

Islamic Banks and the European Banking Union: An Overview of Critical Issues and Perspectives

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Abstract— The aim of this paper is to provide a general, but in-depth overview of aspects of incompatibility and actual interest profiles of Islamic finance in relation to the legal system of the European Banking Union, identifying some prospects for positive future developments. It examines the relevant Islamic principles for banking and the differences from conventional European banks for regulation and supervision, a number of experiences and possible relationships. The modern communication between the Islamic banking scheme and the European (and international) one is certainly allowed by the activity of the IFSB regulator, especially as regards the adaptation to the Basel Committee standards and the related capital requirements, transparency criteria and common references, considering the global application to operate in the international markets. The examination of the relationship with the European Banking Union allows the identification of future profiles for debate and research in economics law, considering the suitability for regulatory adjustments and the interaction between EU and national law and the interesting ethical aims of the socially responsible Islamic finance.

Keywords: *Islamic finance, Islamic banking, European Banking Union, Regulation, Supervision, Transparency, Certainty of rules, Comparison, Perspectives*

I. INTRODUCTION

In Europe, for several years now, there has been a significant growth of interest in Islamic finance and banking for investment companies, Islamic bond products and other credit collection instruments. Very significant was the position of the Financial Service Authority which, in 2004, issued an authorisation to operate to the Islamic Bank of Britain [1] and to the first European Islamic Investment Bank. Other European countries have experimented with Islamic financial

products, albeit in a limited way [2]. In this context, it is interesting to look further at the possible relations between the conventional bank model that operates in the EU market and the Islamic bank that follows criteria, including ethical-religious ones (e.g., the prohibitions of *riba* and *gharar*), but with issue regarding risk control and data transparency, regulation and prudential supervision [3], especially in relation to the current European system, capital requirements and the Basel III Agreement.

The age-old question of the prohibition of interest is also known in conventional banking, in the sense of considering the difficulties of the weak contractor for elementary forms of lending; moreover, the reference to the prohibition of usury and to the forms of protection provided by the national systems that extend to the various forms of traditional operations is inevitable, while for the issue of supervision and risks, the evolution has been very different until the appearance of European banking supervision. From the Islamic perspective, instead, the mechanism of pecuniary interests has been replaced by the “sharing” of the creditor in the profits and risks of the banking activity. In essence, the result of profit can be achieved through sophisticated legal constructions (shareholdings, investment funds, linked contracts) also to encourage credit, given that banks use credit in commercial operations, or with the affirmation of ethical justifying principles linked to necessity or the common good.

In addition, the prohibition of gain (*gharar*), based on uncertainty for reasons inherent in the value of the asset for speculative purposes or when the asset is not determined for the contracting parties and, therefore, the contract is qualified aleatory, involves an element of risk and uncertainty that is, instead, central to contracts in European (and international) financial markets [4]. A derivative financial product is, of course, an instrument that “derives” its value (price) from that of an underlying financial asset. Derivatives are intended to

hedge business risks (e.g., foreign exchange options to hedge foreign exchange transactions between importers and exporters), but are currently mainly used for speculation on future price movements, as the value of derivative contracts consists of multiples of the actual economic transaction. These financial instruments certainly do not meet the requirements of linkage to an asset and the character of “non-speculation”; conservative Shariah scholars argue that the prohibition of gharar eliminates speculation on interest, options and some conventional insurance contracts because they conflict with the prohibition of uncertainty and wagering (maysir), even if there is a hedging of an underlying economic transaction [5].

The main ways of collecting credit consist of current accounts for the management of payments, for which interest payable and receivable are foreseen and repayment is only guaranteed, and in savings deposits for which there is no form of guarantee regarding the return or the repayment of capital, but a share of profit paid periodically [6]; the other collection instruments, traceable to forms of co-participation or partnership - *mudāraba* and *mushāraka* [7], *murābaha* [8] - are clearly different from bank deposits.

For the well-known principle of the prohibition of interest, there are further particular rules in the Islamic banking model [9]; it is based on precepts of the Shariah: the prohibition of investing in activities forbidden by Koranic law and in speculative activities, the sacredness of the contract and the obligation to pay the *zakat*, which is a religious tax; moreover, these principles also apply in the securities market [10]. Therefore, the model of the Islamic bank, precisely because of its necessary conformity to ethical-religious values, is conditioned in several respects: in investments, the bank must ascertain the credibility of the projects, the entrepreneurial skills of the client and the ethical character of the financed operation with regard to the aims; thus the collection of savings must be ethically consistent and the objective is obviously to attract the interest of savers, even if no interest is paid, through investment funds with participation in the profits according to pre-established conditions.

As we know, the Islamic banking has adopted the Basel III standards, a solution that revealed a significant regulatory challenge, given that the agreement does not consider the specificities of Islamic banks and Islamic products present various profiles of incompatibility with the European (and international) markets [11]. The context is complex and Islamic banks are required to be adequately capitalised to inspire trust and maintain sufficient liquidity under Basel III, like European banks, in order to protect depositors and avoid expensive governments “bail-outs” in the case of defaults. Besides an increasing number of Islamic funds screen equity investments to ensure they are permitted and there are even indices tracking Shariah compliant stock, most notably the S&P Dow Jones Islamic Indices.

This framework suggests a reflection on the sector in relation to the European Banking Union, in order to identify conflicting legal profiles, and to highlight the need for specific European and national rules and compatibility aspects especially considering sustainable finance. The aim of the

research is to outline legal considerations regarding the prospects for the establishment of Islamic banks and the use of financial products; the results that emerge may provide a reference for future research.

II. LITERATURE REVIEW

The article adopts an interdisciplinary analysis between law and economics, in the sense that the legal reflection cannot disregard decisive economics studies. The literature cited in the “References” section shows jurists have not confirmed a particular interest, beyond the episodic in the context of conferences, especially in the Italian legal system or the initiatives of financial institutions (ECB, Bank of Italy). The results of economic studies make it possible to acquire an adequate awareness of the affirmation of Islamic finance in the international markets and of the reasons for its necessary consideration in relation to the European legal systems.

It should also be pointed out that the role of lawyers depends on the existence and interpretation of disciplines or at least the adoption of bills; as is well known, there are not European rules for Islamic banking, but individual experiences of some European countries. From the bibliographical references emerge a clear minority of law studies and an extensive panorama of in-depth studies by Italian and foreign economists who analyse the relevant presence in international market of Islamic finance from several points of view.

Predieri was the first Italian jurist to deal with Islamic banks in essays in 1996 and 2006 with the broader aim of fostering knowledge of Islamic law and contributing to cultural enrichment; Piccinelli also follows this line, focusing on legal instruments. Since 2006, some authors (Donato, Donini, Freni, Gimigliano, Miraglia, Piccinelli, Porzio, Rotondo, Russo, Santoro, Scolart, Casoria) have explored the topic from an interdisciplinary perspective, above all, in several collective volumes, often containing conference proceedings that highlight the intention to solicit further studies. However, the debate has not had much follow-up among Italian jurists, while there has been more interest in other legal systems. There are also some contributions from foreign lawyers (Aldohni, Al-Rimawi, Ariff, Arnaud, Decock, Engels, Farook, Housby, Lewis, Sagaert, Wilson, Knan, *et al.*) dealing with the differences between conventional and Islamic banking systems, also with reference to the European Union and the experience of the United Kingdom.

Undoubtedly, the most numerous and specific studies consist of economics studies by many foreign (Abbas, Abiad, Ahmed, Aracil, Ariff, Asad, Ashraf, Asutay, Chazi, Ginena, Gintzburger, Hassan, Khallaf, Khavarinezhad, Jafari-Sadeghi, Khan, Zamir *et al.*) and Italian authors (Biancone, Calandra, Colecchia, Floreani, Miglietta, Paltrinieri, Prandi, Lanzara *et al.*) who addressed various aspects of Islamic finance: the response to the crisis, capital requirements and the application of Basel III, risk exposure of GCC banks and activities in the European context as well as sustainable finance profiles.

In this survey, the law and economics studies, reports and publications of the Islamic Financial Services Board (IFSB) [12] represent crucial references for an overall knowledge of the sector and regulation aimed not only at Shariah compliance, but also at aligning Islamic banks with international standards acquired by the European Banking Union and the Single Supervisory Mechanism.

This article could help fill a gap in law studies on possible relationships between the European system and Islamic banking industry.

III. METHODOLOGY

The method of investigation adopted consists in comparing the typical legal principles and the economic aspects of Islamic finance and the European Banking Union and national law, in order to verify whether the establishment of Islamic banks and investment companies is conceivable or whether, for reasons of structural incompatibility, the current European regulations and organisation can only admit the offer of Islamic finance products by conventional European banks.

More precisely, the method of comparative law [13] allows a comparison of the relevant aspects of the two sectors of banking activity that belong to different law systems, examining the European discipline and the principles of Islamic finance in order to identify possible areas of “coexistence” in the same system. The survey draws on the contribution of the extensive economics literature cited in the “References” section which has supported the study of legal profiles, in the light of the modern interdisciplinary research that is indispensable in such complex areas. In fact, for the field of Islamic finance, economic studies are prevalent compared to the limited interest of European jurists.

The difficulty of finding legal scholarship conditions the debate, which focuses mainly on the economic consequences and less on the construction of legal instruments for operational adaptation in the European banking system. In fact, lawyers tend to examine disciplines that already exist in the system of reference, the possible changes or bills; in this case there are no specific rules of European law, but there are general principles and individual experiences of some European countries that have allowed the use, within certain limits, of Islamic financial products.

Economic studies, on the other hand, can evolve by examining global economic phenomena using case study criteria and empirical analysis of the activities of operators according to international standards. The approach is more open, and the object of the research concerns the economic consequences of existing legal schemes, which can provide an interesting basis for legal reflection, especially when a sector, such as Islamic finance, is so widespread that it cannot be ignored by European legal systems.

IV. FINDINGS AND DISCUSSION

A. *The comparison with the European conventional banking system and differences*

Relations with conventional banks are difficult because of the characteristics of Islamic finance and banking activities exercised in the EU context according to different rules for the financial intermediary, above all, considering the management of the risk, to the rules of vigilance and to the regulation of competition. For the intermediary from the Islamic discipline, the implementation of transparency depends essentially on the respect of conduct provided by the supervisory authorities and by the Shariah guarantee committee for an ethical control, while the informative obligations depend on the discretion of the bank with inevitable problems of transparency and certainty of the rules. However, the IFSB has contributed significantly to improving relations with the conventional banking system. A central aspect that must be examined is the compatibility of the Islamic banking activity with the European supervision discipline, on the requirements of liquidity of the capital and on the financial system in order to envisage a framework of admissible relations.

In general, as we have seen, the principle of participation which is linked to the sharing of the risk characterises Islamic banking activity and because of its structure it is not linked to an obligation of guarantee for the capital deposited and funds reimbursement, a substantial aspect which is not compatible with European banking discipline and the requirements of capital liquidity, especially after the innovations of the Banking Union. However, it is necessary to distinguish between the regime of free and participating deposits and, in fact, only the latter can be affected by losses, if the bank is not able to meet them with its capital reserves. Moreover, it is necessary to point out that the location of the bank, be it Islamic or conventional, conditions the applicable discipline in the relative order; the purposes of the bank deposit are different: in the Islamic system, the capitalisation of savings and the guarantee of preservation, while in conventional banks the deposit has represented, at least until the financial crisis and the drastic reduction of interest rates, also a solution of investment and short-term savings [14].

An immediate comparison [15] between the two systems shows the different nature of the discipline: since for conventional banks the functions and operating procedures are provided for by European and national laws and standard rules, while for Islamic banks the reference is the Shariah to which the production of profits must conform, an objective common to the conventional bank, while the main function is different, which in the first case consists in participation in partnership activities and in the second in the intermediation of funds. The relationship with clients is a three-way one, i.e., between investors, partners and intermediaries, which is different from the “traditional” one based on the creditor/debtor dynamic; as for interest, this is not applicable as it is contrary to the rule of risk sharing between depositors and custodians of funds, unlike our system which provides for active and passive interest rates as a return and costs to be

incurred for the deposit. The approach is also different for the phase of verification of admission to projects financing, since the Islamic bank gives importance to the feasibility, while the conventional one gives priority to the reliability of the applicants and financing based on the provision of guarantees. In the event of defaults or delays, the Islamic bank cannot set interest or other charges, a rule that is, instead, general in the conventional scheme, and neither would there be an obligation to fully guarantee deposits, an issue that has been the focus of attention in the EU and in the choices of the ECB until the introduction of a single mechanism for the resolution of banking crises (Reg. (UE) 15 July 2014, n. 806; Directive (UE) 15 May 2014, n. 59).

In any case, the obstacle of the prohibition of interest has prevented easy access to the interbank market and investment in “conventional” securities precisely because of their intrinsic nature of referring to interest-based return mechanisms. However, specific forms of investment and credit collection have been developed for issuance, consisting of transactions, especially in mutual funds, in participatory corporate contracts and in the issuance of bonds and Sukuk, which are bonds deriving from the securitisation of portfolios of contracts, and in participatory current accounts. Islamic bonds are issued by the state or other public entities according to the scheme of securitisation of public assets through sale and lease *Ijarah*. In the mutual fund, the holders of the shares entrust the management of a capital to a specialised operator who is entitled to a fixed amount of the profits deriving from the management and the investor is entitled to a share in profits and losses proportional to the amount conferred, based on the trust agreement between bank and depositor. The management of the fund can also take place through a company, which is responsible for the correct administration of the investments in compliance with the Islamic discipline and the directives of the body (committee or council) in charge of monitoring compliance with the ethical rules and for any financial losses from which an obligation of compensation generally derives [16].

B. Islamic Banking and European Banking Union

The Islamic bond market has gained significant consideration even among conventional investors as well in the last decade precisely because these instruments are linked to material assets and, therefore, with a high degree of security [17]. Not only Muslim investors are involved, as they formally conform to Islamic principles, but also European ones, given the financial crisis caused mainly by the circulation of instruments that have unsafe mechanisms, based as they are on interest and debt. Indeed, these securities are currently traded in the largest secondary markets mainly because of their security qualities.

The growth of Islamic banking can certainly be traced back to the spread of investment funds and Islamic bonds; the establishment of the Islamic Bank of Britain [18], which is an expression of this evolution also by means of innovative management methods in order to acquire credibility in the markets, notwithstanding its very particular and distinct

framework compared to conventional banks. Regarding taxes, the legislation in the UK facilitated the practical implementation of traditional models of acquisition avoiding interest, which are compatible with Islamic law. New rules have been implemented to levy the stamp duty only once in cases of Islamic mortgages and at first HSBC Amanah first offered such Islamic mortgages, with other banks following suit.

However, it is necessary to highlight the problematic issues of compatibility with the conventional market, regulation in the classical sense and the necessary transparency of requirements, when Islamic banks operate in European countries. It is necessary to consider the supervision exercised by the ECB and national central banks, according to the approach of European banking supervision (Reg. (UE) 15 October 2013, n. 1024 and Reg. (UE) 16 April 2014, n. 468 and related disciplines) and many rules (Basel III, EBA) that impose obligations of capital requirements and procedures of necessary transparency (e.g., the “stress test” for banks) about aspects of accounting and internal decisions that can only be based on the adoption of technological innovations for communications between the operators involved. Islamic finance schemes present interesting aspects from the perspective of a sustainable and socially oriented finance, but the critical issue is the certainty of the rules and their effective knowability through widely available technological tools.

It is, therefore, necessary to have a high level of transparency in internal controls by the Council of Shariah, which plays a role analogous to the ethics committees, but according to Islamic ethical-legal rules from which derives a certain unpredictability in the application of rules of conduct by way of interpretation. Moreover, a certain uniformity of rules would be necessary, given the obvious differentiation according to the countries of origin, an objective in theory constantly affirmed by the GCC, but difficult to implement even for the discipline of competition [19].

The Islamic bank is, however, for certain activities, certainly comparable to a conventional credit institution, but for further services of a financial nature, problems of vigilance arise and for the collection of credit “at risk”, there is a need for greater transparency also for the savers, especially for European investors. From the *mudāraba* and *mushāraka* schemes derives a significant involvement in the business risk of the bank and, therefore, adequate supervisory measures are necessary. In the case of *mushāraka*, the partnership contract between bank and client foresees that the capital in goods or liquidity derives from both and allows the control to actively participate in the project [20]. Moreover, the need for an organisational separation of the activities of the bank is also envisaged for the Islamic bank, in order to avoid possible conflicts of interest between the parties involved in the business, like the universal bank scheme [21].

C. Tasks of Islamic financial and banking authorities

The Islamic financial activity has, therefore, objectives of an economic nature (preservation of the capital, profits,

equilibrium between liquidity and profitability) and ethical-religious rules (respect for the precepts and standards of behaviour of the Koran and of the Shariah, considering the legitimate goods - halal - and excluding the forbidden haram activities). Moreover, the concept of cooperation replaces the traditional concept of competition in the market mechanism, which is instead central in the EU.

The difficulty of “translating” ethical-religious or, at least, moral principles into rules of prudential supervision, which in the international market must be compatible with the requirements of Basel III, is evident, in addition to the uniform European framework for Member States. Furthermore, there is the necessary availability of information that can be acquired by financial intermediaries and investors, a condition favoured by technological innovation and tools in the most advanced countries along with the establishment of competent authorities.

The schemes of Islamic finance present characteristics that seem, in effect, to favour economic and social sustainability; however, the risk of unpredictable interpretations adopted by the Shariah supervisory committees is still an element of significant perplexity, especially if we consider the essentiality of legal certainty and reliability of the financial products, after various crises for different reasons. The current solution represents a delicate compromise between the acceptance of international standards and the objective of Shariah-compliance activities.

The national Islamic banking supervisory authorities must guarantee the stability of the financial system according to two objectives: the control of capital requirements with international indications and the modalities of activity that must be Shariah-compliant. This stability depends on ensuring that Islamic banks have systems in place to control requirements and internal Shariah governance policies and processes to identify, monitor and control or mitigate Shariah risk as a result of interpretations that may be inconsistent. As regards the relationship between liquidity and credit risk, some studies have compared Islamic banks and conventional ones and revealed that the former are better than the latter in managing risks [22]. In addition, a further objective of financial regulation is the protection of consumer rights that may be affected by the proposed instruments, and it is essential that Islamic banks ensure fairness and diligence in their operations and compliance with Shariah precepts, as depositors are attracted to these institutions primarily for their ethical and religious principles.

Thus, the IFSB advises supervisors to provide banks with a framework of uniform internal rules to enable Shariah compliance, although supervisors will inevitably have differing views on Shariah governance given the different legal systems in which the banks operate. In addition, the IFSB ascertains the different needs of individual banks, which vary depending on different factors such as size and capital requirements; regulators should ascertain whether banks have control systems in place to ensure Shariah compliance. To this end, the IFSB has developed some guiding principles on

requirements for the distribution of Islamic products in the capital market, for Sukuk and collective investment schemes.

The focus issue is the implementation of good practice in financial reporting and the establishment of an independent auditing systems and the task for any supervisory body can be made more manageable by learning from the experience of others and by applying available standards and guidelines. In this sense, the Basel III rules have contributed significantly. At the same time, it is possible to say that Islamic finance schemes may contribute generally to spreading an economic approach of solidarity.

D. The relationship of the GCC countries with the ECB and some limited experiences of Islamic finance in EU Member States

From 2005 onwards, it is possible to identify frequent contacts between the EU and the GCC, managed by the General Secretariat [23], and requests for specific advice to the ECB on the single currency project, which was planned for 2010, highlighting the European experience as a model to be followed for the establishment of a centralised banking entity, price stability, and fiscal and monetary convergence parameters [24]. However, links and political relations between the GCC and the EU date back to 1988 and a cooperation agreement, which provided for advice, mutual dispatch of delegations and annual meetings of ministers in sectors such as energy, transport, research and innovation, and the EU-GCC Clean Energy Network and the EU-GCC Trade and Business Cooperation Facility. At present, the objective of the single currency is postponed or at least suspended, given that there are no recent definitive decisions in this direction, to which have to be added the problems of agreement between the various countries, especially for the international policy guidelines that have created diplomatic difficulties.

Decisive decisions are still being awaited on monetary union, while for the financial markets the European discipline has already influenced regulation well beyond its natural boundaries of application due to the need for necessary harmonisation in order to encourage investment, despite the critical aspects. In fact, in the adopting standards, the IFSB, which includes GCC banks, has inevitably further rooted the European schemes as an experience of best practice in conventional markets, initially considering the Directive 2003/71/EC (on trading in financial instruments), the Transparency of Issuers' Information Directive (2004/109/EC), the UCITS Directive 2009/65/EC (regulation of undertakings for collective investment in transferable securities) and, subsequently, the most recent regulations in force, as well as the criteria adopted by the Basel Committee for European and international standards.

The cooperation of the ECB with non-EU countries has therefore also involved GCC countries, as it has strengthened relations with the General Secretariat, central banks and monetary bodies of the Member States since 2005, particularly with a view to introducing a single currency. Instruments have also been developed to enhance cooperation with the major

central banks of many non-European states, including those of the GCC and their monetary authorities, through specific seminars [25], technical assistance and guidance, including through the contribution of expertise in the conduct of monetary policy, payment systems and banking supervision, as a “source of inspiration” for various systems. This advisory activity is part of the institutional tasks as provided for by Article 5 of the Statute of the ESCB-ECB (Protocol no. 4); for the collection of statistical information, the ECB “shall cooperate with the institutions, bodies, offices or agencies of the Union and with the competent authorities of the Member States or third countries and with international organisations” (Article 5.1.) while Article 6 refers to international cooperation and participation in international monetary institutions.

The ECB cultivates international relations [26] for cooperation with countries outside the EU; in particular, the Article 8 of Reg. (EU), 15 October 2013, no. 1024, on banking supervision, provides for the possibility for the ECB “to establish contacts and enter into administrative arrangements with supervisory authorities, international organisations and administrations of third countries, subject to appropriate coordination with the EBA. These agreements do not create legal obligations for the Union and the Member States”. This provision, which also allows for forms of cooperation in prudential supervision, may help to expand relations with other systems, especially in the exchange of information and the adaptation to common international standards.

In addition, a regulatory convergence between the EU, the GCC and other Islamic countries is necessary for the establishment of Islamic banks in Europe regarding the prerequisites for banking authorisation (Articles 4.1 (a) and 14, Reg. (UE), no. 1024/2013), capital requirements, safety nets, independence and powers of supervisors. In fact, EU law and national legislation provide for rules on administrative and decision-making bodies in a way that is far removed from the presence of the Shariah board.

Islamic financial instruments have been offered on the market for some time; in 2004, in the United Kingdom the Islamic Bank of England obtained its authorisation, in 2006 Sukuk was listed on the stock exchange and in 2014 saw the widespread issuance of Islamic bonds with a specific discipline, as in Luxembourg; while in 2004, Germany, the Land of Saxony-Anhalt decided on the issuance of Sukuk as in France [27].

In Europe, the financial sector considers the needs of Muslims with some solutions, apart from the older case of the United Kingdom, now no longer part of the European legal framework, due to the significant presence of a very traditionally oriented Muslim population. In Germany, there is a significant experience: the Kuveyt Türk Beteiligungsbank (Frankfurt) which obtained a licence as a deposit and investment bank in 2015 after an experience that began in 2004 [28], through a German bank that allowed the knowledge of Islamic finance, along with some national regulatory innovations. Other jurisdictions have introduced a special tax regime for Islamic investors for specific products.

Stock exchange values are currently listed in the Dow Jones Islamic Market and FTSE Global Islamic Indexes. European banks already distribute shares in Islamic equity funds for financial investments that exclude companies involved in gambling, alcohol, tobacco or interest-bearing loans.

The development of Islamic finance has depended on its significant reliability and resistance to financial crises (2007/2008 financial crisis period) due to its low indebtedness and use of operational instruments that are based on real assets. Certainly, financial products are more expensive as sharing entails control costs, problems of information asymmetry and property management. For an effective contribution to sustainable finance, a common regulatory and supervisory system is needed to ensure transparency and certainty, as well as contracts with clear content, especially considering the link between law and moral principles in order to limit legal risk as much as possible.

However, there are critical views regarding the tendency of Islamic financial institutions to offer products and services that are in essence similar those offered by conventional institutions and to try to come up with new ideas to remain competitive as a viable alternative to conventional finance; at the same time Islamic financial experts must ensure their Islamic character [29].

Financial transactions are guaranteed by assets and risk-sharing and transactions have real purposes (concrete and productive activities, real estate), limiting financial speculation; moreover, some recent reports [30] on Islamic finance reveal prospects for growth, despite the difficulties caused by the pandemic [31]. These aspects are of considerable interest to European legal systems as an opportunity and alternative source of financing. In Europe, there is a significant presence of “Islamic counters” that have opened in conventional banks for depositors wishing to implement religious principles, but regulatory innovations must be introduced for supervision and regulation, in the sense that the EU member states where these banks are located should adopt their legislation considering all the potential risks in relation to this new financial activity.

These perspectives also appeal to the Italian system, on the assumption of appropriate regulatory changes necessary to overcome tax issues and incompatibilities with internal rules, in order to encourage the establishment of Islamic banks, especially in the form of investment banks, while European advisory companies are already widespread. In 2010, a seminar, organised at the Bank of Italy, brought together GCC central banks and monetary authorities to examine financial and economic developments in these countries and in the euro area and the consequences of the global financial crisis for stability and monetary policy. A relatively favourable economic experience emerged, especially in comparison with advanced economies and emerging markets. The GCC Region was seen as a major player in international financial markets, engaged in the efforts of the international community to reform the global framework for financial stability and banking supervision [32].

Later, in 2013 at the IFSB Forum in Rome at the Bank of Italy, the Governor Ignazio Visco focused attention on the interest for Islamic finance and the opportunity to attract foreign capital to underpin economic progress and the intensity of the commercial and financial links with the southern shores of the Mediterranean and make it increasingly important for Italy and its financial system to be equipped with the knowledge and the operational instruments needed to interact with financial systems complying with shariah principles: the principle that profits should be generated from fully sharing in the business risk of an investment, the so-called “profit and loss sharing principle”. The asset-banking requirement complements these prescriptions, providing for the link between each financial transaction and an identifiable underlying asset, but it has to be clearly ethical and certainly transparent.

The offer of Islamic financial products is characterised by high growth rates and the most relevant component is banking, but in non-Islamic systems an adaptation of traditional and fiscal schemes is required. The Italian legal system shows a limited and slow interest in these alternative financial instruments, compared to other European countries. Bill no. 4453 of 2 May 2017, presents provisions concerning the fiscal treatment of the operations of Islamic finance, given that a decisive obstacle to the expansion of Islamic finance in Italy consists in the “duplication” of taxation because of the complex structure of the operations to ensure compliance with the Shariah, with an aggravation of fiscal costs in comparison with the instruments of conventional finance [33].

The objective is to “assure a taxation equal to that of the conventional financial operations” (Article 1), in order to attract foreign investments and depositors from the Muslim community in Italy who already hold a high amount of savings. The “constant monitoring” will certainly have to be extended and supplemented by specific rules of regulation and supervision to be included in the current system.

At present, the project is still assigned to the VI Finance Commission, but there have been no further developments. The slowness of the Italian legislator has led some banking operators to consider the possibility of offering Shariah-compliant products through “Islamic windows”, i.e., special branches created in conventional banks. Regulation appears to be a very important issue, in order not to exclude from access to credit a sector of the population corresponding to at least one million residents, both for social reasons and for evaluations of credit support and incentives for investment funds.

E. The role of the IFSB

The context of reform of the international rules and global difficulties have undoubtedly aggravated the relevant complexity of the multiple tasks carried out by the IFSB as regulator and supervisor of the Islamic banks in the system of natural belonging and as an authority that adopts the choices of necessary alignment to the conventional system for obvious interests in international markets. This organisation promotes

and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles, broadly defined to include banking, capital markets and insurance sectors.

The respect of punctual constraints of capital is a further controversial aspect, given that for the Islamic banks the prevailing limits consist in ethical rules of the Shariah, in addition to the evaluations of control of merit which depend on the interpretation of the Shariah, exercised by a council (or committee) of the Shariah, and limits for the liabilities in the balance sheet. However, in addition to these forms of ethical-religious control, there is also the regulation of Islamic banks for the aspects that are linked to risk and capital requirements. In this context, the IFSB has taken on a decisive role, established in 2002 and operational since 2003, precisely because of the particularity of the requirements of financial institutions, which involves several banks in the Arab countries of the GCC and which provides international standards and obligations comparable to those provided by Basel III and the discipline on banking supervision. Indeed, the IFSB has published standards, guiding principles and technical notes covering various regulatory aspects for Islamic banking markets, insurance markets and financial markets.

The IFSB is an international organisation aimed at introducing standards, promoting and enhancing the soundness and stability of the Islamic financial services industry by issuing prudential rules and guiding principles for the financial services industry (banking, capital markets and insurance sectors). The standards developed derive from a complex process specified in guidelines and standard-setting procedures, which are characterised by the issuance of exposure drafts, the conduct of workshops and public hearings. In addition, the IFSB prepares very concise annual reports, conducts research and coordinates initiatives, roundtables, seminars and conferences for regulators and industry participants and for these purposes it cooperates with international, regional and national organisations, research institutes and market participants, as a “dialogue” entity with the conventional banking system.

The IFSB standards follow a comprehensive due process as outlined in its *Guidelines and Procedures for the Preparation of Standards/Guidelines*; it involves the issuance of exposure drafts and carries out workshops and public hearings, research, conferences for regulators and stakeholders [34]. These activities are carried out in cooperation with relevant international and national organisations, research entities and market players.

The *Islamic Financial Services Industry Stability Report 2021* [35] offers a selection of results from the IFSB international research and surveys to achieve a broader and common understanding of critical issues in Islamic finance. In line with governments and regulators in other countries engaged in economic recovery and the adoption of fiscal and monetary measures, the IFSB has been engaged in analysing the most effective interventions to support the banking sector and sustained its growth momentum in 2020 recording a growth rate of 10.7% year-on-year based on significant

improvement, especially in the Islamic banking and capital markets segments. The financial stability indicators remained satisfactory, especially when compared with previous years' performance, conventional peers, and assessment criteria used by international standard-setting bodies.

The IFSB closely monitors developments in the global financial system generally and specifically in the jurisdictions of its members; it has published a compendium of policy responses and a paper on the impact of the pandemic on the Islamic Financial Services Industry (IFSI) and several standards, guides and technical notes to complement the work of other international standards but also to cater for the specific tasks of the IFSB. The analysis conducted on the Islamic banking segment is based on the Prudential and Structural Islamic Financial Indicators (PSIFI) database of the IFSB, which has extended coverage of the database to both the Islamic capital market and takaful segments from 2020 onwards. The report examines the implications for the soundness and resilience of the global IFSI and recent economic developments and changes in the global financial system, with a particular focus on the pandemic.

The 2021 Report presents an overview of the vulnerability aspects and the outlook of the global Islamic financial services industries and IFSB members regarding the three key sectors: Islamic banking, the Islamic capital market and Islamic insurance that are objects of an in-depth analysis based on data from the Prudential and Structural Islamic Financial Indicators database of the IFSB. This document provides an indicative outlook for the IFSI, which makes it a prime reference for information on the stability of Islamic finance globally and across national systems.

The developments and significant economic impacts depend on the widespread public health measures for the global pandemic, an external shock that did not affect the banking sector. However, the economic and social impacts have affected the stability of financial systems. The Islamic social finance sector can promote stability by diversifying the financial system and indirectly by financial and social inclusion through providing inclusive financial services for poorer people. This financial sector could complement the commercial financial sector through the zakah and waqf that can provide stable funds to tackle the adverse impact of negative shocks such as the pandemic. The zakah is a percentage of wealth a waqf represents in social capital that is relatively stable during negative shocks, and they provide support to people in need [36].

Covid-19 has impeded the achievement of many goals, but it has also highlighted the need to make significant changes. According to the report, in this regard, Islamic social finance needs to transform to become more effective and resilient in order to help promote the development of sustainable and stable economic, social, environmental and financial systems. As in the European system, economic support measures and macroprudential policy measures [37] helped to improve financial conditions and to mitigate any potential financial stability risks that remained relatively resilient with significant differences in several countries.

Reading the report reveals the Islamic banking and Islamic capital markets sectors contributed to the increase in total worth of the global IFSI, while takaful sector experienced a slight contraction; otherwise, the IFSI demonstrated overall growth in 2020 despite many systems experiencing economic recessions as a result of lockdowns and heightened uncertainty due to the pandemic [38]. For example, the GCC countries maintained their position as the most important market for Islamic finance activities in 2020 and the Middle East and South Asia region is the second largest share remaining consistent with the previous year.

The data emerging from the report do not seem negative, if compared to the European experience and if we consider the level of transparency adequate; however, adjustments are also needed to participate in the European market. The countries examined, although they share an Islamic approach to the economy, also have very different situations in the financial sectors, due in part to differences in internal regulations, profitability levels and the market for available energy resources, as the Report clearly shows.

For a useful comparison of compatibility with the European system, it is therefore necessary to examine the commitment to the Basel III standards. The Report considers the Basel Committee programme and strategic priorities for 2021-2022 that focused on implementation and evaluation; it will complete existing work on the prudential treatment of crypto-currency exposures about which a consultation document was published in June 2021 and on disclosure requirements related to market risk and sovereign exposures. In particular, the Report specifies that disclosure requirements may have some impact on future IFSB standards, confirming the direct influence on Islamic banking system.

In 2020-2021, international entities in the banking, securities and insurance sectors issued several documents (reports, consultations, standards, survey reports) that are relevant to the tasks of the IFSB, and show global developments and the impacts of new choices also as a result of the pandemic. The IFSB, "being the complementary global standard setter" for the Islamic banking, capital markets and takaful sectors, monitors standards and guidelines of these global authorities (Basel Committee on Banking Supervision, International Organisation of Securities Commissions, Financial Stability Board, International Association of Insurance Supervisors). Their activities and standards have been seriously affected by the pandemic; in fact, some entities have done significant short-term work in response to it, for example, by providing members with access to information on measures taken in other jurisdictions.

Some postponements of the implementation dates were decided for agreed reforms in order to allow institutions to focus more fully on their responses to the pandemic crisis, for example, the consultation on new Principles for Operational Resilience and revised Principles for the Sound Management of Operational Risk of the BCBS. The IFSB also adopted a consultation on Effective Practices for Cyber incident Response and Recovery, and IOSCO consulted on revisions to its Principles for Outsourcing with operational resilience as a

driver of several changes. In these documents, there are no references to the specifically Islamic financial and banking regulations, but their influence on the work of the ISFB will emerge in future standards on broader aspects such as risk management or the supervisory review process.

Other topics for specific definitive standards relate to the impact of financial technologies, particularly crypto-assets and “stable coins”, but also include the use of artificial intelligence and machine learning by asset managers and other capital markets intermediaries and the use of big data analytics in insurance [39].

The Islamic financial system has shown resilience, and unprecedented interventions by governments and regulators have allowed markets to continue in their tasks [40]. The IFSB has identified a programme focusing particularly on fund liquidity and non-bank financial institutions based on analytical study and a number of changes in standards. In fact, Islamic capital markets have some very positive profiles such as the very limited use of derivatives and the adoption of social projects of financing, while in the Sukuk market a shortage of liquidity has become apparent.

F. The regulatory criteria, standards and supervision of Islamic banks: the needs for transparency and knowability through technological innovation

The implementation of IFSB standards represents a challenge in some jurisdictions that have a limited experience, because they should have adequate infrastructure to support Islamic finance and a skilled policy team. The guidelines represent an opportunity to improve implementation rates by leveraging on the experience of other members and sharing the basic steps of regulatory and supervisory authorities that have successfully implemented IFSB standards [41].

Most of the regulatory and operational aspects of Islamic banking depend on the respective central banks which develop the legislative framework for competition within the Islamic financial sector; the legislations also contain provisions on governance and provide for Shariah compliance committees or boards for financial institutions, present e.g., in all GCC countries [42]. The main role of the Shariah supervisory boards is to ensure that the instruments offered by financial institutions are coherent with the fiqh (jurisprudence) on ethical-religious rules as a form of supervision and governance with additional tasks, e.g., advising the board of directors, providing guidance to Islamic financial institutions on the limits of activity, without executive functions that fall exclusively to the management of the bank or a strategic role for the board of directors. The Shariah board has no competence regarding the management of the risks, apart from those deriving from its own decisions or from the fatwa [43] which is a legal opinion on any Shariah question, according to a predetermined methodology. In fact, the board establishes rules and principles relative to Shariah, ensures that the policies and procedures of the Islamic financial institutions are compliant and can take decisions to create certainty of compliance. Together with the board of directors and other

operational committees, the Shariah committee can prevent aggressive lending and higher-risk activities, counter unethical practices, and ensure compliance and principles for social justice purposes, although there may be changes of direction in decisions [44]. In this context, Shariah-compliant financing is a contributing factor to the efficiency of the GCC national banks and the functioning of the overall financial sector.

While several banking laws regarding Islamic finance require banks to have a Shariah board in-house, most regulators are reluctant to engage in Shariah matters and this trend is controversial. Malaysia’s regulation [45] is an exception, as the central bank has its own Shariah board, whose fatwa may be of a higher level than the Shariah boards of individual Islamic banks for internal control [46]. This ensures consistency and probably a reduction in risk, but it could potentially limit debate in the future by centralising the decision on compliance. Within the corporate governance system, therefore, adequacy to Shariah is essential, not least to help mitigate the effects of potential risks through due diligence respecting the ethical underpinnings of Islamic economics. However, from recent empirical evidence it emerges that the best practices of Shariah governance have not achieved the efficiency envisaged by the banks, which pursue objectives of governance of the activities according to the ethical Islamic economy [47] and the prevention of financial crises.

Compliant financing has demonstrated positive effects, but improving the quality of institutions, the rule of law, and the effectiveness of government action have emerged as equally important aspects as part of strengthening lending by banks in GCC countries. The main policy implication is that governments and policymakers will have to adapt legislation more vigorously and adopt reforms of laws and regulations governing the banking and financial sector and a more open economy. GCC countries have, in fact, long been in the process of continuously reforming their business sectors to make them more competitive internationally, but attention to strengthening the institutional framework in which finance operates is essential [48].

However, the issue of securities regulation cannot be addressed independently of an examination of the legal context, especially since there are no abstract schemes developed in advanced regulatory regimes that can be adequately introduced into systems with different assumptions and ethical-religious limitations that are a source of legal risks inherent in the application of Shariah and constitutive effects for commercial legislation, such as the prohibitions of riba and gharar that limit the *modus operandi* of stock markets and the choice of securities [49].

The Shariah produces legal and economic risks that are not quantifiable a priori and that can directly influence modern Arab commercial legislation and, in the worst-case scenario, could render the new discipline inapplicable, given the exercise of supervision according to ethical-religious criteria. In essence, the influence of Shariah cannot be fully foreseen in the examination of commercial legislation, as assessments are based on criteria that are subject to interpretation that is often

not unambiguous and not even accessible through instruments of certain knowability. The need for transparency is particularly evident in order to reduce risks as they can be known and foreseen in advance [50].

G. *The rules on capital requirements*

The IFSB institutional website has been enriched with content, and transparency has undoubtedly increased in recent years; however, the difficulty of framing ethical-religious principles in uniformly applicable rules and standards of banking regulation is evident.

The objectives of the guidelines are very similar to those pursued by the EBA and ESMA and, therefore, to the indication of technical standards as a basis for national regulatory and supervisory authorities to define, in turn, specific rules and guidelines on adequacy requirements for the marketing of financial products and investment funds [51], the dissemination of information in the sector and, in particular, greater harmonisation of regulation and practices, in order to encourage investments from third countries. In addition, they include the competence to prepare stress tests [52], similar to the EBA. Among the guiding principles in the offer of Sukuk securities and investment funds, inspired by good practices in conventional and Islamic markets, are the rules of clear, accurate and not misleading information to investors as well as timely disclosure for a reasonable investment decision; in particular, for Sukuk securities, the structure and related contracts must be described with sufficient clarity to allow the investor to understand and assess any risks attached to it [53] and there are similar rules for investment funds adopted by national regulators [54].

The regulatory standards and guidelines for Islamic banks can be divided into two basic categories: the first set of standards relate to Islamic counterparties and consist of guidelines and conventional international standards that include the prudential standards necessary to ensure a stable financial system; in this development the IFSB uses existing international standards issued by relevant bodies, such as the Basel Committee, as the basis for its own standards with adaptations to suit Islamic banking practices. For example, the Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services (2005) is based primarily on the principles of Pillar 1 of the Basel II standards. In particular, the IFSB amended and adapted two Basel Committee documents to develop appropriate capital requirements for Islamic banking practices. Following the financial crisis, IFSB considered the new guidance of Basel III by adopting Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services (IFSB-15) incorporating the changes in capital adequacy requirements of the new international standards [55]. Thus, the Basel Committee rules are acquired indirectly through the intervention of the IFSB which adapts them to the reality of Islamic banking. The second type of IFSB standard rules is unique to Islamic financial activity and consists of guidelines for an adequate supervisory framework in the application of

Shariah for Islamic financial institutions also through digital solutions [56].

The IFSB, in its publication Guiding Principles of Risk Management for Institutions (other than Insurance Institutions), has defined the various categories of risk (e.g., credit, investment, market, liquidity and operational risk) and clarified that Islamic financial institutions should be characterised by a comprehensive risk management process and transparency and reporting requirements. The process should consider adequate measures to comply with the rules and principles of the Shariah and ensure adequate risk reporting to the supervisory authority; among the forms of risk, credit risk: the Islamic Financial Institutions (IFIs) should have a specific strategy of financing and the instruments used must be in conformity with the Shariah, which recognises the potential credit exposures that can arise in different phases of the various financing agreements [57].

As regards investment risk, IFIs should have appropriate risk management strategies and reporting processes in place in relation to risk characteristics for equity investments, including *mudarabah* and *musharaka* investments. With respect to market risk, for all assets, IFIs should have a system of appropriate technology tools with respect to risk management and reporting, to be considered separately, including for those that are not intended immediately for the market and/or exposed to high volatility pricing. In terms of liquidity risk, IFIs should have a liquidity management framework (including reports) in place, considering separately and in total liquidity exposures related to each category of current accounts, and restricted and unrestricted investment accounts. Finally, for operational risk, IFIs should have adequate systems and controls in place, including oversight to ensure compliance with ethical and religious norms and principles, including the risk of non-compliance with Shariah [58].

Thus, Islamic banks face the same risks (dependent on insolvency, commodity price fluctuations, liquidity management, regulatory and market risks) as conventional institutions, but the typical risk is that of not properly fulfilling the principle of risk sharing in financial transactions or religious precepts related to economic activities.

The principles prepared by the IFSB also concern the transparency and necessary detailed information on the financial instruments and the investment funds for conformity to the Shariah, in order to allow informed decisions according to ethical-judicial rules; furthermore, specific regulations are provided for the composition of the board, their roles and responsibilities, the circumstances in which the non-compliance can occur and the procedures to detect and control the risks, the processes of internal and external audit as well as the possible pecuniary sanctions as a measure of "purification" for the non-compliant incomes. There are requirements for transparency and constant updating of data by appropriate electronic reporting systems.

The Shariah-compliant contracts used by Islamic banks modify the risk-return characteristics of the products and have relevant regulatory implications [59]. However, despite the

particularities, some regulatory standards of the Basel Committee can be applied to Islamic banks, while the specific characteristics in relation to ethical rules are certainly not considered by international regulatory standards. For example, the use of profit-sharing investment accounts (PSIA) raises several issues, e.g., whether to consider them as deposits or treat them as capital, as there is a risk-sharing element to the assets. Moreover, since the returns of PSIAs are based on the principle of profit-loss ratio, the rights of investor-depositors need to be protected and the fiduciary nature of the contract also requires greater transparency in the related banking operations [60].

This is a concrete problem common to other international bodies adopting rules with standard provisions and, in fact, even the IFSB does not have “enforcement powers” [61] to ensure the effective application of its prudential standards in the various countries involved, and it is inevitable that enforcement depends on national regulators; in essence, few supervisors have incorporated these standards into national regulation and it is possible to state that the regulatory regimes of Islamic banks can be traced to three solutions: the first concerns a few countries (e.g., Bahrain, Oman [62]) that have adopted specific regulatory guidelines; the second solution concerns countries that require banks to follow the regulations foreseen for conventional banks, even if adaptations are necessary to respect the Shariah.

The third solution adopted by countries such as Saudi Arabia and the United Kingdom [63] is to subject Islamic banks to the same regulation as conventional counterparties and Islamic banks adjust their operations to the existing regulation. While in the jurisdictions where there is no regulation of Islamic finance, the banks, also Islamic, adapt to the national regulatory provisions based on the standards of the Basel Committee and in these countries the Islamic banks must use products and instruments that conform to these rules and to the ethical-legal rules of the Shariah even if a frequent contrast emerges between products that conform both to those standards and to the ethical rules. Thus, e.g., under the Basel III rules on capital requirements, Islamic banks should ascertain acceptable capitalisation (Tier-1 and Tier-2) and the value of risk-weighted assets in their portfolios with the new risk benchmarks. Since PSIA cannot be accepted as capital under the strict Basel III definitions, one solution may be to issue long-term equity-based Sukuk that meet the definition of capital under the new regulatory requirements. In addition, as Basel III pays more attention to market and other special risks, the risk references for partnership contracts such as *mudarabah* and *musharaka* and sales-based instruments such as *salaam* and *istisna'a* (a medium-term funding technique) are likely to increase.

The Basel Committee had already published guidelines in relation to liquidity for risk management prior to the crisis (Basel II), but with the crisis, the central role of capital further emerged, and this led to the definition of specific requirements with Basel III. The aim of introducing the appropriate capital liquidity requirements is to promote a more flexible banking sector, improving its ability to withstand shocks from different

sources. Basel III introduced the Liquidity Coverage Ratio (LCR) to meet short-term liquidity needs and risks and the Net Stable Funding Ratio (NSFR) to ensure adequate medium and long-term liquid funds. In particular, Saudi Arabia has implemented the requirements set out in Basel III, through the Saudi Arabian Monetary Authority, which has undertaken a number of initiatives to strengthen the prudential framework for bank capital and issued the Basel III risk-based capital framework in December 2012 to implement the first phase, which came into force in January 2013. A number of new rules and policies were also introduced in October and December 2012, in particular on capital requirements for bank exposure to central counterparties, the 3 Pillar and the Liquidity Coverage Ratio. The United Arab Emirates also recently adopted the capital requirements of Basel III through its own regulations [64].

The risk of liquidity arises when banks face problems in acquiring sums of cash at reasonable cost from loans or from the sale of assets. In conventional banks, the needs of financial liquidity can be satisfied by private sources, by other financial institutions and by inter-bank money markets. The Islamic banks, instead, must consider the constraints of the Shariah in accessing liquidity from these sources. Since interest-bearing loans are prohibited, under Shariah it is not possible to borrow funds to meet liquidity requirements in case of need and, therefore, there are limits to borrowing; moreover, debt sales are prohibited by Islamic law in most cases and banks could not sell their debt-based assets to ensure market liquidity.

In this context, the identification of quantitative limits to borrowing is a central issue, as banks cannot receive large sums as interest payments and loans must not consist of more assets than the assets held, and loans involving large debts cannot be used to ensure liquidity; over the years, the general rules have been expressed more clearly as a certain reference for the banks and, in particular, the Shariah-compliant financial parameters [65] of the *Dow Jones Islamic Market Indexes* [66] are relevant as criteria of reference for the Shariah boards of the financial institutions [67]. For example, it is prohibited to hold shares in corporations which are in debt to the amount of more 33% of their own capital resources, which draw more than 5% of their profits from non-operating interest revenue or whose receivables amount to more than 45% of their own capital resources. Besides, there were several attempts to establish generally binding standards in order to guarantee sufficient legal security such as the Shariah standard of the Accounting Organisation for Islamic Financial Institutions (AAOIFI) based in Bahrain [68].

Without an adequate supply of Shariah-compliant liquidity instruments and active markets in which to trade, it will be difficult for Islamic banks to meet the requirements of Basel III, since they would have to shorten the maturity of their assets and increase the duration of their liabilities and capital, in order to meet the liquidity requirements. This may put Islamic banks at a disadvantage compared to their conventional counterparts and create obstacles to long-term growth; therefore, additional measures and initiatives with innovative interpretations for Shariah compliance need to be

introduced to address liquidity requirements.

In many contexts, there are no inter-Islamic banks or organised money markets with reference funds in the event of a crisis. Furthermore, due to the lack of liquidity for Sukuk instruments and active Sukuk markets, the Islamic banks present significant risks of liquidity, given that these certificates represent a positive alternative to the traditional bonds (the issuer must return to the buyer the initial counter-value and the agreed rate of interest), but are structured in such a way that the profits are linked to a concrete asset or to an underlying property with a relative right of ownership.

While central banks in some countries play an important role in providing tradable instruments to meet short-term liquidity needs, liquidity quotas are still a major problem, forcing many banks to raise more funds. The prohibition of the interest rate entails difficulties in the management of the liquidity in the absence of a Shariah-compliant inter-banking market and because of the impossibility of investing in government securities at short expiry and at low risk; a solution is represented by the issuance of Sukuk to be understood as share certificates of Islamic investment, even if related, by affinity, to bonds. Therefore, liquidity management is one of the most challenging and relevant objectives, but with a particular difficulty if liquidity instruments and infrastructure do not evolve. A robust liquidity framework for the Islamic financial sector will be needed, not only to meet liquidity requirements under Basel III, but also for the development of private sources of liquidity and public support services.

V. CONCLUSIONS

A. *Prospects for Islamic finance in the EU and future economics law research*

In the European system of conventional banks, the need to adapt to the requirements of the Basel standards, transparency rules and digital transformation and innovation, raise issues that may inhibit the development of Islamic finance. In fact, the Euro-system provides for interest-based instruments, and, for prudential regulation and supervision, all European banks are required to adhere to deposit insurance and financial services clearing systems, especially after the Banking Union. In contrast, Islamic jurisprudence, which has long prevailed in several Islamic countries, has held that the investment deposits of Islamic banks, which follow the “profit and loss sharing principle”, cannot be covered by deposit guarantee schemes. However, recently, this aspect has evolved due to the significant role played by the IFSB. Moreover, there is a significant further obstacle to the creation of Islamic banks, as the corporate governance and management board of European banks, which take full responsibility for management decisions based on EU and national laws, can certainly not be shared with the Shariah board [69].

In general, therefore, there are several legal difficulties and complex profiles for the spread of Islamic banks in Europe, precisely because of the prevailing legal schemes. The establishment of banks would require a specific legal rule, not

so much because of the European regulation that, in any case, is in line with the well-known international standards, but because of the issue of banking authorisation which still involves the supranational and national regulatory level and above all because of the internal national rules that need to be integrated.

In fact, Article 14.1, Reg. (EU) n. 1024/2013 provides that any application for an authorisation to take up the business of a credit institution to be established in a participating Member State shall be submitted to the national competent authorities of this legal system in accordance with the requirements set out in relevant national law.

Thus, for example, in the case of an Islamic credit institution to be established in Italy, the related application must be consistent with the objective requirements determined by Article 14 of the Italian Banking law (Testo Unico Bancario), in line with the approach introduced by Directive 1977/780/EU now merged into Directive 2013/36/EU [70].

The authorisation is an administrative measure, which is issued when the conditions laid down in Article 14.1 are met. It is issued by the ECB, on the proposal of the Bank of Italy, and is denied by the ECB or the Bank of Italy, when the verification of the conditions, provided for in paragraph 1, does not guarantee sound and prudent management. For the establishment of non-conventional banks, it would be necessary to introduce specific rules on the admissibility of issuing authorisation with additional conditions for carrying out the activity, given the profound differences, just as specific rules are needed for the offering of Islamic financial products by domestic banks.

The study of the German experience could be a useful investigation for new rules and future economic law research, in order to identify a solution compatible with Italian (or other European) banking laws and tax disciplines, on the assumption of a clear desire on the part of the legislator, obviously following a political decision.

On the other hand, it would be easier to foresee European banks offering Islamic financial products or branches, although the problem of taxation or other legal compatibility questions would arise. This solution should be encouraged and studied, in view of the tangible advantages associated with it and for the presence of Islamic savers and investors, but with adequate controls on the purpose of the investments. However, EU and national legislation need a solution for reasons of legal certainty.

Apart from these central aspects, it is necessary to consider the process of profound change, already underway and accelerated by external events, affecting the activities of banks, the acceleration to new technologies and the related and new risks associated with them, issues that require rapid innovations in terms of the tasks of regulators and legal disciplines.

From the European perspective, the pandemic has confirmed the importance of a solid system of rules capable of directing banks towards virtuous and prudent behaviour and strengthening the ability of the system to cope with the crisis. Reforms and the establishment of the European single

supervisory mechanism go back some ten years to address the financial crisis, but the framework made it possible to respond to the problems of the health crisis with more adequate capital strength and liquidity. Banks during the most acute phase of the pandemic supported the economy and regulators and supervisors strengthened the resilience of the financial system.

Currently, the Basel Committee intends to improve prudential rules based on studies to verify their actual adequacy and effectiveness; the implementation of the “Final Basel III” standards has been postponed to January 2023 due to the pandemic and to increase banking capacity to face the new challenges.

These considerations can only be extended to Islamic banks: their challenge will be the “Final Basel III” implementation for their attractiveness in the international markets, and future success will depend on the imminent further adjustment in the direction of homogeneous standards. Certainly, this evolution will be examined by future legal and economics research.

Thus, several regulatory measures were adopted at international and EU level, allowing banks to absorb losses and lend during a very challenging period. The choices of postponing the implementation of the recommendations to 2023 and not adopting any further reforms (the so-called “Basel Hard Stop”), in order to ensure the medium-term stability of the prudential regulatory framework, are consistent and appropriate, while not undermining the commitment of banks to transpose the new rules. The European Commission has formulated a proposal for a legislative act from which a wide-ranging debate has ensued to ensure the competitiveness of European banks, compliance with the Basel recommendations and the application of the proportionality of the rules, without any substantial weaknesses [71].

This context undoubtedly has international consequences and can only affect Islamic banks and their relations with EU banks. For future research it will be interesting to examine how the forms of risks (credit, market and operational) are dealt with in the European Banking Union, according to the Basel indications, and how the same risks are assessed by the IFSB which, moreover, has adopted the same rules, precisely in order to cultivate profitable relations with conventional banks.

The reform of the Basel III rules has pursued three objectives to improve credibility, simplicity and comparability and has affected all risks of the so-called first pillar (credit, operational, market). In the case of market risk, it has not been easy to reconcile credibility, which is linked to the ability of quantitative measures to correctly reflect risks, with that of simplicity, which entails the rapid and immediate application and interpretation of calculation methods. Consequently, the search for a compromise has prevailed.

The previous reform of the Basel standards took place more than a decade ago, in connection with the 2007/2008 crisis, involving a comprehensive review of prudential standards and confirming the appropriateness of risk-sensitive rules. Indeed, from the outset, the Basel II rules had significant limitations and an inadequate incentive scheme, and so needed to be corrected. The new formulation has improved the credibility

of risk measures, including through the reporting system, and has limited non-responsible behaviour in risk management. The pandemic has certainly confirmed the desirability of ensuring the existence of adequate capital for banks that can help to cope with external difficulties as financial support for companies and other private clients.

Regarding credit risk, as the EBA pointed out in the “Call for advice” of the European Commission, numerous revisions to be considered as widespread practices in the EU. Other revisions allow the European legislator discretionary choices that may contribute to the adoption of a discipline adapted to the specific aspects of the European systems. For operational risk, Final Basel III significantly amends the current framework by providing a single standardised approach for calculating the capital charge that replaces the previous approaches, of which three were standardised and one was based on internal models, which showed complexity, inadequacy in identifying the risk profiles of the banks, and significant problems of comparability across banks and systems.

Regarding market risks, the path has been very complex. The new standards, which were approved in an initial version in 2016 and in 2019, change the treatment of risks according to a more appropriate approach to identify all the risks related to the trading activities of banks. The increased focus on risk has resulted from the increased complexity of the rules, as the new standard has been defined based on the operations of major international banks.

The transposition of the rules in Europe entails the application of the principle of regulatory proportionality, adequately balancing the simplicity and specificity of the measures, the provision of strict conditions for the use of internal models, but which must not constitute regulatory barriers accessible only to the major international banking groups, and simplified solutions for those banks that carry out insignificant trading activities, even though less sensitive to risk.

This complex evolution inevitably affects the adaptation of Islamic banking and financial products for access to the European market. There are several practical implications that cannot be solved by interpretation, but require a specific European legal framework on which to base national implementing rules, a model that is already applied to conventional banks for harmonisation requirements.

Therefore, a special regulation is needed for the coexistence in the Banking Union of European banks and Islamic banks and financial products, at least to obtain banking authorisation for legal certainty and uniformity of solutions. In addition, national supervisors could assess the admissibility of Shariah-compliant banking contracts offered by conventional banks through the combination of several schemes that allow for effects that comply with domestic banking laws. The adoption of legal rules will, of course, depend on political choices, both at supranational and internal level.

Economic studies examine the relevance of Islamic banking activities also for some interesting sustainability aspects and this is a concrete basis for legal considerations to request regulatory interventions at European and national level.

Adaptation, not immediate and simple, to international standards cannot be considered the only solution because of the implications, also theoretical, of the relationship between two sectors that are based on some very different principles.

Finally, we must mention the various similarities between the principles of Islamic finance (e.g., in the case of sukuk) and the principles of public-private partnership for infrastructures [72], regarding risk sharing, the lender as partner, the exclusion of speculative intentions and certainty in the definition of contractual performance. The comparison could be the topic for interesting studies in the future.

Moreover, the United Nations published a study in 2016 highlighting the possible contribution of Islamic finance to promoting the sustainable development goals of the 2030 Agenda to finance infrastructure. However, sustainable finance requires rules and techniques to manage risk and technology to enable knowledge of standards and accounting rules for the maximum transparency in transactions, and control of compliance with Islamic law as well as compatibility with the conventional system: objectives that are very complex to achieve [73].

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Standards for the financial reporting framework (in *GCC Quarterly Review*, Q4, 2016, at www.linklaters.com).

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[67] M. Ashraf M. and A. Lahsasna, “Proposal for a new Shari’ah risk rating approach for Islamic banks”, *International Journal of Islamic Finance*, 2017, 1, 87 ff.; A. Musleh Alstartawi, “Performance of Islamic banks: Do the frequency of Shari’ah supervisory board meetings and independence matter?”, *ISRA International Journal of Islamic Finance*, 2019, vol. 11, No. 2, 303-321.

[68] The Central Bank of Bahrain has issued capital adequacy regulations (Circular n. 52/2017, which came into force on 1^o February 2017 and fully implemented in 2019) in line with Basel III, see *GCC Quarterly Review*, Q1, 2017, at www.linklaters.com. About the role of central banks, see A. A. Hossain, *Central Banking and Monetary Policy in Muslim-Majority Countries*, Cheltenham: E. Elgar, 2015.

[69] E. Aracil, “Corporate social responsibility of Islamic and conventional banks: The influence of institutions in emerging countries”, *International Journal of Emerging Markets*, 2019, 14 (4), 2019, 582-600; I. A. Oladapo et al., “Perception of stakeholders on governance dimensions of the Islamic banking sector”, *International Journal of Emerging Markets*, 2019, 14(4), 601-619; S. El-Halaby et al., “The non-economic consequences of disclosure in Islamic banks”, *International Journal of Emerging Markets*, 2018, 13(6), 1948-1968. About jurisprudence see S. Coopchik, “Judicial Decision-Making in Islamic Banking and Finance”, *European Journal of Islamic Finance*, 2015, 2, 1 ff.

[70] See the Italian banking law “Testo Unico Bancario (T.U.B.)”, especially artt. 10 et seq.; T. V. Russo, *I contratti Shari’a compliant*, cit., 140 ff. About collection of savings, the principle of the obligation to repay under art. 11 T.U.B. is contrary to the typically Islamic current accounts which exclude it, but combinations of contracts would be possible,

obviously according to mechanisms which would have to be accepted by the supervisory authorities, see F. Miglietta and P. P. Rampino, *Gli strumenti di finanza islamica a sostegno del Sistema Italia*, cit., 69-71. On banking activities see G. Gimigliano, “Art. 10”, in S. Bonfatti (a cura di), *Commentario al Testo Unico Bancario*, Pisa: Pacini, 2021, 41 ff., and banking authorisation see A. Benocci, “Art. 14”, *ivi*, 74 ff.; C. Brescia Morra, *Il diritto delle banche, Le regole dell’attività*, Bologna: il Mulino, 2020.

[71] European Commission, “Banking Package 2021: new EU rules to strengthen banks’ resilience and better prepare for the future”, 27 October 2021, for the implementation of Basel III (also known as Basel IV) agreement that will involve the amendment of Directive 2013/36/EU, Reg. (EU) n. 575/2013 and separate proposals about the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV), at ec.europa.eu. On amendments (Commission Delegated Regulation (EU), 20 October 2021, n. 439/2022) to the CRR see “European Banking Institute Report on Economic Policy and Financial Regulation Measures: International, EU and Euro Area Levels”, 19 March 2022, at www.ebi-europa.eu.

[72] U. F. Moghul, *A socially responsible Islamic finance: Character and the common good*, London: Palgrave Macmillan, 2017; F. Miglietta and P. P. Rampino, *Gli strumenti di finanza islamica a sostegno del sistema Italia*, cit., 79 ff.; Forum Finanza Sostenibile (2019), “L’Unione europea e la finanza sostenibile, Impatti e prospettive per il mercato italiano”, at www.finanzasostenibile.it.

[73] S. Khavarinezhad and P. P. Biancone, “Future Trends and Finance Approaches in Islamic Banking”, *European Journal of Islamic Finance*, 2019, 12, 1 ff.; S. Khavarinezhad, P. P. Biancone, V. Jafari-Sadeghi, “Financing in the Islamic System and Sustainable Economic Development of Selected Islamic Countries”, *European Journal of Islamic Finance*, 2021, 19, 18-23; V. Brescia, A. Adam Sa’ad, R. Bt Hassan, S. Musa Bin Syed Jaafar Alhabshi, F. Lanzalonga, “Exploring sustainability from the Islamic finance perspective”, *European Journal of Islamic Finance*, 2021, 19, 45 ff.; F. Lanzara, “Islamic finance and Sustainable Development Goals. A bibliometric analysis from 2000 to 2021”, *European Journal of Islamic Finance*, 2021, 18, 1 ff.