Introduction

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When the Prophet Muhammad began His war to defend poor debtors from the insatiable demands of their lenders, the Christian Church had already condemned *usurae*: any kind of interest claimed on a loan. However, since the twelfth and thirteenth centuries, economic development created pressure to remove the prohibition, and merchants – especially Italian merchants – thought up many kinds of contract to make profits from their money outside the confines of the church laws (Chapter 1). Almost the same thing happened in the Muslim world, too (Chapter 3).

In more modern times, when the needs of growing capitalism prevailed, theologians from the reformed churches (Lutheran and mostly Calvinist) felt that interest on loans was legitimate and, at the same time, in Western Europe civil law had become sharply distinct from religious rules (Castro, 2007; also Chapter 5). So the ‘war’ of the Christian Church ended in defeat, and the Napoleonic civil code of 1804 definitely allowed paying out interest for any type of cash loan. This code was widespread and was especially enforced in Egypt by the French army; although obviously, during the time of colonization, the European laws were valid in every country colonized.

In the frame of decolonization, the prohibition of *riba* was again under discussion in most Islamic-profile countries and the first formal attempt to put the concept of Islamic banking in practice is often reported to have taken place in Egypt – an historical joke – around 1963, when a savings bank was opened in a small town, Mit Ghamr. There is, however, evidence that suggests the basic principles and practices of some of the recent forms of Islamic finance date back to the early part of the seventh century (Euromoney Report, 1997, www.euromoney.com).

We shall call an ‘Islamic bank’ a financial institution which, complying with *Qur’an* and *Sunna* precepts, neither gives nor requires any interest (Chapters 2 and 3) and also chooses its investments according to ethical criteria.

Islamic banking appeared as a global reality in the early 1970s when Islamic financial institutions popped up in Geneva, Luxembourg, Dubai and Jeddah. Since then this phenomenon has showed an unprecedented

growth over the global scene. Now the institutions dealing with Islamic finance exist in more than 50 countries. The total number of such institutions is more than 275 of which 54 are reported in Europe.¹ These institutions are estimated to be handling funds somewhere around \$500 billion growing at a rate of more than 15 percent per annum. The emergence of these institutions is helping to bring out funds into the banking channels which were previously avoided on the grounds of the religious injunctions against interest-based banking. It is this phenomenon of capturing the money which has previously bypassed the formal financial channels that is causing the Islamic banking and finance industry to show unprecedented growth.

The historical developments which were briefly summed up at the beginning of this introduction have tried to explain why *Qur'an* proscriptions against lending with interest are not a problem in Europe. In fact, now, Western banks do not often pay interest on deposits, especially in the case of current accounts (Chapters 10 and 14).

Generally, the operations of Islamic banks are often very similar to common European banking or finance operations (Chapter 2). Islamic banking is far from problematic; indeed recently, many European bank and investment institutions have made their financial instruments compliant with Muslims' needs (Chapter 8).

Many issues may arise when an Islamic bank attempts to carry out its business in a European Union country. This is the main concern of this book.

It is not easy to say whether and how an Islamic bank may operate in European countries because of the high number of European States and market rules. It explains why single State authorities do not give the same answer to this question (we have asked French, German, British and Italian authorities).² However, we can try to draw some conclusions from the papers in this book (see Chapters 11–15).

First, we have to look at European Union legislation. In European countries the business of receiving deposits or other repayable funds from the public is not free, and the European Commission and the European Parliament have laid down two kinds of institutions entitled to operate in financial markets.

1. Credit institutions (or banks). Under the European Banking Code, a credit institution is defined as 'an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account' (art. 4, Directive 2006/48 EC). Indeed, according to ancient western traditions, the obligation (duty) to 'repay the funds received' and to 'grant credit for its own account' makes

banks different from other financial intermediaries: banks bear the risk of investment of the repayable funds and their clients are always entitled to have back the funds granted.

2. Investment firms. An investment firm is defined as ‘any legal person whose regular occupation or business is the provision of investment services for third parties on a professional basis’ (article 4, Directive 2004/39 EC). In other words, investment firms behave as brokers and dealers in the transferable securities market.

Recently, the European Union has passed a new directive providing rules on payment institutions. A payment institution is a financial intermediary different from banks and investment firms, and been defined as ‘a legal person that has been granted an authorisation (. . .) to provide and execute payment services’ (Directive 2007/64 EC). But banks preserve their competitive advantages because they are authorized to perform payment and investment services under the same rules, exactly like payment institutions and investment firms.

Credit institutions and investment firms may not set up and perform their business unless they have been authorized by the national authority empowered by domestic law and, once authorized in relation to the listed activities, they are subject to the prudential supervision of a competent authority (art. 6, Directive 2006/48 EC; art. 5, Directive 2004/39 EC). The domestic authority must grant the authorization when statutory requirements are met but, as regards both of them, it refrains from granting the authorization when the management of the business, the links between the credit institution and other natural or legal persons or the suitability of shareholders or members do not fulfil a ‘sound and prudent’ assessment (art. 12, Directive 2000/46 and article 10, Directive 2004/39 EC).

Once authorized by the home state regulator, credit institutions and investment firms are enabled to establish their branches and to provide cross-border services in all EC Member States (the host States); they are entitled to perform the authorized activities complying with only their home statutory rules. It is the so-called principle of mutual recognition of authorization and of prudential supervision systems: the European passport.

Starting from 31 December 2007, banking activities and also, in some respects, investment firm activities have to comply with Basel 2 provisions (International Convergence of Capital Measurement and Capital Standards, Comprehensive Version, June 2006).

The principles mentioned above concern financial institutions having both their registered office and head office in the same EC country (article 11, Directive 2006/48 and article 5, Directive 2004/39 EC). While the

EC framework has not enacted any precise proscriptions on the credit institutions and the investment firms having their head office outside the European Community, it does prevent Member States from laying down any statutory regimes more favourable than those accorded to European financial institutions. Nevertheless the EU Commission carefully controls the authorizations granted to non-EU institutions and, in accordance with the directives, the Commission is allowed to reach an arrangement with third countries on the business of financial intermediaries.

Looking at the European definitions there is no doubt that Islamic banks are not banks, but if we look at every single European jurisdiction, the answer appears more doubtful and extremely complex (Chapter 14).

Although EC directives try to bring about the harmonization process of domestic legislation, even the definition of credit institutions (or banks) is not the same in each Member State. Especially in UK, German and French jurisdictions even the definition of 'bank' does not meet the European definition of 'credit institution', and their respective terms of reference are broader than the European definition (in this book, Part IV; also Cranston, 2004). Furthermore, the authorization of banking does not include the same services in all jurisdictions, and therefore in some countries the difference between bank and investment firm is hard to perceive. Moreover, the enforcement of the EU rules is very different in single European States. For example, looking at the Italian experience, the Bank of Italy, as home State regulator, frequently refers to 'sound and prudent' management rules to refuse the authorization, adding up to interesting polemics (recently, Oddo and Pons 2005).³

In the legal framework outlined above, a distinction may be drawn among the following hypothetical situations:

1. An Islamic bank, having its head office outside the European Community, carries out its business in the European Community Area (with or without a branch). Certainly, it needs authorization to establish its business either as a credit institution or as an investment firm from the competent authority, but we cannot easily foresee if the authorization will be granted. It depends on home Member State law and the enforcement action.
2. An Islamic bank either keeps a 'participation' or takes a 'qualifying holding'. In both of these it may have an interest either in European credit institutions or investment firms. In this case, it needs a specific authorization and the refusal of authorization can be justified not only because the 'sound and prudent' management may be at risk but also because the third country's regulations may prevent the exercise of the

supervisory function of the authority of the EC Member State (article 12, Directive 2006/48; art. 10, Directive 2004/39 EC).

3. A bank located in an EC Member State asks for authorization to take up business complying with Islamic prescriptions. In a lot of European countries, the statutory framework allows this institution to be authorized either as the bank or as the investment firm (see, in this book, Engels, Arnaud and Wilson). However, it raises two kinds of doubts:
 - (a) Whether the authorized Islamic institutions were able to get a European passport and, therefore, to exercise the right of establishment and the freedom to provide services throughout the European Community: the answer depends, again, on the definition of bank set out in every jurisdiction.
 - (b) How the prudential rules of Basel 2 might be enforced, allowing for the remarkable balance-sheet outline of the Islamic banks. This is the most noticeable issue (Chapter 7).

Besides the controversial issues dealing with banking and investment firm authorization, the 'sound and prudent' management control, namely the enforcement of Basel 2 rules to the Islamic banks, is an equally important issue.

There are, however, some infrastructural developments taking place in the context of the Islamic financial industry. These infrastructural developments, initiated and run collectively by countries with a substantial presence of Islamic banking and finance, aim at providing credibility and support to the Islamic banking and finance industry at the global level. The most important of these developments, perhaps, is the establishment of a body known as the Islamic Financial Services Board (IFSB) which is governed by the Central Bank Governors of countries where Islamic banking exists. The membership of the Board also includes the IMF, the World Bank and the Bank for International Settlements.

To help the regulators and supervising bodies in providing a level playing field to Islamic banks without compromising on the efficiency and ethical standards already in vogue in the national and global financial markets, the IFSB is rigorously reviewing international standards and developing standards for Islamic banks in the following areas:

- Capital adequacy
- Risk management
- Corporate governance
- Transparency and market discipline.

The Board is also in the process of developing prudential and supervising standards in these areas for the purpose of promoting best practice for the industry at the national as well as global level. These standards are meant to complement the guidelines issued by bodies such as the Basel Committee on Banking Supervision and the International Organization of Securities Commission. Besides the establishment of the Islamic Financial Services Board, the following important infrastructural developments are also worth mentioning:

1. The establishment of the International Islamic Financial Market. One of the most important elements of risk management in Islamic banks is related to liquidity management. The problem of liquidity management arises because of the fact that most available conventional instruments for liquidity management are interest-based and therefore cannot be used by Islamic banks. The absence of an Islamic money market and an Islamic inter-bank market is, therefore, a serious hurdle in the way of liquidity management. The development of the International Islamic Financial Market in Bahrain which will provide a secondary market with Islamic instruments will provide a good opportunity to Islamic banks for liquidity management.
2. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in Bahrain, plays an important role in integrating and harmonizing the accounting and auditing practices.
3. The Islamic Rating Agency (IRA) is another infrastructural institution which gives credibility to Islamic financial institutions.

A FINAL REMARK

There is no doubt as to the positive effects of the increasing business and number of Islamic banks in the European Community on the global economic integration and on the growth of financial services on offer to Muslim people in Europe.

However, we want to underline, as many scholars have stressed, a relevant feature of Islamic bank management (see Chapter 5) that relates to the governance issue and ethical control over the Islamic banking business. Certainly, a large number of *Shari'ah* prohibitions do not agree with Western culture, but, in general, it is very important that the relevant ethics and issues of social responsibility must be taken care of, for good governance of these institutions.

The idea of ethical accountability is being increasingly emphasized within the hub US and European business and financial cultures (Buonocore,

2004; Chapter 8, this volume); referring to emerging ethical funds and ethical banks (Becchetti and Paganetto, 2003; also Chapter 9) and also to the campaigns waged worldwide against the non-ethical behaviour of banks and business entrepreneurs (Centro Nuovo Modello di Sviluppo, 2002). Such campaigns are expected to increase from the Islamic banking and finance industry bearing in mind the ethics and moral fibre of the culture that these institutions refer to as the *raison d'être* of their existence.

NOTES

1. This includes fully-fledged Islamic financial institutions as well as the conventional banks and institutions operating Islamic windows or conducting Islamic financial transactions. Source: Institute of Islamic Banking and Insurance, London. Website: http://www.islamic-banking.com/ibanking/ifi_list.php
2. It is known that there is an interesting economic, management and legal literature in the field (Porzio, 2009), but there are very few specialized studies about the issues of Islamic banking in the European legal framework.
3. At the time of writing, only the Financial Services Authority (UK) has granted authorization to an Islamic bank.

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