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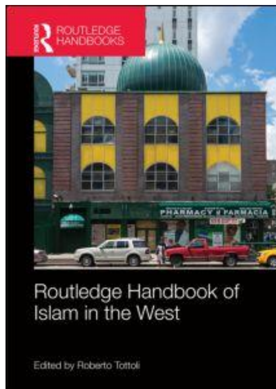

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Development and perspectives of Islamic economics (banking and finance) in the West

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Development and perspectives of Islamic economics (banking and finance) in the West

Gian Maria Piccinelli

About forty years ago, with the establishment in 1975 of the Islamic Development Bank in Jeddah, the new Islamic approach to banking operations took its first steps outside the Muslim world. From the 1980s and early 1990s, in particular, mainly as a consequence of the enormous increase in oil prices, along with the consciousness of a common religious and cultural identity, Islamic banking and finance has grown stronger and consolidated, becoming able to compete worldwide with conventional systems through "*shari'a* compliant" operations.[1]

The continuing growth of Islamic banking assets in global markets is forecast to exceed US$2 trillion by 2015. Considering that Islamic banks grew to US$1.3 trillion in 2011, we should notice an average annual growth of about 20–24 percent in the last three years. Moving from the Middle and Far East, through experiments in the West, forecasts of future establishment are projected in BRICS countries, from China to Brazil (see Ernst & Young 2012a). The birth of a system of banks, operating in compliance with Islamic legal principles, has been the first concrete result of a long debate covering the entire twentieth century. Islamic doctrine, in connection with the Qur'anic prohibition on usury (*riba*, Qur. 2:275), has discussed the legitimacy of banking interests applied by Western financial institutions operating in Islamic countries as well as the feasibility of specific instruments that are alternatives to interest (Saleh 1992).

The ethical-religious character assumed, today, by Islamic banks, with the intention of preserving consistency with the divine precept prohibiting any kind of usury, is itself part of a common historical heritage; early Western depositories and, later on, banks were born from the same cultural hummus. In Islam, the fundamental and constant dialectic between ethics and market clearly emerged in pre-capitalist times (see Rodinson 1968). The historical context, in which the relation between Qur'anic prohibition of usury and the financial demands of medieval trade surfaces, is that of the city of Mecca, flourishing as one of the most prosperous trade centers at the time of the Prophet, showing an indisputable understanding of such demands. The latter institutions appear, in more recent times, to have forgotten the ethical aspects connected to lending and, consequently, to so-called irregular deposits.

In Islam, on the other hand, prior to the nineteenth century – the period of codification and birth of nation-states – there was no theorization of autonomous rules and regulations with respect to religious *jus commune*, whereas this autonomous character of state law has mostly

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meant a slavish adjustment to the civil and commercial normative models of colonial Western powers. For this reason, in the latter part of the twentieth century modern Muslim doctrine pursued the design of an Islamic economy newly founded on a more attentive reading of the prohibition of usury, imagining the possibility of building a valid "alternative" (from a Muslim perspective) to the social projects founded on capitalist liberalism and on socialist statism – an alternative founded, among other things, on the abolition of the pecuniary interest system, substituting it with a system based on profit- and risk-sharing.

Ancient associative contracts were thus recovered. This type of contract was (whether consciously or unconsciously) common to all traders in the Mediterranean *koiné*, itself active and in force already prior to the time of the Prophet Muhammad. These contractual instruments – such as the *mudaraba*, which already in the fifth and sixth centuries AD showed great affinity with coeval usury activity – were adopted by the Prophet, a skilled trader himself, and continue to be used by Muslims after him. The *mudaraba* is quite close to the medieval *commenda* (silent or limited partnership) and such development progresses in modern European corporate law; here, however, a progressive separation takes place, with the bank reaching, at the end, complete neutrality with respect to the risks involved in its clients' transactions. On the other hand, the ideological perspective founding the Islamic banking system has deliberately included and operatively reaffirmed the client–partner model, and it has developed, around this central core, increasing competitive ability through the elaboration of specific financial products in compliance with the values, principles, and ethical-juridical precepts of Islam.

The topicality of such a system, for a Western observer, resides first of all in the ethical challenge revolving around the modern meaning of the prohibition of *riba*, reinscribed in the light of the fundamental values of solidarity, cooperation, justice, and fairness in the social and economic realms. Such values should be the bases of financial and entrepreneurial activities, both private and public; a goal pursued, also in the West, by various bank initiatives, such as ethical banks, micro-credit, and renewed strength in cooperative credit. This reality and a (historical) convergence have been necessarily included and underlined in the following comparative analyses.

From theory to practice: the client–partner model

With the first experiment, in 1966, of a "bank without interest" in Egypt (with many comparable elements in common with the rural banks and cooperative credit banks well known in European history), the Islamic economic system clearly opened the way for the adoption, in practice, of an associative relation between bank and client, thus representing an ethically licit alternative to the arithmetical calculation of interest both in giving and in taking.

The fundamental element in an Islamic bank is not so much the absence of interest in giving and taking (although this is a strongly distinctive aspect when compared with the Western bank experience), but rather – in theory at least – the implementation of the partnership scheme of sharing between bank and client in most transactions, both active and passive (see Anwar 2003). Being the subject that contributes the capital to the bank, the client cannot be alien to the company, but instead becomes a "partner," taking on the risks connected to such a position and, at the same time, gaining the right to receive possible benefits (profits) from the bank's economic activity, according to the typical pattern of profit- and loss-sharing which has demanded a quick and complex trial of innovative operational instruments, as well as the regulation of conventional tools.

Participation in financial risk legitimizes the profit both parties gain from the use of capital, and allows human activity to prevail on the gainful automatisms of capital. In theory, this frees

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the contractual relation of aleatory vexing and speculative elements, guaranteeing the highest possible equality for the two parties to the contract. It is in such a conceptual framework that the recovery of traditional types of capital and labor (such as *mudaraba*) or more typically corporate (such as *musharaka*) association must be analyzed, in which the profit shared among the partners is always the result of the activity of the enterprise, implemented with the contribution of both parties.

The profit- and loss-sharing model is applied to transactions of funds and savings management, as well as to unitization. More recently, this system was extended to insurance companies, with the aim of overcoming the limits imposed by the ban on aleatory contracts (*gharar*): a system similar to traditional mutual insurance was created using *takaful* – literally, "solidarity" – contracts, in which the element of solidarity prevails on the speculative-aleatory factor (see Archer et al. 2009).

In the Muslim tradition, the model for business is the *mudaraba*, a capital and labor association where the capitalist (*rabb al-mal*) entrusts his capital (*ra's al-mal*) to an agent (*'amil or mudarib*), to be managed and employed in generally determined trade operations. The agent agrees to return the capital when the transaction is complete, along with whatever profit has been agreed upon, while keeping the remaining amount of profit as compensation for his work. The financial risk is entirely assumed by the capitalist, while the agent is not charged with any refund if the deal fails for a reason not attributable to him. The combination of the elements of loan, mandate, and partnership (in which *intuitus personae* prevails) is the principal reason for the success this contract has attained throughout history.

Different types of financial instruments, without direct participation, have been implemented within the Islamic system through some asset-based transactions where the bank offers a financing facility to the client, buying and reselling goods, equipment, or real estate. Contracts like *ijara* (financial leasing) or *murabaha* (mark-up sale) are the most widespread transactions considering their short-term structure and the possibility for the bank to recover the funds rapidly.

The classification of deposits in Islamic banks is based on the consideration of the extent of profit- and loss-sharing management tools, like *mudaraba*. We find "call accounts," for which there is no participatory structure and therefore no form of profit, nor, generally, any charge. Deposit accounts (*al-hisab al-jari*) and savings accounts (*hisab al-tawfir*) are classified as call accounts. The bank may use the deposit funds (on the basis of a *wakala* – a mandate by the client) and guarantees the repayment of the entire amount of money at any given moment. Although there is no compensation conventionally agreed upon, at the end of every financial year, and at the bank's discretion, the clients who have opened large accounts may be rewarded through a payment in kind (*hadiyya*, *ikramiyya*), through small donations (*hiba*) in money, or with certain "privileged" conditions in access to credit (*tamwil*) for the sponsorship of small projects, or for installment purchases of durable or instrumental goods. The Islamic "call account" is no different in its structure from the non-Islamic one, except for the absence of remuneration based on interest. This is why, much more rigidly than in other systems, clients may take out money and write out checks only within the limits of their account or of the overdraft agreed upon. The same happens with the use of debit cards and ATM cards, while credit cards are not popular yet, due to the difficulty of accessing international circuits, based on interest-operation accounts.

"Savings accounts" (*hisabat al-tawfir*) and "investment accounts" (*hisabat al-istithmar*), on the other hand, have a sharing structure, with profits proportionally depending on the profits of the bank. In general, these are time deposits, the typology of which may vary significantly; they may be designed for a specific investment project, or reused by the bank for its ordinary

financial activity, including common *mudaraba* or *musharaka* deposits managed by the bank. In this case, it may be necessary for the depositor to sign a mandate (*wakala*) for the bank, specifying the operations the funds may be used for. Without a specific mandate, the bank either uses the funds freely or establishes different specific investment funds.

This specific condition is designed to guarantee a broader transparency of management, allowing to both the client and the *shari'a* Control Councils – or other control bodies inside or outside the banks – strong control of the ethical-religious aspect of transactions. Theoretically, the consequence of the general implementation of the participatory principle and the consequent idea of risk permeating the entire activity of the Islamic bank is that no form of guarantee on the deposit is allowed, and the lack of an explicit obligation of reimbursement of the funds collected from the public may represent one of the main elements of "incompatibility" with the common Western bank discipline.

In this respect, a distinction is due between the protection of cost-free deposits and that relative to participation deposits. Only the latter can actually suffer losses potentially deriving from a negative sign in the bank operations balance and only if the bank capitals and reserves are insufficient to cover the losses.

Islamic finance developments in Western countries

Islamic banks have constantly turned their attention to the possibility of entering Western banking systems, primarily as an answer to the requests of growing Islamic migrant communities. On the other hand, with reference to the position of Western countries in this respect, I would underline three main issues that are to be considered at the national and supranational level:

1. *The opportunity of attracting surplus liquidity from main Islamic countries and financial centers.* Such liquidity represents the most important factor in the growth of Islamic finance. Although in the last decade Islamic finance has been directly affected by the two main world crises, the market of Islamic capital seems to maintain a stronger profile than the conventional market. After the first two years of decrease following September 2001, Islamic investment funds recovered their losses at a ratio of more than 20 percent a year, and Islamic banks (including *takaful* funds) increased their assets by about 40 percent from 2006 to 2007. Furthermore, in the global financial crisis we are still experiencing, Islamic banks seem to be suffering less than many of their conventional rivals, with a more rapid recovery since the first months of 2010.
2. *The challenge of Islamic finance as an alternative method of investment*, which is less speculative and more likely to produce sustainable development in real economies. *Shari'a* compliant institutions invest in companies that charge no interest, do not engage in significant leverage, and avoid investments in derivatives and complex collateralized securities, which are at the heart of the present critical situation.
3. *Integration policies of Muslim communities in Europe* and the growing demand for compliant financial and banking services. Significant revenues could be obtained by retail banking services, donation management (coming from remittances and charity funds like *zakat* and *sadaqa*), consumer interest-free credit, small enterprise financing (even adopting micro-credit principles), home financing (through specific agreements). In innovating banking business, attention should be given to the relation between the *ethical label* and the *Islamic label*, where both can be perceived as a framework of religious and moral values that operates as a filter for choices concerning investments and the use of money in general.

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Great Britain

Since the early 1980s, European continental countries have contemplated very carefully the Islamic experiments conducted in Great Britain with Albaraka International Bank and other Islamic institutions. In general, according to the European principles of freedom of establishment, Islamic banks, together with every other bank with legal and administrative headquarters in a European country, may open branches in the territory of another country of the Union. So far, the European Central Bank (ECB) has never authorized the opening of Islamic branches at the European level. In this case, every Islamic bank established in Great Britain has not received the "passport" to Europe and has remained only English state chartered.

After the success of HBSC Islamic Loans (2003), a new season started in 2004 with the foundation of the Islamic Bank of Britain, headquartered in London and with branches in Birmingham, Leicester, and Manchester. With a majority of Qatari private shareholders, the Islamic Bank of Britain is the first and only retail bank offering *shari'a* compliant services to British Muslims (several types of deposits and accounts, mortgages and house purchase planning, investment funds, personal pension, *zakat* service, etc.). Other financial institutions, mainly as asset managers, have since been founded:

- HSBC Amanah Finance;
- European Islamic Investment Bank (2006);
- Bank of London and the Middle East (2007);
- Gatehouse Bank (2008);
- Qatar Islamic Bank – UK (2010 – awarded the "Best Asset Manager (Europe)" at the CPI Financial's 2012 Islamic Business and Finance Awards).

Other Islamic finance providers based in the UK, even as subsidiaries of foreign banks, are: ABC International Bank PLC, Ahli United Bank, Bank Negara Indonesia, Barclays Capital, Halal Financial Services Inc., HSBC Amanah Finance, Islamic Mortgages.

The wide space for an Islamic financial market encounters strong limitations deriving, first, from competition with conventional banks. Most British Muslims, in fact, continue to use high street banks, while Islamic operators continue to have high fixed costs in relation to customer numbers. As a consequence of the low income of Muslim families, deposits and investments from residents are too small to be involved in major financial activities. At the same time, the Islamic system is strengthening efforts to attract and accept deposits from other banks, including its Gulf-based relatives; and treasury activity largely involves commodity *murabaha*, which is a more expensive alternative to an Islamic money market.

France

Also within continental Europe, a more critical approach towards Islamic finance appeared after 2001, along with the structural changes occurring in the EU economy: the introduction of a common currency, the EU monetary policy, the creation of the ECB and of the European System of Central Banks, the coordination of credit and oversight policies, the control of payment systems. Thus, while European operators have gained a wider knowledge of the Islamic system, the Islamic system has gained strength in the effort to achieve compatibility with international standard rules governing transparency as well as risk and capital management requirements.

After the British experience, France – a country with one of the largest Muslim communities in continental Europe – made the first steps in testing the progress of Islamic financial

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engineering. BNP Paribas and Société Générale are among the most engaged banks in the field. Thanks to the expertise of BNP Paribas Najmah, centered in Bahrain, BNP Paribas works in extra-European markets and it offers Islamic instruments for savings, credit, and investment: deposits, operations of *murabaha*, *sukuk*, *ijara*/leasing, asset management products, as well as FOREX with swap-free account and derivatives (about the last two operations there is no widespread acceptance by Muslim jurists). Investment funds are linked to the Dow Jones Islamic Market Index and to the FTSE Islamic Global Index.

Société Générale, through its controlled company SG Asset Management – Alternative Investments (SGAM AI), entered in the market between 2004 and 2006, launching the first protected capital products, which reached US$500 million at the end of 2007. SGAM also created a dynamically managed proprietary index (SGAM Baraka Index), based on an active selection from a basket of thirty Dow Jones Islamic Market Index stocks, appraised in advance by its *shari'a* Control Committee (Ratings Intelligence Partners).

These products are prepared using dynamic portfolio insurance (recognized as *halal* by some *shari'a* committees) combined with a *murabaha* contract (which is a pre-agreed mark-up sale) and an option (*'arbun*). They are mid-term protected investments that offer complete capital restitution or, if more positive, 85 percent of the highest market value obtained before stock maturity.

In 2008, SGAM AI launched a new passive index range, SGAM Index S&P Shariah, which seeks to track the performance of the 500 Islamic titles listed in the S&P Shariah indexes, within the SG unit trust in Luxembourg (in conformity with UCITS III European Directive). Such funds were approved by the French Autorité des marchés financières (AMF) in July 2007. Furthermore, Banque Française de Commerce (BFC) of the SG Group, launched SGAM AI Islamic products in the French territory of Réunion (with an average of about 7 percent of Muslim citizens). BFC has introduced a new short-term product named SGAM AI Shariah Liquidity with an eighteen-month maturity, which provides daily liquidity through a certificate managed in accordance with *murabaha* principles. The main obstacle to a wider introduction of Islamic financial transactions, in France and in most European civil law countries, has been represented by the need to adopt legislative revisions, following the model of English trust with the distinction between legal property and economic property, as well as with the opposability of the destination clause to third parties.

United States

The development has almost been the same for Islamic banking and finance in the United States. The first institution, the LARIBA Finance House, in 1987 started offering home financing products according to the Islamic prohibition on usury and interest. LARIBA was located in California with the idea of using capital from individual American Muslims to provide home financing to other American Muslims (see Thomas 2001). Only after 1997 did a federal branch of the United Bank of Kuwait, under the National Bank Act, apply for a *shari'a* compliant *ijara* (lease-to-purchase) home financing program named Al-Manzil. In 1999 the program was approved to also offer *murabaha* (cost-plus-profit) home financing products in California. The program was closed after one year, having provided financing for sixty homes. The most important issue was the "customer training" required to educate customers about the special features of the Islamic operations.

Since then, no further authorization on Islamic products has been granted at US federal level. The events of September 11, 2001 had the effect of drawing stronger attention to Islamic finance, both for security issues and for a deeper Western presence in *shari'a* compliant affairs.

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The University Islamic Financial Corp., founded in 2003 and controlled by University Bancorp (in Ann Arbor), offers different kinds of mortgages (home financing and commercial real estate financing) and savings accounts according to the profit- and loss-sharing scheme.

With the same goal of serving the American Muslim community, the Devon Bank (originally opened in Chicago in 1945 as the Devon North Town State Bank by local merchants who believed in the potential of community banks) has tailored its financial services to the particular demands of the local community. The bank began offering Islamic products in 2003, after receiving approval from Chicago-based Mufti Muhammad Nawal-ur-Rahman and the *shari'a* Supervisory Board of America, as well as in collaboration with the United Bank of Kuwait and the Institute of Islamic Banking and Insurance in London.

Nowadays, few state-chartered banks provide *shari'a* compliant products in the USA, whether for home financing or other financing facilities based on *ijara* and *murabaha*.

Banking/mortgages

- Broadway Bank of Chicago (Chicago, IL)
- Devon Bank (Chicago, IL)
- Guidance Residential (West Falls Church, VA)
- United Trust Bank (Bridgeview, IL)
- University Bank (Detroit, MI)
- Zayan Finance (Chicago, IL)

Wealth advisors/fund companies

- Allied Asset Advisors (Burr Ridge, IL)
- Azzad Asset Management (Falls Church, VA)
- Saturna Capital (Bellingham, WA)

Investment banks

- Arcapita (Atlanta, GA)
- Overland Capital Group (Boston, MA)
- TransOcean Group (Boston, MA)
- UIB Capital (Chicago, IL)

The most interesting development in the USA has been the opening of the American multinational banking industry to the Islamic system. Citi Islamic Investment Bank was incorporated in 1996 in Bahrain, as a subsidiary of Citicorp Banking Corporation, operating as the dedicated Islamic banking vehicle of CitiGroup. The core Islamic banking business of Citi Islamic Investment Bank has been the origination, structuring, and distribution of Islamic banking transactions in trade finance, structured trade finance, leasing, fund management, and Islamic securities. It also works as a "bridge" to introduce into the Islamic banking market other national companies of the group in Brazil, Korea, Turkey, Egypt, Mexico, South Africa, Pakistan, India, and Bangladesh.

Islamic capital market

The Islamic capital market offers a wide range of funds: about 200 Islamic funds are currently operating at a national and/or international level. As a general trend, over 60 percent of such

funds represent investments in stocks on the international, regional, and national markets: this is mainly due to the favorability of the *shari'a* compliant investment scheme for equity investment in the light of Qur'anic interdiction of *riba* and to the traditional inclination for risk-sharing forms of investment.

Since 1999, two key indexes contain stocks considered to be Islamic compliant, which are thus listed on international markets: the Dow Jones Islamic Market Index and FTSE Global Islamic Index. In recent years, other Islamic stock indexes have introduced further lists of companies based on *shari'a* compliant activities and detailed performance requirements. This success is also due to the preference for equity investment in the light of the Qur'anic system of *riba* and the traditional inclination towards risk-sharing forms of investment.

A number of criteria for the identification of companies operating in compliance with the Islamic precept were progressively developed. Such companies are periodically collected in national and international directories. In Malaysia, for example, the audit activity is carried out by the *shari'a* Supervisory Board, part of the Securities Commission, which in turn controls stock market operations. A similar directory is used in India, commissioned here by private groups (Parsoli IBF-Net Equity).

In recent years also the West has seen the emergence of stock directories containing stocks considered to be "compatible" and listed on international markets: the Dow Jones Islamic Market and FTSE Global Islamic Index. The Dow Jones Islamic Fund, created for Islamic equity funds in 2000, selects "compatible" companies among those listed in the Dow Jones Global Equity. The criteria on which stocks are considered compatible according to the *shari'a* may be summed up as follows:

- the main activities carried out by the company in question must not be involved in any of the following fields: swine breeding and swine food production; alcohol beverage production; conventional financial services (banks, insurance companies, etc.); entertainment (gambling, betting, pornography, cinema, music, etc.);
- the company balance must prove that: the total liabilities are not larger than 33 percent of the total assets; profit from bank interest is no higher than 5 percent of the total assets and must be used for social and charitable causes; collectable credits must not exceed 45 percent of the total assets.

With respect to the latter condition, it must be emphasized that the ratios are calculated on a venture capital basis, so that any estimate of loan interest is impossible in the ordinary activity. Islamic financial brokers have set up various types of *interest-free bonds* aiming to attract savings from Muslim communities and offering clients a wide variety of options. Among them we find *takaful* certificates and *sukuk* bonds.

The *takaful* contract is based on the Islamic principle of solidarity and offers a "mutual insurance." It is a pact amongst a group who agree to donate contributions to a fund that is used to jointly indemnify covered losses (in case of death, illness, or other negative events regarding life or health) incurred by the members of the fund. In conventional insurance, companies engage in investments that may derive income from interest and they accept anticipated premiums for future and uncertain claims. While the concept of *takaful* revolves around mutuality and is founded on a non-commercial basis, the operations and the funds are commonly managed by financial operators on a commercial basis through the classic schemes of *mudaraba* or *wakala*. According to the *mudaraba*, policyholders are owners of the fund and entitled to its profits, being at the same time both the insurer and the insured. Mutual guarantee means common liability in the financial result of the fund investment, sharing profits and losses arising

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from it. All investments must be *shari'a* compliant, through the use of instruments that are free of *riba* and are not involved in *haram* activities.

In the last few years, we have witnessed very fast growth of the *takaful* market, where some non-Muslim consumers also found appeal in the specific features of the products. In fact, *takaful* certificates seem to attract interest well beyond their "religious appeal." Ethically or socially responsible investors and consumers identify the market of *shari'a* inspired products as a full-potential and interesting sector of financial undertaking. Along this wave, the global expansion of *takaful* activities (excluding Saudi Arabia, which requires all insurance companies to operate under a cooperative business model; see Ernst & Young 2012b: 67) reached US$4 billion in 2012 (by comparison with US$0.9 billion in 2005–6), with a predicted further increase of about 15 percent in 2013.

On the other hand, *sukuk* (conventionally named Islamic bonds) are asset-backed or asset-based securities, deriving from the securitization of *ijara* and *murabaha* transactions, with the property of the asset divided into equally valued units and incorporated in the certificates. *Sukuk* cannot represent a debt (in Islam debt-selling is forbidden), as conventional bonds can; they must instead represent a property of a specific asset. The value of the *sukuk* thus remains connected to the value of the underlying asset. Some Muslim countries (i.e. Malaysia) are using *sukuk* as a substitute for public debt bonds.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has so far issued standards for fourteen types of *sukuk*, the most widely spread of which is the *ijara sukuk*, which, as the name itself indicates, is linked to assets granted in leasing through a specific account, where the bond represents a quote of property rights.

The *sukuk* market has witnessed a rapid increase outside the *dar al-islam*, entering the global financial markets and attracting non-Muslim investors as well. For this reason, and considering the opportunities deriving from the presence of migrant communities, interesting experiments have been conducted in Western countries. For example, the German Saxony-Anhalt *sukuk al-ijara* (an asset-backed security based on leasing agreements) was issued in 2005 for US$100 million according to the following criteria:

- the underlying asset, consisting in buildings owned by the German Ministry of Finance, has been conferred on the Special Purpose Vehicle (SPV) (operating as a *mudaraba*) for 100 years;
- the SPV has handed the buildings over to the Ministry with a five-year leasing contract and an option to renew the lease;
- the benchmark has been set to one basis point above six months Euribor;
- the *sukuk* has been indexed on the Luxembourg stock exchange; the certificate's rating is AAA for Finch and AA- for Standard & Poor's.

In November 2012 FWU AG Group, a German financial services company, issued the first and largest private *sukuk* in Europe, with a size of US$55 million and a tenure of seven years remunerated by an annual profit rate of 7 percent. This is also the first *sukuk* to implement intellectual property rights under an *ijara* structure. FWU Group, which offers *takaful* solutions through strategic cooperation and distribution arrangements in Europe, the Middle East, and Malaysia, entered into the transaction through the Dubai branch of its subsidiary FWU Dubai Services GmbH. The ultimate financiers were GCC-based investors represented by *takaful* companies that have assisted FWU in raising funding through the leasing method. The *sukuk* were issued through a Luxembourg Issuer SPV incorporated using a Dutch *Stichting* (foundation) structure – first used in connection with the quasi-sovereign *sukuk* issuance by Saxony-Anhalt in 2005.

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Banking activity: a comparison between models

In order to verify the feasibility of the establishment of an Islamic bank or window operating in one or more European countries, first of all we must compare the fundamental notion of bank in both Islamic and European systems. As a consequence of its compliance with *shari'a* principles in banking activities, since its very beginning the Islamic system has applied two distinctive methods: the elimination of *riba* (money interest) from all transactions, as well as the choice of directly or indirectly participatory contracts – the so-called profit- and loss-sharing (PLS) – in most financial activities.

An Islamic bank can be defined as an institution that collects money (savings) from the general public and provides credit through interest-free transactions on both the asset and liability sides. At the same time, positively, we shall define Islamic banks as institutions operating through a system where profits and losses are shared between the parties of each transaction. PLS contracts are mainly an innovative result of the effort (*ijtihad*) to elaborate alternative financial instruments that could be competitive under the market profile and lawful (*halal*) from the religious point of view.

At present Islamic banks offer a wide range of deposit accounts, repayable on demand or with a term or call period; they operate as credit and investment intermediaries; they provide loans as well as private equity capital. Profit- and loss-sharing, as we have seen, is the main characteristic of most credit instruments in Islam. There is a distinction between directly participatory contracts, like *mudaraba* (limited partnership, joint venture) and *musharaka* (venture capital, project finance), and contracts with indirect participation, like *murabaha* (mark-up sale), *ijara* (leasing), *istisna'* (procurement, order to manufacture), etc. In the second group of contracts, the bank does not assume the role of partner of its own customer; it maintains instead a secondary economic risk in connection with the financial operation since the property of goods and equipment must necessarily be acquired by the bank before transferring it to the customer.

If we compare this model of banking activity with the current European concept we notice some relevant distinctive points. First of all, it is possible to denominate as "banks" only those enterprises whose main activity (so-called "banking activity") consists both in collecting repayable funds from the general public and in providing loans as well as all other financial activities (Italian Banking Law L. 385/1993 – art. 10.3). This specific activity is a requirement distinguishing Islamic brokers from other financial brokers. The activity of collecting funds produces the bank's obligation to repay and the depositor's right to be reimbursed, while it does not produce any duty of compensation on the deposited amounts.

The comparison between the two concepts of bank highlights the disparity, since in the Islamic system the different types of deposit do not produce a debt-based transaction between the depositor and the bank, but an equity-based transaction. Theoretically, as a consequence of the general implementation of the participatory principle and the consequent idea of risk, no guarantee on the deposit is allowed. The lack of an explicit obligation to reimburse may represent one of the first elements of "incompatibility" with European regulation. In this sense, according to the general European definition, Islamic banks cannot be considered banks. Nevertheless, in the domestic legislation of European countries the consideration may be different, as in the case of Great Britain.

With regard to financial cover on deposits, a distinction is made between cost-free on-demand accounts and participatory accounts: only the latter can actually suffer losses potentially deriving from a negative trend in the bank's balance sheet, and only when the bank's capital and reserves are insufficient to cover the losses. Apart from the abolition of capital remuneration based on interest and the introduction of the profit-sharing mechanism, Islamic and non-Islamic

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banks are equally subject to the general national legislation in force concerning, particularly, liquidity and reserve regulations. If the raising of the funds engenders some questions about repayment of deposits, the credit side operations require particular attention with regard to guarantees and fiscal profiles.

A specific arrangement is required for credit risk management (and insurance through the *takaful* scheme), which presents greater complexity since various degrees of borrower risk do not correspond to the application of different interest rates, but are congruent with different allocations of profit shares. For this reason, transparency-level analysis is largely suitable in relation to credit management under the profile of both the informative symmetry/asymmetry between the parties and credit monitoring tools and procedures by the bank. Furthermore, legislative reforms are required in European civil law systems in order to create an appropriate legal framework for new Islamic banking institutions or Islamic windows to be opened within existing banks or groups. Such reforms concern specific private law institutions:

- the law of trust in civil law systems with special regard to the opposability of beneficiary's rights to third parties (in Italy art. 2645 ter Civ.Code was introduced in 2006; in France the already mentioned project to modify art. 2011 *Code Civil* was approved by the National Assembly in October 2009 but currently enactment has been rejected by the Constitutional Council);
- the discipline of guarantees in the sale of goods (i.e. *no vice* guarantee or redhibitory fault guarantee) as well as guarantees relating to debt or credit transfer (i.e. debtor's performance guarantee) in consideration of the temporary nature of *murabaha* and *hawala* contracts;
- the leasing contract affecting goods or real estates, with special attention to installment payment conditions and to purchase options.

Further reforms are necessary also in fiscal legislation mainly in order to avoid double imposition in temporary purchase and sale transactions (such as *murabaha* financing and *musharaka* home financing agreements). In the case of non-profit purchase and sale *murabaha* agreements, the ideal fiscal system would provide for the allocation of sums paid in advance for publicity rights and registry rights on deferred payments, as well as neutralization of the impact of the fiscal rights platform (i.e. VAT) on the seller on credit, while distinguishing, in the final purchase price, the principal price of the cost of credit.

Ethical banks vs. Islamic banks

A remarkable point is a certain parallelism between financial practices according to both the Islamic and the ethical viewpoint. Their collective investment schemes are equally defined by a process of selection of the listed company, based on both negative and positive criteria. The *shari'a* compatibility test excludes all those activities expressly violating Qur'anic precepts (alcoholic production, swine processing, pursuing of aims related to gambling and pornography) or conflicting with Islamic ethics deriving from the same precepts (some *entertainment* activities, but also tobacco, drugs, and weapon processing and manufacturing, projects aiming to create or maintain situations of poverty, or cases of exploitation and economic dependence).

In general, the criteria adopted in the ethical or "socially responsible" field appear to be less stringent because they do not directly depend on strict legal-religious provisions. The ethical pockets exclude all activities related to weapons, pornography, tobacco, drugs, alcohol, nuclear energy, animal testing, and, more recently, genetic manipulation and all those activities with a negative impact on the environment and development. At the same time, ethical investment

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should support sustainable economic development in emerging countries; as well as promote environmental sustainability, favoring renewable and clean energy, best practices in waste minimization and recycling, also taking into account energy efficiency. It should favor fair trade, good occupational health and safety practices, equitable industrial relations, gender equity.

In both cases a screening process of the pocket based on efficiency evaluation and company performance criteria is also implemented, with the aim of reassuring investors about the correct (from an ethical or Islamic point of view) practicality. From here, at least theoretically, derives a binding need for transparency and information disclosure, characterizing the two models of investment. Such a need directly regards the psychological security of each investor and calls for the principle of individual conscience to decide whether to follow an alternative route in investing money. In a case where, as frequently occurs, some of the activities emerge as not conforming with the theoretical model, it is necessary to activate a sort of "purification" of the investment returns, re-employing – all or part of – them in social or charitable or ethical targets.

If we read the bylaws of ethical banks, we will find aims and objectives certainly shared by Islamic operators. In ethical banks, savers renounce all or part of the interest, which is targeted at the financing of projects in the third sector with a strong social value. If stated in the bylaws, for an Islamic bank this practice could become an efficient way to purify the returns realized inside a system based on interest as the predominant instrument to compensate the financial risk at all levels of the market. Second, both systems share the necessity of carrying out most of their activity according to a "client–partner" model and, therefore, with the joint liability of the client in the decisions of the bank on the investment side. The cooperative typology of companies the ethical banks are based on in Italy offers the opportunity for an interesting convergence for *shari'a* compliant institutions who want to settle there. Although in the cooperative credit scheme there is no necessary coincidence between client and shareholder, the "partner–client" experience has on the other hand been widely developed, with the shareholder taking up the bank services. The widespread community of shareholders that characterizes cooperative and popular banks makes the transposition of the Islamic model easier and it represents an efficient means to customize clients.

This is relevant to institutions that make transparency and closeness to the client's needs (from the economic, social, and religious point of view) their point of strength. The activity directed towards the general public, in this case, should be limited to collecting repayable funds on demand accounts (fully repayable also in Islamic banks), in order to promote investments and asset-based credit activities providing the application of pre-agreed fees instead of interest rates. However, the additional burden of costs derived from the duties of both information and oversight remains particularly onerous for banks with an atomized shareholder community.

An interesting operational sector would be represented by instruments that channel donations managed by banking and financial mediators offering clients the opportunity to subsidize non-profit organizations controlled through a (generally variable) part of the return on savings. Through an Islamic bank, we can also imagine the channeling of donations coming from payment of the *zakat*, the legal tax due annually from any pious Muslim on its patrimony with its mandatory (as written in the Qur'an) aim of solidarity; or donations derived from the *sadaqa*, voluntary alms to be devolved generally to humanitarian and philanthropic aims. The management of remittances to immigrants' countries of origin, furthermore, could find the proper space here. In all cases, religious clauses or conditions relating to services and procedures performed by an Islamic financial institution must be carefully evaluated in order to avoid any possible form of religious discrimination.

We should also contemplate the growth of demands for credit coming from so-called ethnic firms, the necessity to purchase real estate from newly stabilized immigrants, the growth of

market sectors for production, transformation, and selling of "faith compatible" goods. In Western ethical institutions, it is structurally impossible to elude the fundamental duty to reimburse deposited capital, but this can be worked around with some formal correctives that make the obligations more acceptable from the *shari'a* point of view (such as, for example, compensation with the dividends eventually due to the saver-shareholder in his position of shareholder, maintaining the distinction between the deposited capital and the capital of the bank).

On the other hand, the "ethical" approach of the Islamic bank can actually represent a spur to the level of "bank customization" of Muslim communities, which in Italy, unlike in Great Britain and France, represent a prevalently poor economic bracket with low levels of saving and investment. Notwithstanding this issue, in some regions, like Emilia-Romagna, we find well-integrated communities in the economic-productive system and active under the entrepreneurial profile. In the meantime, the living reality of cooperative credit could become the basis for an ethical Islamic experiment. Domestic and European authorities should integrate with such elements the "sound and prudent assessment" required by European directives (2000/46 and 2004/39) in authorization procedures.

In this view of convergence, ethical institutions could certainly benefit from the wider experience of "Islamic financial engineering" and from the higher skills in resource allocation that we have seen are proper to Islamic finance. On the regulatory and organizational side, Islamic operators could benefit from the experience acquired by the system of cooperative banks in the Italian and European markets.

Conclusion: complementarity vs. alternativeness

With respect to the Western approach to Islamic banking and finance, we should consider two different issues. The first concerns the impact of these types of operations and services at the national level. A significant development has been reached within Islamic countries and outside wide politically and economically integrated areas, where a possible encounter of supply and demand from Muslim communities has generated a positive process. BRICS countries are now attracting much investment from *shari'a* compliant institutions that are looking forward to opening local structures. Inside the European Union and the United States, noteworthy progress has been made in certain jurisdictions (namely in the UK, France, Ireland, Luxembourg, and in three or four American states) to broaden the value proposition of Islamic finance. This situation nevertheless remains limited and somewhat fragmented. Each of these countries has tended to focus on the promotion of Islamic finance from their national-state perspective. This is for different reasons: the concern of most European governments considering the Eurozone crisis and the partial lack of dedicated resources in Europe to promote competition and challenge between Islamic and conventional finance.

Furthermore, the solution to the request to use an *Islamic label* (i.e. the implementation of religiously compliant expressions in bank logos and trademark or contracts) is certainly complex, considering the different shades of meaning given to the idea of secularity. A fundamental role is to be played not only by the economies and foreign policies of the individual countries, but also by socio-economic integration policies and economic support for the stabilization of Islamic communities. Through these communities, the international image of a country can find significant promotion. The severity of performance challenge has prompted several institutions to initiate wide-ranging transformation programs concerning (Ernst & Young 2012a: 4):

- regulatory framework – involving compliance risk, capital optimization, integrated balance sheet management and liquidity management;

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- risk management – around *shari'a* governance, single data management framework, segment specific risk models and fund transfer pricing capabilities;
- retail banking operations – strengthening the customer-centric operating model, channel integration and technology enablement: developing a "whole-customer" view of requirements and profitability will be an essential capability for Islamic banks to improve performance;
- supervisory uniform standards and transparency enhancements – harmonizing the interpretations coming from *shari'a* boards and building a new model of reliability towards the client/consumer.

The second and most important adaptation challenge is rising on a supranational level. From its beginning, Islamic economy (with its banking and financial operative tools) has been introduced as an ideal "alternative" to liberal and socialist ideas. Its alternativeness has also been its fortune. The possibility of attracting pious Muslims concerned about the payment of interest, along with creative and trustworthy financial engineering, has created a launchpad for entering both national and international markets.

Despite these developments, the "alternative" model is not always successful. Within Europe, as well as the USA, and their very strong and structured centralized banking systems, Islamic banking needs to seriously consider the opportunity of becoming a complement to conventional banking and capital markets, not a substitute. Given the valuable attributes of Islamic finance and its affinity with tangible economic assets, transparency, fairness and alignment with socially responsible investing, much more is feasible and can be expected.

The adaptation to the European environment needs to avoid overdependence on technical jargon and explore opportunities of connectivity with socially responsible investing (i.e. sustainable investments); and, in the case of *takaful*, to be aligned with mutual and cooperative insurance structures, finding a strong mix and balance between Islamic and conventional ethical finance. The financial innovation that the Islamic system has realized so far is questioning the West about the compatibility of existing rules not only from the technical-legal point of view, but also in the light of its financial and social policies.

Indeed, these are elements of strategic importance: we cannot forget the continuous adaptation and contamination amongst different social, economic, and legal cultures deriving from globalization and from their unavoidable dialog. Complementarity – without giving up its own ideal values – will be a challenge to the conventional banking and financial system, brought by Islamic banking, in order to contribute to a better integration of Muslim communities in the Western context and to further incorporate the Islamic economic pattern in the plural global market (Cattelan 2013: 228–9).

Note

1 Islamic banking and finance, during the last decades, have shown themselves to be a very attractive issue for scholars and professionals. For a comprehensive bibliography on this subject, see Henry and Lamm 2010.

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