

# Islamic Finance and Conventional Financial Systems

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# OUTLINE

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## ❖ ISLAMIC FINANCE IN EUROPE

- ❖ Where and how?
- ❖ Why?
- ❖ Future developments and key challenges

## ❖ A CENTRAL BANK'S PERSPECTIVE

- ❖ What has been done in the EU?
- ❖ Monetary policy and regulatory challenges



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## ISLAMIC FINANCE IN EUROPE

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# Islamic Finance in Europe

## Where? How?

# ISLAMIC FINANCE IN EUROPE – WHERE? (1/2)

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- **UK and Luxembourg key financial centres**
- **Ireland's increasing importance**
- **Some other initiatives:**
  - **France**
  - **Germany**





## ISLAMIC FINANCE IN EUROPE – WHERE? (2/2)

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- **Issuing and negotiation of sukuk**
  - **2 sovereign sukuk (UK, Luxembourg)**
- **Management of Islamic funds**
- **Retail banking is still at its infancy and limited to the UK**

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# Islamic Finance in Europe Why?



# ISLAMIC FINANCE IN EUROPE – WHY?

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## DEMAND SIDE:

- **Potential demand from a growing Muslim population**
- **Strong ethical underpinnig and link to real sector (attractive also to non-Muslims)**





# ISLAMIC FINANCE IN EUROPE – WHY?

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## **SUPPLY SIDE:**

- **Public debt financing**
- **Possibility of attracting funds from Middle Eastern countries**
- **Increased know-how by financial institutions**
- **Potential for financial intermediation for international business**

# MAIN CHALLENGES

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- **Lack of**
  - product standardisation
  - harmonisation of Islamic rules
  - transparent and harmonised standards
  - reliable data
- **Differences in**
  - policy position
  - regulatory and supervisory approaches
- **Tax barriers**
- **Liquidity management**
- **Education and training of IF experts**
- **Communications/marketing**
- **Ethical dimension**
- **Low profitability and sub-optimal size**

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# A Central Bank's Perspective What Has Been Done in the EU?

# WHAT HAS BEEN DONE IN THE EU?

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- **Government task forces**
- **Legislative amendments in some EU countries**
- **Approaches taken by Central Banks and supervisory authorities**

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# A Central Bank's Perspective Monetary Policy Issues

# MONETARY POLICY ISSUES

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Monetary policy instruments are not shari'ah compliant

In the Euro Area:

- OMO, standing facilities and minimum reserve requirements
- Sukuk are not ECB eligible collateral

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# A Central Bank Perspective Supervisory and Regulatory Challenges

# The reasons behind bank regulation (1/2)

Ensuring the correct and prudent conduct of financial institutions



- ➔ Enhancing financial stability – crisis prevention
- ➔ Protecting the interests of depositors
- ➔ Promoting fair competition – keeping down financial costs for customers



## The reasons behind bank regulation (2/2)

The Bank of Italy carries out checks of varying intensity on intermediaries.

➔ Documentary checks

➔ Inspections

Checks are performed on different aspects of the business:

➤ fulfillment of the requirements to engage in it;

➤ capital stability

➤ sound and prudent management

quality of management;  
control of risks;  
capital adequacy;  
compliance with transparency/AML  
usury law.

# Islamic banking vs traditional banking (1/3)

Islamic banks are subject to compliance with the precepts of the Islamic religious law (Sharī'ah)



Prohibition of Ribā' (interest payment)



Prohibition of investing in activities that imply:

- Gharār (excessive uncertainty/ambiguity)
- Maysīr (speculation)
- Harām (behaviours forbidden by the Koran)

As a consequence, Islamic banks present some peculiarities compared to traditional intermediaries

# Islamic banking vs traditional banking (2/3)

## Assets structure

### Islamic banks

- Cash (interest-free)
- Contracts based on PLS/AB transactions
- ....
- ....

### Traditional banks

- Cash (interest bearing)
- Credit products (mortgages/leasing/personal finance....)
- Financial products (derivatives/interest-bearing assets...)
- ....
- ....

## Liabilities structure

### Islamic banks

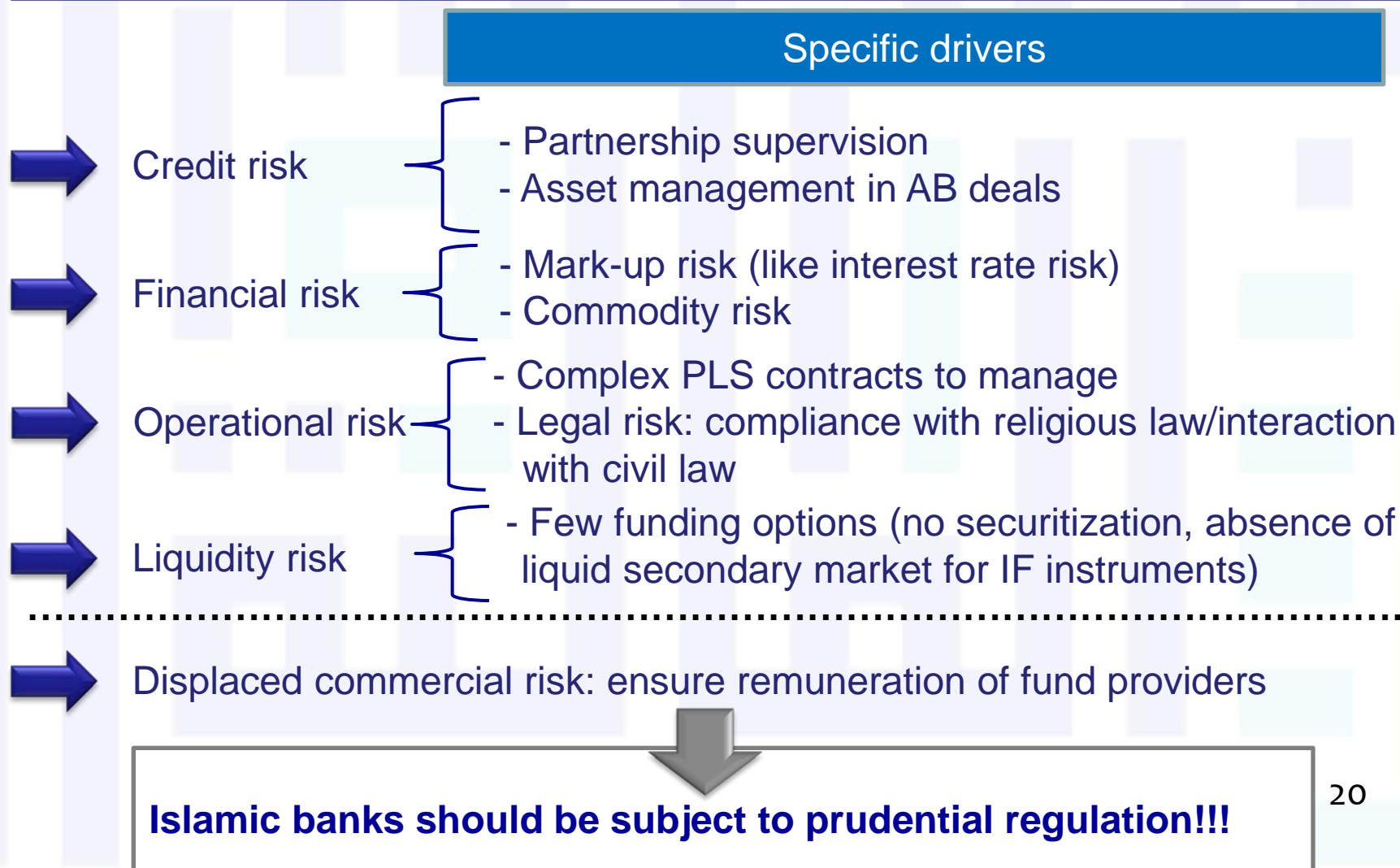
- Deposits
  - Current accounts (interest-free)
  - Saving accounts (PLS)
- Equity

### Traditional banks

- Deposits (interest bearing)
- Equity

# Islamic banking vs traditional banking (3/3)

Islamic and traditional banks basically face similar risks, although with some differences due to their balance sheet structure



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# Islamic Finance in Italy?

# The Italian legal framework

Supervision is regulated by a body of provisions that is continuously evolving in response to the growing integration of markets and intermediaries, driven by the internationalization of finance and the ever greater complementarity between banking and financial products

The regulatory framework for supervision rests on:

- ➔ International rules (EBA, ESMA, ecc.)
- ➔ Community laws (Directives/Regulations)
- ➔ Primary (TUB-1993 Banking Law)  
Secondary (BoI regulations) domestic laws

# Regulatory challenges (1/2)

**Credit institution** means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (CRR, art. 4)



Islamic banks seem to fall into the definition (even if a case-by-case valuation could be required). As a consequence, should an IB enter into the Italian market, it would be subject to the Italian regulatory framework for supervision.



## Main challenges



Deposit guarantee scheme: essential to operate in Italy



Governance: role of the Sharī'ah supervisory board

Prudential rules require:

- a clear definition of the responsibilities of internal functions/bodies;
- avoidance of redundant structures;
- fit and proper/interlocking assessments for management/supervisory boards

# Regulatory challenges (2/2)



## Main challenges



Classification of Islamic bank operations with respect to relevant prudential regulation:

- Limits for direct investments in real estate
- Outsourcing
- .....



Transparency rules: lack of product standardization



Tax regime

- Double stamp duty on property purchase
- Lack of deduction for funding costs (passive interests)
- VAT on Murabaha mark-up



# Final remarks

**1 Islamic banking doesn't look strictly incompatible with the existing regulatory framework**



At any rate, solutions should be found to adapt the peculiar business model of Islamic banks to the regulatory environment.

**2 Islamic finance is gaining momentum, but raising awareness on the topic remains important**



Benefits may arise from the creation of an inclusive financial system and from the attraction of Middle Eastern investments.

**3 The lack of a unified regulatory framework has limited the expansion of the Islamic banks in Europe.**



The progressive convergence to a European prudential regulation and the centralization of banking supervision should lead to a common approach to Islamic banking supervision and foster IB diffusion in the EU.

# THANK YOU

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