharīʿah compliant products and services really "Islamic," given the fact that more emphasis has been given to compliance with conventional legislation rather than with Islamic finance principles[16]? In this respect one might mention the way the issue of deposits has been dealt with. Does customer choice have any legal enforcement if the customer chooses the "Islamic" way when a dispute arises between him/her and the bank?
- Does the current approach favour some types of IF products over others? Or is it a matter of convenience and/or an industry request[17]? In this regard, the legislation of *Ṣukūk* provides a typical example of such an issue. In the summary of responses of the consultation paper in relation to the legislation of *Ṣukūk*, the government stated that 'the proposed regulatory framework is not intended to cover all types of *Ṣukūk* (some of which are more akin to equity or equity-indexed instruments [i.e. Asset-backed *Ṣukūk*]) (HM Treasury & FSA, 2009:5). So 'the legislation intended to cover *Ṣukūk* that are structured to have similar economic characteristics to conventional debt instruments [i.e. Asset-based *Ṣukūk*]'. And it seems that the issue is not limited *Ṣukūk*, it rather represents a general policy for the taxation of IF instruments in European countries. In reviewing the taxation of Islamic finance in major Western countries, UK in particular, Amin (2007) concluded that "*the new tax treatment only applies to a commercial return which equates, in substance, to the return on an investment of money at interest*". Amin goes further to say that the tax treatment of IF "*is designed to mirror the tax treatment of conventional finance, it is limited to transactions which are providing finance economically equivalent to debt, and it does not apply to something which is economically in the nature of an equity participation*".
- How can one make sure that the information given to a customer is not misleading? Is it enough to have just the signature or the stamp of the

[16] In this respect, one can understand the argument of the FSA, as a secular regulator that has nothing to do with the certification of religious verdicts, but regulators, as noted Wilson (2003) should make sure that proper procedures are in place for ensuring Sharīʿah compliance (Wilson, 2003:1). We think this matter could be dealt with within the general framework of corporate governance issues that the regulators require from the firms that are granted licenses to carry out financial services transactions in their jurisdictions.

[17] In justifying the rationale of the policy adopted for the legislation of asset-based *Ṣukūk* rather than asset backed ones, the government indicated that the majority of issued *Ṣukūk* are of this nature and it was the industry that has asked them to focus on this type of *Ṣukūk* (HM Treasury and FSA, 2009:5).

"extensively" used scholars, to ensure the "*Islamicity*"[18]? Or again, is it enough to provide general and brief information about the products, when in fact very lengthy and complicated contracts are provided at the moment of signing the deal?

The above issues are but some examples of the concerns raised by customers most of whom are still reluctant to use these products. We are aware that some of the issues raised, especially the latter ones, may apply to conventional products as well, but there is a big difference between the two cases. Conventional practices and contracts are well established and understood, and the laws that regulate the disputes are clear, and the legal expertise is widely available. On the other hand, it must also be stressed that what the UK government has done towards IF, many Muslim and Arab countries have failed to do; so, in that situation the reservation we have made must be read within this context and the context of the scientific enquiry that requires a balanced and rigorous examination that puts every opinion and analysis in its perspective.

4. 2. The Experiment of France

Despite the fact that France is home to the largest Muslim minority in the EU countries, and the fact that French banks have played an important role, since mid 1980's in offering Sharīʿah compliant products in the Gulf region and elsewhere, France becomes only recently active in the area of IF. At the end of 2008, French authorities took a pro-active attitude in promoting Paris as a European hub for IF. France's goals in this respect are twofold (Arnaud, 2010:171); attracting global funds to French soil and making France more competitive in the area of IF. In order to achieve that, the authorities have looked into how legislative amendments can be made to attain these goals. The process went through various stages, and at the end, the authorities concluded that (Arnaud, 2010:173):

"IF should not need any exceptional consideration under the French law; the only point is that the structure of the products be examined on a case-by-case basis… institutions and customers using Islamic financing schemes are protected by the same level of strength and legal soundness using conventional schemes … [as a result] *specific issues that arise could be dealt with in the existing framework".*

The table below gives a summary of the most important eventualities that have taken place from 2009 up till now:

[18] This issue "*raises concerns over the ability of* Sharīʿah *scholar boards to provide enough rigorous challenge and oversight of firms' products and services*" (Arnaud, 2010:171).

Table-3: Measures Taken by the French authorities to accommodate IF Products and Operations

Date	Event
February 3, 2009	The Islamic Finance Committee of Paris Europlace states in its 2009 work program the need to adapt the French trust system to allow the issuance of *Ṣukūk* in French law
February 25, 2009	French tax planning framework for *Ṣukūk* and *Murābaḥah*
March 18, 2009	The Senator Philippe Marini proposes an amendment to the civil law and the trust system (régime de fiducie) to develop the French financial system and facilitate the issuance of *Ṣukūk*. The Senate adopted the law
September 9, 2009	Member of parliament Chantal Brunel proposes a disposition in favor of Islamic finance as part of a bill facilitating SME financing
September 17, 2009	The parliament adopted the bill after a heated debate
September 18, 2009	60 parliamentarians of the opposition filed a censure motion to the Constitutional Council
October 14, 2009	the Constitutional Council censure Article 16 concerning Islamic Finance
August 24, 2010	Publication of tax instructions on the *Ṣukūk*, *Murābaḥah*, *Ijārah* and *Istiṣnāʿ* by the General Directorate of Treasury and Economic Policy (DGTPE)

After the failure of the French government in passing laws for IF through the Parliament, it seems that the French approach has turned to the route of tax instructions for accommodating various IF products.

4. 3. The Experiment of Luxemburg

As mentioned in Section I, Luxemburg has engaged in IF since the beginning of the eighties of the last century; however, its legislative initiative took off only over the last three years. In April 2008, the Ministry of Finance formed a task force to identify obstacles to the development of IF and to pave the way for its growth (Luxemburg for Finance, 2010:1). In 2009, the government asked tax authorities to examine the characteristics of IF products and to come up with solutions that provide level playing field with conventional counterparts. In early 2010, the Ministry of Finance produced a comprehensive document detailing the regulatory and tax treatment of IF transactions and operations in Luxemburg (Luxemburg for Finance, 2010). In that document more emphasis was given to investment funds, private equity, capital venture, real estate investments, and wealth management. However, the documents also dealt with tax treatment relating to the well known modes of finance, such as *Murābaḥah* and *Ṣukūk,* as a continuation process of an early circular issued to the tax authority on this regard (Administration des contributions directes, 2010:3-5). The main guiding principle in these procedures was to treat revenues of IF products as if they ‘were interest’ (Administration des

contributions directes, 2010:3-5). Once again it can be noticed that this approach is akin to that of the UK (HM Treasury, 2008:16).

4. 4. The Experiments of Other Countries

In other European countries not much work has been done except the awareness programs in the form of seminars or colloquies organized by some regulatory authorities, like the *Banca d'Italia*[19] Italy Central bank, in order to give authorities the opportunity to understand the reality of IF and its regulatory and supervisory implications for the hosting countries. Up to date, there are varying views with regard to the presence of IF in these domiciles. One of these views, like the one held by the Italian regulators (Donato *et. al*., 2010:197), is letting the market forces decide when IF may enter their domicile; the other is rather skeptical and doubtful about the presence of IF in a European country. This latter view is held by BaFin[20], the German single financial regulator.

5. CONCLUSION

The above analysis, with regard to the issue of accommodating IF in European conventional systems, reveals that there is a spectrum of views ranging from the more advanced and welcoming to the skeptical and doubtful. The UK is an example of the former, and Germany is an example of the latter. In between the two opposing views, some other countries are adopting the 'wait and see' policy to let market forces impact the direction of the swing. Furthermore, the European experiment showed that the main work has concentrated on the tax treatment through the economic substance of IF transactions, rather than on their legal form structure, to provide 'level playing field' for IF industry. Hence, the process seems to prefer the avoidance, as much as possible, of indulging in the legal process which is not only cumbersome, but probably also very difficult and time consuming to pass through legislative bodies. The French have tried that route, but they were not able to overcome the very sophisticated and sensitive hurdles that path was fraught with. The analysis also reveals that the handling of matters arising from the regulation of IF in Europe has been highly affected by the approach taken by the UK authorities. Over all, there are good lessons and important practical steps to be learnt from the European approaches in regulating the activities of Islamic finance in conventional systems, especially in the more advanced financial centers. However, it must be stressed that the current positions and trends are not established enough to allow us to derive concrete and somehow well confirmed

[19] On November 2009 the Bank of Italy organized an awareness seminar about Islamic Finance and its relevance to Europe in general, and Italy in particular. Official delegates from the Central Banks of Italy and Malaysia, as well as academics from the UK and Italy, attended the seminar.

[20] For details about the BaFin reservations about the presence of IF in Germany, see **(**Engles, 2010:179-180).

policies. It is left, therefore, to other jurisdictions to look into these experiments, taking into consideration the infancy development of many aspects of IF industry at the European level and elsewhere. In this sense, the standards developed by the IFSB and other infrastructural bodies might ease the process of new- comers in the race of opening the gates for IF to operate in conventional systems.

REFERENCES

Administration des contributions directes (2010), "Circulaire L.G.-A n°55", Luxembourg: Ministère des Finance, 12 Janvier.

Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., and Ravalia, A**.** (2007), "Islamic Finance in the UK: Regulation and Challenges", London: Financial Services Authority.

Al-Iqtisadia (2011)**, "**Experts: Saudi Arabia is capable of becoming a pillar in Islamic Finance in the World", 6372, March 23rd.

Amin, M. (2007), "The taxation of Islamic Finance in Major Western Countries", Sixth paper, *Arab Banking Review*, 138(1), 1-40.

Arnaud, A**.** (2010), "The French Licensing authority faced with globalization of Islamic Finance*",* in M. F. Khan and Mario Porzio (ed), *Islamic Banking and Finance in the European Union*: *A Challenge*, Cheltenham – Northampton: Edward Elgar, 167-174.

Autorité des Marchés Financiers (2008), "Admission to listing of Islamic bonds (*Ṣukūk*) on a French regulated market", July 2nd, Source: www.paris-europlace.net, accessed February 27th, 2011.

Belabes, A. (2011), "Variety of Models for Welcoming Islamic Finance into Conventional Law", forthcoming article in Les Cahiers de la Finance Islamique, Strasbourg Business School, University of Strasbourg, No.3.

Belouafi, A**. (**2011), "Islamic Finance Outside the Muslim World: the Experiment of the United Kingdom", forthcoming article in Les Cahiers de la Finance Islamique, Strasbourg Business School, University of Strasbourg, No.3.

Chapra, M. U., and Khan, T. **(**2000), "Regulation and Supervision of Islamic Banks", Jeddah: Islamic Development Bank and Islamic Research and Training Institute, Occasional paper 3.

Donato, L. and Freni, M. A. (2010), "Islamic Banking and prudential supervision in Italy", in M. F. Khan and Mario Porzio (ed), *Islamic Banking and Finance in the European Union*: *A Challenge*, Cheltenham – Northampton: Edward Elgar, 189-206.

El-Hawary, D., Garis, W., and Iqbal**,** Z. (2004), "*Regulating Islamic Financial Institutions: the Nature of the Regulated*", World Bank Policy Research Working Paper, 3227, March.

El-Gamal, M. A. (2006), *Islamic Finance*: *Law, Economics and Practice*, Cambridge: Cambridge University Press.

Engles, J**.** (2010), "German banking supervision and its relationship to Islamic Banks", in M. F. Khan and Mario Porzio (ed), *Islamic Banking and Finance in the European Union: A Challenge*, Cheltenham – Northampton: Edward Elgar, 179-180.

Financial Services Authority (2006), "Islamic Banking in the UK", Briefing Note BN016/06, 9 March. Available at: www.fsa.gov.uk.

Funds@Work (2010), "The Small World of Islamic Finance", Funds@Work & Zawya Shariah Scholers, Version 5.0, October, 5th.

George, E. (2003), "Towards Islamic House Financing in the UK", *Review of Islamic Economics*, 13, 73-78.

Hesse, H., Jobst, A. A., and Solé, J. (2008), "Trends and Challenges in Islamic Finance", *World Economics*, April-June**,** 9(2), 175-193.

HM Treasury and FSA (2009), "Legislative framework for the regulation of alternative finance investment bonds (*Ṣukūk*): summary of responses", London: The Treasury and the FSA, October.

HM Treasury (2008), "The Development of Islamic Finance in the UK: the Government's perspective*"*, London: The Treasury, December.

HM Treasury (2009), "Banking Act 2009", London: The Treasury, February.

IFSL Research (2010), "Islamic Finance 2010", London: IFSL in collaboration of UK Trade and Investment and City of London, January.

Islamic Financial Services Board **(**2010), "Islamic Finance and Global Financial Stability", Kuala Lumpur: Report published by IFSB in collaboration with IDB and IRTI, April.

Krawczykowski, R., and Ammar, A. **(**2010), "Clear Commitment: Luxembourg Tax Authorities Issue Guidance on Islamic Finance", www.islamica-me.com, accessed March 7th.

Llewellyn, D. (1999), "The Economic Rational for Financial Regulation", London: The Financial Services Aauthority.

Luxemburg for Finance (2010), "Luxemburg Vehicles for Islamic Finance Structures", Luxemburg: Luxemburg for Finance**,** April**.**

Merton, R. C. (1995)**, "**Financial Innovations and the management and Regulation of financial institutions", *Journal of Banking and Finance*, 19, 461-481.

The Banker (2004), "Global News: Germany Launches Europe's First *Ṣukūk*", September 1st. http://goliath.ecnext.com, accessed February 27th.

Walmesley, G. (2011), "Another year of growth and development for the London Stock Exchange markets for Islamic finance", *London Stock Exchange Islamic Finance Review 2010/11*, Available at: www.londonstockexchange.com.

Wilson, R. (1999), "Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience", *Thunderbird International Business Review*, July – October, 41(4/5), 421-444.

Wilson, R. (2003), "Regulatory challenges posed Islamic capital market products and services", IOSCO Task force on Islamic capital market.

Wilson, R. (2007a), "Islamic banking – opportunity or threat?", Common Ground News Service, 23 January.

Wilson, R. (2007b)**, "**Islamic Finance in Europe**",** Florence: Robert Schuman Centre for Advanced Studies, European University Institute, RSCAS PP 2007/02, December.

WEB SITES

- www.ifsb.org.
- www.hm-treasury.gov.uk
- www.fsa.gov.uk
- www.londonstockexchange.com
- www.commongroundnews.org
- goliath.ecnext.com
- www.islamica-me.com