

ISLAMIC RETAIL FINANCE 2004

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“The Issues of Compatibility Between the Italian Banking System and Islamic Banking” - Alberto G. Brugnoli

The Italian banking system is based on a model that follows the rules of both public law and business law, requiring an interdisciplinary approach to individual issues.

As we know, national banking systems arise and have been influenced in quite different ways - depending on the individual situation - by general events occurring within the economies in which they exist, and they have developed characteristics that always conform to the legal system to which they belong.

In Italy, the banking system played an extremely important role in the industrialization process, which arrived later than in countries such as Great Britain, France and Germany. We can identify various periods within this process - each one marked by the existence of banking laws promulgated to meet regulatory needs in this sector - which legislators delineated and interpreted in different ways, based on social and economic conditions prevailing during each individual point in history.

Major reform of the entire financial market began in Italy in the second half of the 1980s. Legislative Decree 385 of September 1, 1993 promulgated the "Consolidated Banking and Credit Laws," which implemented organic reform of the sector. The year before, Legislative Decree 481 of December 14, 1992 had made it possible to integrate the national banking system with the European system, by accepting the principle of "mutual recognition of banking licenses."

Now that Italy has completed the process of reorganizing the credit and financial system according to a legislative policy that uses the business model as a central frame of reference for activity, a new phase has begun in which the national banking system is once again called to rethink its structure based on

recent economic-financial developments in Europe. For our purposes, one of the most important of these is the emergence of new models of credit brokerage that are based on principles that are more strictly ethical, social and religious in nature. While in Great Britain this development has already resulted in the emergence of the first banking structure governed by Koranic law, in Italy we have only recently seen the development of a banking model - the ethical bank - as an instrument that can properly meet the needs of an increasingly broad, diverse clientele that is highly sensitive to ethical-social problems.

Today, the problem of the compatibility of typically Islamic structures with the current Italian banking system requires an analysis that must necessarily begin with the second EU directive on banking, no. 646, of December 15, 1989, which affirms two fundamental principles:

- mutual recognition, through which EU lending institutions can freely do business in European Union member States, either by establishing a branch, or by offering services directly from the country of origin, provided said activities are included on the list annexed to the directive
- prudential vigilance over the activities of a branch established in a host country, carried out by the control authority in the country of origin (home country control)

To deal with increasing EU competition, the Italian banking system some time ago adopted the universal bank model as an alternative to the multifunctional model, eliminating all distinctions between lending companies and institutions that were based on the duration of deposit-taking operations. The process of aggregation among institutions in different legal categories was thus facilitated. Banking supervision was decisively geared to pursuing the stability and efficiency of the system, overcoming conditioning due to the trade-off between the two fundamental principles.

As already noted, the Consolidation Law had a profound effect on the overall rules of the sector:

- by applying the principle of "healthy and prudent" management of business activity, which until then had not been established by any express provision
- by strengthening the powers of credit authorities in harmony with the principles of the EU system (Art. 6)
- by making changes in how activity was regulated, with the goal of completing the despecialization process and thus giving substance to the parties' name change, which for all purposes went from "lending institutions" to "banks."

Bringing an Islamic "profit loss sharing system" into the Italian regulatory system clearly requires us to resolve important interpretative issues on the legal classification of the activity. In other words, we must determine whether the current regulatory structure can embrace the Islamic model of banking activity or whether, in light of any pronounced incompatibility, it becomes necessary to identify other norms that actually permit legal regulation of the model.

The clearest analogy between the two systems is doubtless the overall structure of the activity that characterizes them: taking deposits from the public and then distributing them to businesses. The only difference we find at this level is that Islamic banks never pay interest on deposits or collect it when providing financing.

But another very important difference is the characteristic, totally peculiar to the Islamic system, that there is no obligation to repay funds received. On the other hand, in the Italian legal system, repayment is one of the specific requirements of a bank deposit contract (Art. 1834 of the Civil Code) but not remuneration for enjoyment of the sums deposited, which is based entirely on the intent of the parties. In this regard, the element of risk is clearly important; this element of risk which in the Italian credit system has been resolved through a complex framework of protection for the bank depositor - protection which in the Italian system is provided through

constitutional legislative policy (Art. 47 Constitution). This is totally absent in the Islamic system, where the depositor is distinguished by his awareness of and full sharing in the bank's risk.

In this regard, it is worth noting that the Italian supervision framework - above all that complex, detailed system of rules designed to ensure that the credit function is carried out properly and prudently - includes specific regulations that protect against the risk of the bank's failure to be performed on behalf of the depositor, and this by requiring banks to participate in a protective Interbank Fund, whose actions are in fact aimed at guaranteeing full repayment of funds collected in the form of bank deposits.

To further protect the depositor, this time in terms of investing deposits, Italian regulations provide a complete, organic system of rules and limits for engaging in brokerage activity. This system includes rules that require the bank to be separate from the financed industrial business in terms of ownership of shares (Art 19 of the Consolidation Law), and rules - borrowed from the ordinary operating practice of healthy, prudent bank management - that are designed to avoid situations where the bank's assets are compromised by the risks of the financed business (diversification of investments, correlation of maturities, conflict of interest, etc.). The bank's inability to meet its repayment obligations to its depositors could in fact arise from any such "compromise."

The situation in Islamic bank framework is completely different. Here, there are no limits to the depositor's direct sharing of the risk of the economic initiative that is financed by these funds. In this sense, it is said that the depositor has no right of repayment from the bank of the sums he originally deposited and remuneration of sums he loaned the bank is not based on the nature of the original deposit contract (abstract enjoyment of the benefits the bank receives from possession of the sum deposited), or on the parties' intent, but is rather based on the favorable conclusion of the economic initiative financed. Here is where we

find full implementation of the Sharia principle through which the lender and the user of the funds jointly share the risk, which leads to the proportional allocation between them of profits derived from the favorable conclusion of the operation. Contractual models used, such as the mudharaba or the musharaka, make clear reference to sharing and participating in the risk of the banking operation.

The difference in the level of risk that the depositor assumes in the Italian versus the Islamic system is the very core of the compatibility problem. It is moreover quite clear that if an Islamic bank wants to operate in Italian territory, it must comply with the rules imposed by the Italian system. If one admits, as appears beyond doubt, that in terms of deposit-taking, the Italian system permits an irregular banking contract to be concluded even without providing for interest payments, in terms of investing deposits the implementation of operating methods that do not provide for interest payments, in exchange for the risks the bank assumes, should be evaluated based on both compliance with the principles of healthy and prudent management, and on the adoption of effective contractual models that take in consideration the need for remuneration for sharing the risk of financing.

According to the provisions of Art. 41 of the Italian Constitution, with regard to the fundamental right to do business, it is not possible to deny the right to go into business to a bank that intends to establish itself in Italy for purposes of doing business according to Koranic law, as long as, of course, it is willing to submit to supervisory regulations and controls, which, as we have already noted, are designed to neutralize the prejudicial effects of engaging in an activity with a high degree of risk. In this context, a newly established Islamic bank would have an important duty to meet all obligations that arise from participation in the Interbank Fund that protects depositors. This, however, would require it to give up one of the basic

principles of its activity - the Sharia principle of the shared risks of the financier and the party financed, which makes repayment of deposits non-mandatory.

Posed in these terms, the question of compatibility would seem to require an immediate negative response, although a more in-depth analysis would reveal possible alternative forms of insuring deposits to the extent that risk sharing is admitted by Islamic laws (takaful insurance). On the other hand, there are no insurmountable barriers to adopting contractual models that can adapt the proper need for the remuneration of the deposit to the joint participation in the initiative financed (in this regard, consider joint ventures, leasing, factoring, and project financing agreements etc.). Neither does an analysis of organizational structures find substantial differences between Western banks and Islamic banks, given that the systems to which they reciprocally refer accept, albeit in some different ways, rules that encompass the general criterion of "healthy and prudent management" (spreading credit risk, transparency of information, etc.).

The conclusion however might be different if an Islamic bank with offices in a European Union country desires to establish an affiliate in Italy. In this case, the provisions of Art. 15 of the Consolidation Law would be applicable; the third paragraph governs methods and conditions - with the latter related solely to "reasons of general interest," - which govern the branch's operations. The activities that an EU Islamic bank affiliate could engage in are clearly all those permitted by the Second EU Directive, based on the principle of mutual recognition, and these activities can be pursued in Italy without requesting additional authorization from the Bank of Italy. With this in mind, it should be considered on a case by case basis whether the affiliate's activities are permitted under the principle of mutual recognition, considering that commonly used contractual models in the Islamic system are based on forms of risk-sharing that are not included within the types of operations permitted.

In these cases, Art. 17 of the Consolidation Law would be applicable. It provides that the Bank of Italy, in compliance with the resolutions of the CICR (Interministerial Committee for Credit and Deposits), may authorize even activities where mutual recognition is not admitted, provided that (Art. 4 of the Ministry of the Treasury Decree of December 28, 1992) the lending institution effectively engages in them in the country of origin and that, the competent Supervisory Authority in the country of origin (which is responsible for controlling stability and efficiency) has been informed of the EU lending institution's intention to engage in these activities in Italy. By applying the principle of home country control in these cases, one can overcome problems connected with protecting the depositor, as noted above, that would prevent the establishment of a "new" Islamic bank.

In conclusion, there are no insurmountable obstacles to establishing an affiliate of an EU Islamic bank in Italy, thanks only to EU regulations that permit complete harmonization of banking regulations in EU member States.