**ISLAMIC FINANCE IN NON-MUSLIM-MAJORITY JURISDICTIONS**

**1.Introduction**

Islamic finance in Europe is no passing fad. Though Islamic retail banking in Europe cannot yet be called a resounding success, banks specialising in wealth management or real estate investment are doing better, first of all in the United Kingdom. Some countries, such as the Netherlands, are without Islamic banks, though the Amsterdam offices of international law firms will happily arrange Islamic financing by Gulf financiers. The main causes of the hesitant rise of Islamic banking in Europe probably are:

i- Hostility and fear of ‘Islamization’ among part of the public and politicians, which leads to unwillingness to adapt laws and banking and financial market regulations to facilitate Islamic finance.

ii- Lack of awareness and knowledge of Islamic finance and lack of interest among the Islamic residents of European countries (see for an overview of surveys Visser, 2013 pp. 180-182).

iii- Aversion to the Islamic finance industry among Muslims because it is seen as conventional finance made more complicated, being mainly debt-based (see Visser, 2016).

iv- Regulatory issues, or administrative hurdles, or the complexity of adapting the regulatory framework to Islamic finance.

The regulatory issues form the subject of this paper. The discussion will be restricted to banks. Investment funds face fewer hurdles, but insurance companies and pension funds are a different story. Islamic insurance or takaful is constructed as a mutual protection scheme, but often managed by a commercial firm, which for instance means that shareholders’ funds and policyholders’ funds must be kept apart (Hidayat, 2016). Furthermore, the ban on interest will throw up many problems for pension funds and takaful firms in a European context. These cannot be studied here in any depth.

The regulatory issues that impact on and may hinder the development of Islamic finance are manifold. An overview is given starting from the idea that legislation and supervision should aim at a level playing field for conventional and Islamic finance while maintaining financial stability.

**2.Single or separate legislation and supervision**

First, regulators and lawmakers have to decide whether to adopt separate legislation for conventional and Islamic banks and other financial institutions, or single legislation for the financial sector as a whole. The leading idea of the economics discipline is that there is no such thing as a free lunch, or, in technical language, there are always opportuniy costs: if you want to have one thing, you will have to give up something else. So both solutions have their pros and cons. Separate legislation makes it simpler to take account of the special features of Islamic finance, but requires more legislative work (López Mejía et al., 2014) and runs the risk of losing sight of the level playing field. Under single legislation, on the other hand, care must be exerted to avoid undue restrictions on the activities of Islamic financial institutions. In 2011 the IMF conducted a survey among 30 non-EU countries plus the UK on how Islamic banks are regulated. It found that only three had a separate regulatory franework for Islamic banking, but the majority of the others supplemented the Basel Committee framework fully or partly applicable to all banks with additional provisions for Islamic banks. These sometimes consisted of prudential standards and guiding principles developed by the Islamic Financial Service Board (IFSB). Some, such as Bahrain, Indonesia, Jordan, Lebanon and Pakistan, have separate supervisory units within a single supervisory authority (Song and Oosthuizen, 2014).

A related question is what accounting standards must be followed. Some Muslim-majority countries follow accounting standards developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), but important players in the Islamic finance field such as Malaysia, the UAE and Saudi Arabia follow the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board, like most countries (Amin, 2015; see for a survey among Islamic financial institutions AOSSG, 2015).

Single regulation without special provisions may hurt Islamic banking because they are bound to the ban on riba, which precludes interest on money loans, and furthermore because it uses a number of financial instruments that conventional banks do not, and which prevailing laws and regulations may not accommodate easily. If, for instance, banks are subject to restrictions as to holding equity positions in companies, this may prevent Islamic banks from providing PLS (profit-and-loss-sharing) finance, and just that is the ideal of Islamic finance (Bakar et al., 2009 p. 84). Other Islamic financial instruments, such as ijara (lease) and istisna (financing of work in progress), imply that a bank holds an interest in real assets for a long period of time, which may be outright forbidden or be subject to onerous capital-asset requirements (Khan, 2010). Banks may furthermore not be allowed to act as a goods trader, as in Bosnia (Klepic, 2009), and thus be unable to provide murabaha finance (purchase and sale with a mark-up, usually against deferred payment).

An issue that calls for special attention is the relationship between an Islamic bank and the central bank.

**3.Legal issues: substance over form?**

A very important question is whether legislation allows, and courts apply, a substance over form approach. The United States tends to be very liberal in this regard (McMillen, 2015; Thomas, 2001). In Europe, Luxembourg and the Netherlands stand out as champions of the substance-over-form approach. Nevertheless, the Dutch tax authorities do not feel free to treat Islamic substitutes for conventional interest payments on home finance contracts as equivalent to interest. This is because Dutch real estate law gives a very narrow and exact definition of interest. If a lease element is involved, as is the case in ijara wa iqtina(hire purchase) and musharaka mutanaqisah (diminishing partnership) home finance, the law for instance very explicitly requires the financier to state which amount of the rental serves as interest payment. Murabahacontracts are subject to the same requirement. As an aside, applying a substance over form approach would not help much if a lease element is involved, as tax deductibility of interest and other costs of home finance is only available to Dutch home buyers if they own at least 50% of the object (Kranenborg and Talal, 2007). A revision of the laws and regulations pertaining to tax and real estate issues would be complex and time-consuming, which does little to convince politicians and civil servants that it is worth pursuing, given also the negative attitude of a vociferous part of the public to anything Islamic and the poor prospects for Islamic mortgages in the retail market, as indicated by the negative experience in the United Kingdom. Note that deductibility of interest and other costs of financing creates other problems. In general it makes incurring debt more attractive for both consumers and companies, in the latter case as an alternative to equity. It makes for higher financial fragility and consequently for a higher potential severity of financial crises.

A problem in some countries, including Italy and the Netherlands, is that some of the financial instruments peculiar to Islamic financial institutions are incompatible with the definition of banks in the respective national laws and regulations. This may for instance relate to investment funds of a musharaka (shared ownership) character, if the national law requires banks to reimburse funds irrespective of the yield of the assets financed by those funds, or to an operating lease, which cannot be classified as credit (Gimigliano, 2016; Verhoef et al., 2008). In the latter case, it should be relatively easy for an Islamic bank to conform, namely by establishing a leasing finance firm as a daughter company.

**4.Tax issues**

Tax issues are inextricably bound up with the substance-over-form question. If Islamic finance is to have a sporting chance in Europe, an economic rather than a legal approach is called for, not only with regard to deductibility of financing costs but also in the areas of indirect taxes and international tax agreements. As an aside, it should be noted that the Netherlands may follow a legal approach on home finance, but , along with Luxembourg, stands out in Europe as a country applying a substance over form approach to Islamic contracts (Muller, 2010).

As for indirect taxes, a level playing field would require a partial exemption on VAT levied on purchases under a murabaha contract. Under a murabaha finance contract, the bank buys a good in order to sell it on with a markup to the customer, against deferred payment. The markup, which is usually roughly equal to the present discounted value of future interest payments on a conventional credit sale, may add considerably to the purchase price of a good and a VAT levy at the going rate on the full purchase price would put murabaha purchases under a competitive disadvantage. Further, levying real estate transfer taxes on each and every transfer of ownership also means a heavy burden on Islamic finance, as Islamic contracts may involve more than one sale and purchase transaction where under conventional finance one suffices. This is the case with murabaha finance, where the financier buys a good and sells it on to its customer, and also with ijara wa iqtina and musharaka mutanaqisa contracts. The UK’s 2003 Finance Act, which was introduced to remove obstacles to Islamic forms of finance, requires only a single payment of Stamp Duty Land Tax on Islamic real estate transactions (UK Government, 2015). In the Netherlands, however, multiple transfers of ownership have a similar provision only for transactions taking place within six months of each other. The 2003 Finance Act also provides for treatment of returns and income payments on debt as if they were interest, which helps stimulate the sukuk(Islamic certificate) market in London (Ahmad, 2003).

International tax treaties are confronted with similar issues. It might, for instance, help if tax treaties replace ‘interest’ by ‘income from debt claims’, in order to take account of Islamic forms of debt, as in the tax treaty between Bahrain and the Netherlands. Furthermore, it may make sense to include zakat(obligatory charity) payments in treaties as a tax, which Kuwait and Saudi Arabia insist on (Muller, 2010).

Tax issues are extremely complicated and unforeseen problems are sure to crop up. The 2003 Finance Act for instance stipulates that under an ijara wa iqtina contract the initial transfer of the property is relieved from Stamp Duty Land Tax if the customer is the registered proprietor (UK Government, 2015). That would imply it does not extend to the financier. The UK Court of Appeal indeed concluded it does not (Hunter, 2016).

**5.Deposit insurance and the classification of deposits in Islamic banks**

Islamic banks offer deposits that have different characteristics from those offered by conventional banks. Take demand deposits, or current acounts. These may be held under a quard hasanor interest-free loan contract, as in Iran, the United Arab Emirates (UAE), Bahrain and Kuwait, or under a wadia(safe custody) contract, as in South East Asian countries. Another variant is the mudarabacontract, as applied in Malaysia, which involves profit sharing between the bank as the mudarib or agent, who invests the funds, and the customer as the rabb-al-malor financier (Bakar et al., 2008 p. 74). Losses should thus be borne by the depositors, which is clearly at odds with deposit guarantees (Hidayat, 2016). Under a quard hasan or wadia contract the bank guarantees the principal amount of the demand deposits, but a mudaraba contract requires the rabb-al-mal to absorb any losses, unless the mudarib is guilty of culpable negligence. In Europe supervisors require demand deposits to be capital-certain, and if Islamic banks and their customers deem mudaraba demand deposits incompatible with capital certainty, they will have to choose another form than mudaraba.

Now the bank may guarantee the principal amount of a demand deposit, but what if a bank fails? Is deposit insurance acceptable from an Islamic point of view? With qard hasan and wadia accounts it should, in principle. Islamic law allows guarantees by an external guarantor against a fee, according to many, though not all, fiqh (Islamic jurisprudence) scholars (Usmani, 1998). The Dutch system that will be phased out to make place for the European Deposit Insurance Scheme might have been attractive to Islamic banks, as it provides for guarantees by the banks collectively to come to the rescue of depositors of a failed bank, without any pre-paid contributions to a fund. Islamic banks and their sharia boards could interpret this construction as takafulor, literally, mutual support. A deposit insurance fund with pre-paid contributions, such as the European Banking Union fund, will be much more difficult for sharia boards to swallow. Most probably the funds will be mainly invested in interest-bearing securities, which goes against the prohibition of riba. Islamic banks will have to stomach a riba-based fund, accepting it as a case of darura or necessity (force majeure). European supervisors and regulators could alternatively consider a separate fund for Islamic banks, which would invest its money in sharia-compliant ways. The downside is that less money would be available to deal with any given calamity. The solution suggested by Gimigliano (2016) that Islamic banks mimic the mutual assistance character of takaful by agreeing to make voluntary contributions does not answer the problen of riba-tainted investments by the guarantee fund.

Savings accounts could be structured in the same way as demand deposits, that is, as a wadia, as in Malaysia, or a qard hasan account, as in Iran, with perhaps allowing people to opt for a mudaraba account if they accept to go without deposit insurance. Banks could provide a yield on wadia or qard hasan savings accounts in the form of a *hiba* or gift. Of course, such a gift cannot be promised in advance, not formally at least, because that would taint the account with riba. With mudaraba accounts, however, potential conflicts between sharia and prevailing banking law arise. Banks would generally be obliged by regulators to provide capital certainty, but that would conflict with the character of mudaraba. The Islamic Bank of Britain came to an agreement with the Financial Services Authority and resolved this conflict by offering full repayment of the savings deposits while informing account holders how much they would receive in a loss-making situation if the character of a mudaraba were fully maintained. Clients who let their obedience to sharia prevail had the option to refuse full repayment (Chiu and Newberger, 2006; Ainley et al., 2007; Ahmad, 2013 p. 105).

In practice banks try to prevent a situation where depositors would be confronted with a negative return. To this end they set part of their profits aside in a Profit Equalization Reserve, enabling them in lean years to pay a return on deposits comparable with the interest rate paid by conventional banks on their savings deposits. Of course, account holders are also free to refuse compensation under a guarantee scheme for money lost in a bank failure. In cases where banks face restrictions on funding a Profit Equalization Reserve, supervisors might consider loosening these, in order to enable Islamic banks to compete on equal terms with conventional banks.

It may be noted in passing that the Sharia Advisory Council of Bank Negara Malaysia, the Malaysian central bank, in 2002 resolved that a deposit insurance scheme for Islamic bank is permissible, even for mudaraba accounts. In 2005 the scheme got off the ground. Malaysia stands apart in applying maslaha, or public interest, in a relativey liberal way in financial regulation, and the ground for this decision was that without an insurance scheme Islamic banks would hardly be able to compete on equal terms with conventional banks (Khairuddin, 2011). Gulf states find such wide applications of maslaha abhorrent. European regulators can point to Malaysia if they do not want to follow the example of the UK Financial Services Authority.

Another kind of accounts peculiar of Islamic banks is the profit-sharing investment account (PSIA), structured as a mudaraba, a musharaka or a wakala (agency). There are two varieties, unrestricted investment accounts and restricted investment accounts, offered for fixed periods. Unrestricted investment, or *mudaraba mutlaqa*,accounts leave the bank a free hand as to the investments it makes with the available funds; restricted investment accounts, or *mudaraba muqayyada* accounts, restrict the portfolio that the bank can invest in. The latter, in other words, define the subset of investments whose yields, that may be negative, are shared with the deposit holder.). The bank in this case is deemed to act as an agent for the depositor, or investor, and should not run any risk itself (unless it is found guilty of fraud or culpable negiglence). AAOIFI recognizes neither restricted nor unresrtricted investment accounts as liabilities of the bank (AOSSG, 2015), but in practice both banks and clients may see little difference between unrestricted accounts and savings deposits. That could be an argument for granting holders of restricted investment accounts recourse to the assets financed by their deposits in case of default of the bank, but not holders of unrestricted investment accounts. In line with this way of thinking, there are jurisdictions, not only Malaysia but also for example Turkey, that provide deposit insurance for unrestriced investment account holders, in the interest of financial stability, that is, using the argument of maslaha (Addo Awadzi et al., 2015 p. 24). This will be especially relevant in cases where banks feel obliged to provide account holders with a return that is comparable with the interest on conventional time deposits, lest they run away after the expiry of the investment contract and cause a liquidity shortage. Such accounts have in fact lost their mudaraba character. National regulators will have to decide whether or not to provide deposit insurance to unrestricted investment account holders only or to all investment account holders, plus mudaraba savings account holders. They should bear in mind that the practice of Islamic banking does not always conform to the ideal. A survey by the Asian-Oceanian Standard-Setters Group (AOSSG) found that many banks do not distinguish between unrestricted and restricted accounts nor between deposits that are pure liabilities and investment accounts (AOSSG, 2015). This would provide an argument for supervisors to deny all such acounts any prior ranking and instead impose deposit insurance, with the client having the right to renounce payment in case of default.

**6.Basel III solvency requirements**

Another task for banking regulators and supervisors is to decide how to treat Islamic banks with respect to the Basel III solvency requirements, as some of the Islamic banks’ liabilities have different characteristics than those of conventional banks.

A case in point are sukuk. AAOIFI accepts 14 different varieties. Decisions must be made to what degree they can be used to fulfil Basel III capital-asset ratios. The central bank of the UAE accepts perpetual sukuk issued by Abu Dhabi Islamic Bank as Tier 1 capital (Kanji and Gill, 2013). This looks eminently sensible at first sight, provided the sukuk have a clear PLS profile, as with sukuk mudaraba and sukuk musharaka. Others have followed in the footsteps of Abu Dhabi. Saudi Arabia’s National Commercial Bank and Qatar Islamic Bank both raised Tier 1 capital by issuing perpetual sukuk mudaraba (IFN Alerts, 2015). But before European bank regulators and supervisors agree on assigning Tier 1 status on such sukuk, or 100% Tier 1 status, they should check whether sukuk holders do have recourse to the assets of the bank in case of default. Accepting subordinated sukuk as Tier 2 capital, popular in the Gulf states, Malaysia and Turkey, looks less problematic. As a general rule, Tier 1 capital is meant to absorb shocks for a bank as a going concern, whereas Tier 2 capital serves to compensate creditors of a distressed bank. Tier 1 is divided into Common Equity Tier 1 and Additional Tier 1 (AT1). AT1 includes unsecured instruments with a minimum of 5-year maturity that rank senior to common equity but rank junior to Tier 2 instruments and to depositors, general creditors and holders of subordinated debt of the bank, plus debt instruments that will be converted into common equity or written down when a pre-specified trigger event occurs. Bank Negara Malaysia includes unrestricted musharaka, mudaraba and wakala sukuk under AT1 (Sairally et al. 2016)). A case could be made for including unrestricted musharaka under common equity, which is what IFSB basically does instead of under AT1, because they should not be ranked senior to CET1, as Basel III requires. However, it is a moot point whether mudaraba and wakala sukuk are suitable for AT1 purposes. IFSB says they are not and Sairally et al. (2016) concur, arguing that mudaraba and wakala sukuk holders have a first claim on the the residual value of the portion of the assets financed by their funds. Supervisors will have to take a decision.

Next we have the investment accounts discussed above. In principle, unrestricted investment accounts share in the total risk of the bank and thus can be accepted as a form of risk capital, whereas restricted investment accounts only share the risks of their specific investments and should not be included in the institution’s risk capital. However, Islamic financial institutions tend not to shift losses to their clients in practice but will practice income smoothing with the help of a Profit Equalization Reserve and perhaps also an Investment Risk Reserve, specifically meant for investment account holders and also funded out of their income (Bakar et al., 2008 p. 194). That would be an argument against assigning these accounts risk capital status, what anyhow would be incongruent if holders have recourse to the assets financed by their funds. To deal with this on-the-one-hand – on-the-other situation the IFSB provides two formulas for calculating the capital-asset ratio: (i) a standard formula, for cases where the investment account holder fully bears the credit and market risks of the assets funded by the investment account; and (ii) a discretionary formula, where a correction factor is applied to take account of the degree in which account holders share the losses (López Mejía, 2014). Of course, these formulas only provide a tool and not a ready-made set of regulations.

Finally, the normal risks that also confront conventional finance may demand a slightly different application of the rules in the case of Islamic finance. Possibly, for instance, Islamic financial institutions run a higher risk of losses than conventional banks because of the fact that their financing activities tend to be closely linked with real transactions. The bank is, however briefly, the owner of the good and has to absorb any loss resulting from theft, damage or improper documentation and, if the customer has second thoughts and breaks his or her promise to buy the good, the risk of a lower price when disposing of the good. Such market risk may go hand in hand with concentration risk, as sharia law precludes accepting clients from a number of industries and Islamic banks have fewer options to spread risks than conventional banks. Islamic banks often are heavily involved in real estate finance, resulting in a high percentage of real estate on their balance sheets (Song and Oosthuizen, 2014). Mudaraba contracts bring with them a high credit risk, as the bank as principal is dependent on the exertions of the client as agent to make a profit. Any losses are solely borne by the principal, or rab al-mal, and the client can be made accountable only if culpable negligence or fraud can be proved. Hedging opportunities for all these risks are limited. The question is whether to require Islamic banks to hold higher capital-asset ratios with an eye to such risks.

**7.Basel III liquidity requirements**

Supervisors and regulators have to ask themselves whether Islamic banks should be subject to different required minimum liquidity ratios than conventional banks. Murabaha loans figure large on Islamic banks’ balance sheet, resulting in a high volume of receivables. These are very illiquid. Sharia law only allows them to be sold at par (though Malaysia’s regulator is more lenient, on the ground of maslaha). Another issue calling for attention is the run-off rate to be applied to PLS funding. Islamic banks rely for their funding to a large extent on short-term investment accounts, which are said to be more volatile than conventional time deposits (Vizcaino, 2014). The run-off rate thus may be high, which translates into a low net stable funding eligibility of PLS funds (*The Banker*, 2014). This would under Basel III imply an obligation to hold more high-quality liquid assets in order to cover net cash outflows for a 30-day period under a high-stress scenario. It is up to national regulators to apply weights to the different funding sources. An IFSB Guidance Note may provide help (IFSB, 2015).

A serious problem for Islamic banks is that they have far fewer instruments at their disposal for liquidity management than conventional banks, as interest-free short-term investment objects other than cash or current-account deposits are few and far between. Sukuk might provide a way out, but the secondary market for sukuk is very thin and supervisors would have to decide which sukuk should be eligible as a liquidity buffer and on any haircuts to apply. Perhaps other banks or the central bank can help Islamic banks with their liquidity management by offering tawarruq and reverse tawarruq facilities, like the central bank of the UAE does. A tawarruq starts with a murabaha contract including a credit sale. The financier, bank B, buys a good, sells it to the customer, in this case the bank needing cash, bank A, against deferred payment and with a markup. Next, bank A, or bank B as its agent, sells the good agains immediate payment to a third party. Such transactions usually involve platinum or aluminium contracts on the London Metal Exchange or palm oil contract on the Kuala Lumpur Commodities Exchange, as such transactions can be made very quickly at low cost and with little risk of price fluctuations. If bank A wants to deposit money it works the other way, with a reverse tawarruq. Bank A buys, as agent for bank B, a commodity contract against immediate payment, sells it to bank B with a markup against deferred payment, and next sells it as agent of bank B on the commodities exchange. Bank B receives the revenue of the sale. The result is that A after a number of months will receive a larger sum from bank B than it has paid for the metals contract, comparable with a conventional time deposit.

**8. Accouting rules**

(i) IFRS 9, which will be implemented from next January, requires lenders to book expected losses in advance, but under AAOIFI rules only incurred losses are recognised (Vizcaino 2016). AAOIFI’s Revised FAS 30 however provides for allowances for expected credit losses to be charged to the income statement. Par. 58: Allowances for credit losses shall be shown on the balance sheet as a deduction from the respective asset. (AAOIFI 2017)

(ii)Under single regulation of the financial industry a solution must be found for potentially conflicting rules with regard to the Islamic finance lease, or ijara muntahia bittamleek. A general difference between ijaraand a conventional lease is that under an ijara contract the lessor is responsible for maintenance, whereas a conventional lease leaves maintenance to the lessee. Islamic financial institutions may be inclined to follow FAS-8, or Financial Accounting Standard 8 of AAOIFI, whereas Western regulators take their cue from IAS-17 of the International Accounting Standards Board (IASB). There are various differences between IAS-17 and FAS-8 (AOSSG, 2015; Hanif, 2016). To cite a few, IAS-17 recommends fair value while under FAS-8 assets are recorded at historical cost at commencement of the lease term. Under a finance lease IAS-17 has an asset recorded in the books of the lessor as Receivables, as if it is sold, but under FAS-8 an asset is recorded as Investment in Ijara Assets. This is because FAS-8 sticks to the form of the contract, which is strictly a lease contract (Islamic law does not allow combining two transactions, in this case a lease and a sale, in one contract, it does not even allow conditioning one contract on another), whereas IAS-17 follows a substance-over-form approach and treats a finance lease as if the asset has been purchased by the lessee. In line with this, FAS-8 treats lease rentals as revenue and depreciation as an expense while IAS-17 has lease rentals allocated between interest earnings and principal. Thus, FAS-8 has earnings spread evenly over the lease term but IAS-17 results in higher earnings in earlier years and lower earnings in later years (the value of Receivables falls in step with the received principal payments, interest earnings consequently fall too and a larger part of the rental is used for amortization). There are no differences between FAS-8 and IAS-17 in the treatment of operating leases. IAS-17 will be replaced by IFRS (International Financial Reporting Standard) 16 as per 1 January, 2019. For the lessor not much changes, but for lessees the differences are substantial. IFRS 16 eliminates the classification of leases as either operating leases or finance leases for a lessee. This means that former off-balance leases now appear on a firm’s balance sheet, with the exception of leases of 12 months or less and leases of inexpensive assets, such as personal computers (*IFRS 16 Effects Analysis*, 2016; *IFRS 16 — Leases*, 2016).

Though sharia boards of Islamic banks or Islamic windows may oppose any enforcement of IAS-17, regulators averse to FAS-8 may point to the fact that some Islamic banks in the Emirates have no compunction following IAS-17 rather than FAS-8 (Gupta 2015). Indeed, AAOIFI accounting standards are compulsory in only a few countries, including Bahrain, Jordan, Oman, Qatar, Qatar Financial Centre, Sudan, and Syria (http://aaoifi.com/adoption-of-aaoifi-standards). A solution may be in sight. The IASB set up a consultative group on Sharia-compliant transactions that commenced work in July 2013. The AAOIFI first declined the invitation to join, but in December 2014 they decided to join after all (Amin, 2015).

(iii) For the finer points of inventory valuation and profit determination of murabaha contracts see Ilter and Elbarrad 2013.

**9.Resolution**

If an Islamic bank has been placed in resolution, its Islamic character is likely to add to the worries. The sharia board of the bank may, for instance, judge the resolution measures not sharia-compliant. If another Islamic bank is interested in acquiring the bank in resolution, the sharia boards of the two banks may disagree on the sharia compliance of the measures. A legal framework should be in place that provides for such conflicts and decides whether the resolution authorities have the power to suspend or remove sharia board members of a bank in resolution, in addition to its directors. The resolution authority might be given the right to establish its own sharia board for advice on resolution measures (Addo Awadzi et al., 2015).

Another issue calling for attention is what triggers should be in place for activating resolution powers in view of the special character of Islamic banks’ products. The conventional capital adequacy and liquidity thresholds do not always seem appropriate for ijara or PLS financing, which are not pure lending. On the liabilities side of the balance sheet, it should be clear whether deposits, in paricular the investment accounts discussed above, have the legal status of client assets. In that case account holders have recourse to the bank’s assets in a resolution. Their deposits are not available for absorbing losses and should be segregated (see for guidelines FSB, 2014).

The ban on riba puts an obstacle in the way of an acquisition of an Islamic bank in resolution by another bank. The ban on riba implies that debt can only be sold at its nominal value and not every sharia board will accept the maslaha argument as applied by the Malaysian regulators. Moreover, resolutions may also find obstacles in their way because mandatory debt write-offs do not seem to be sharia-compliant. Debt can only be discharged if it is paid in full or if it is forgiven voluntarily by the creditor. Circumstances may arise where the resolution authority, or the sharia board it appointed, can only force a decision with an appeal to the principle of darura, or necessity. There is, however, no unamity among sharia scholars how far the applicability of this principle can be stretched.

**10.Sharia risk**

Islamic banks and other financial institutions run a specific risk that does not plague conventional banks. This is sharia risk, or the risk of loss because an Islamic financial institution’s products or activities are found or judged to be not sharia-compliant (see Ginena, 2014, for a comprehensive analysis of sharia risk). Customers may withdraw deposits on the mere rumour that an institution or its personnel do not fully comply with Islamic law. If a contract party suspects non-compliance with sharia it may want to nullify a contract. A lawsuit might impair the bank’s viability, because of damages to be paid and because the loss of reputation makes customers leave. In addition, if a court finds for the complainant, the losing Islamic bank will have to donate any profits from the transactions found to be non-compliant with sharia to a charity (Ginena, 2014; see Howladar, 2010, for the complexities of litigation concerning sharia compliance).

In European countries law courts will likely only apply national law to any dispute (given that the governing law of the contract is national law) and refuse to consider sharia compliance, though US bankruptcy courts are reported to be more willing to consider sharia considerations (McMillen, 2015). Where that is not the case parties can decide to take their case to an arbitration body (Mohammad, 2015).

Regulators may reduce sharia risk by requiring Islamic banks to have a sharia board that meets, for instance, AAOIFI Governance Standards. Usually, Islamic banks appoint a sharia board of their own accord, in order to give themselves a reliable image, and Muslim-majority countries tend to oblige them to do so, but there are exceptions, such as Tunisia and Turkey. Kenya is another country without obligatory sharia boards (Song and Oosthuizen 2014). Better not to leave it to the banks. Regulators might also consider imposing minimum requirements as to the educational background of the employees of Islamic financial institutions. A lack of knowledge of Islamic law on the side of employees increases the risk of breaches of Islamic law. The Malaysian *Islamic Financial Services Act* *2013* (Bank Negara Malaysia, 2013), in particular Part IV on sharia requirements, provides an example of how to lay down rules for minimizing sharia risk.

Regulators should look critically at the composition and the role of a bank’s sharia board. If they have a directorship role, their capability as bankers may not meet a supervisor’s standard. Furthermore, given the scarcity of competent sharia board members, there is a high probability that any board member also serves on the sharia boards of other financial institutions, which may lead to conflicts of interest if they act as a director (Kettell, 2011).

An Islamic financial institution’s sharia risk can never be reduced to zero and regulators and supervisors would have to ask themselves whether to impose higher capital-asset and liquidiy ratios to cope with that risk. These might be variable, depending for instance on the track record of any parent companies.

**11.Final observations**

It will be clear that providing for Islamic financial institutions in a country’s banking laws and regulations is a complicated and time-consuming business. It may not always be possible to fit all forms of Islamic finance in the national regulatory framework and sometimes compromises will be inevitable, with Islamic financial institutions having to apply darura and maslaha considerations. When considering special capital-asset and liquidity ratios it should be taken into account that Islamic banks weathered the 2008 financial crisis relatively well (Beck et al., 2013), that they do not engage in complicated derivatives deals and that there is some indication of low credit risk, though admittedly the evidence is mixed (Kabir et al., 2015). That might more or less neutralize the risks specific to Islamic financial institutions. It all involves a lot of work, but the task can be made more manageable by learning from the experience of others and applying available standards and guidelines.

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