



LEGAL REQUIREMENTS OF ISLAMIC FINANCE

Mohamad Bakkar

Managing Partner - Bakkar Advocates & Legal Consultants-Beirut

PhD Candidate - Paris 2 University



OUTLINE

- ④ Introduction
- ④ Challenges for Regulating and Supervising Islamic Finance in Europe
- ④ Necessity of European Regulatory Strategy
- ④ Shariah Rules and European Regulation
- ④ Conclusion



Introduction

- ② Different School of thoughts(Mazaheb):
 1. **Hanafi**
 2. **Hanbali**
 3. **Maleki**
 4. **Shafi'i**
 5. **Shi'i**

- ② Different Legal opinions (Fatwa's)



Introduction

- ✦ The compliance with Shariah principles is an integral feature in the Islamic banking & finance.
- ✦ An effective and conductive Shariah framework is imperative in assuring such compliance.



Introduction

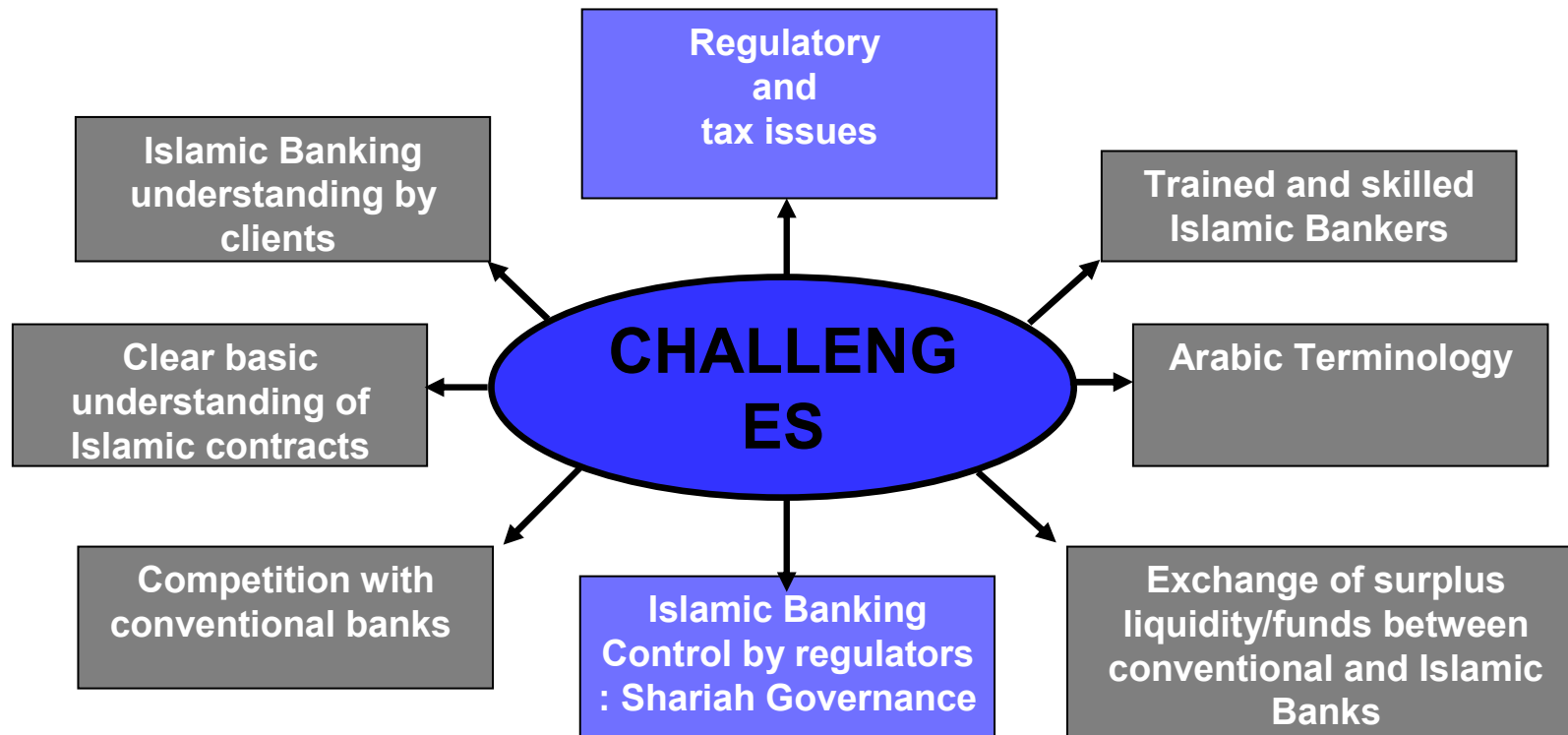
Presently, there is:

neither a **single global authority** to harmonize the different views on Shariah rules and principles

nor an **authority** to issue and ensure international compliance to Fiqh rulings



Challenges in Europe





Regulatory Challenges

EU Regulation

Islamic Finance Directive



EU Regulation

- Does EU Regulation on Financial Services cover banking, insurance and other investment services allow Islamic Finance?
- Definition of deposit/Contradiction with principle of Profit & Loss Sharing
- European “passport”: Once a firm is authorised to provide services in one member state it qualifies for authorisation to provide services or establish a branch in any other member state subject to certain conditions



Islamic Finance in the UK: Regulation and Challenges

- The UK is the only EU member state which has authorised Islamic banks
- The Financial Services Authority - a single financial **regulator**
- The Financial Services Authority has **authorised** 5 Islamic banks and 1 Takaful firm
- This approach contrasts with that in other centres for Islamic banking like Bahrain, Malaysia, DIFC, which have separate authorisation and regulation for Islamic banks



Islamic Finance in the UK: Regulation and Challenges

- **Regulatory definition of products**
 - A 'deposit' is defined as 'a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties'
 - Profit and loss sharing accounts do not qualify
- Importance:
 - Regulated activity – accepting deposits
 - Deposit protection
- Solution
 - Customers have a contractual right to be repaid in full
 - May choose instead to be repaid on Shariah



Islamic Finance in the UK: Regulation and Challenges

Role of Shariah board

- Executive or advisory?
- Directors – the ‘fit and proper’ test
 - competence and capability
 - conflicts of interest
- FSA wants to see role is advisory – no interference with management



UK experience: European Expansion?

- Advantages of FSA's approach
 - flexibility
 - no need for a separate regulatory framework
 - political acceptability

- Disadvantages of FSA's approach
 - regulatory product definition does not match product structure
 - solutions may not be universally applicable

Challenges in other European countries would be similar – but different in detail



Comparison of Laws (1)

Features	Civil	Common	Islamic
Origins	Rome (6 th century AD)	England (11 th Century AD)	Advent of Islam (7 th century)
Sources of Law	Legislature (Codes and statutes)	Precedent judgments of courts	<i>Shariah and Fiqh</i>
Law-makers	Legislatures	Judges	<i>Shariah scholars/ Jurists</i>
Role of State	State above the courts (law)	Law over the state	Law over the state



Comparison of Laws (2)

Features	Civil	Common	Islamic
Sources/ implementers of law	Legislature creates, courts apply	Courts create and apply	<i>Shariah</i> scholars create and Judges apply
Status of judgments	Rulings of one court have no bearing on others	Lower courts follow the decision of higher courts	Judgments of one court has no bearing on others
Closed/ open	Closed-all situations governed by broad principles	Open-new rule may be created based on new facts	<i>Shariah</i> - Closed <i>Fiqh</i> - Open
Evolution	Rigid and slow to change	Can change with new court decisions	Can change within the boundaries of <i>Shariah</i>



Islamic Finance Directive

- If Continental European Countries do not have the tax and regulatory framework to deal with the basic products,
- ... than Continental European Countries will not be in a position to fully participate in the development of Islamic Finance.



Islamic Finance Directive

Definition of Islamic Bank:

Islamic bank is the bank whose Article of Association comprises the undertaking **not to breach**, in the operations it carries out, **the provisions of Islamic Law (Shariah)**, and not to pay or receive interest.

Definition of Deposit: Profit & Loss sharing principle



Islamic Finance Directive

Shariah Advisory Board:

- A Shariah Advisory Board must be established by **each and every** Islamic bank, Islamic window & Takaful operator.
- Reviews and certifies the **permissibility** of products offered by Islamic Bank
- Ascertains that investments and projects in which the Islamic **Bank has participated** are Shariah compliant
- Observes that the Islamic Bank is **managed** in accordance with Islamic principles



EU Directive: a requirement?

- Do we need a new EU Directive on Islamic Finance?
 - ✓ Establish minimum standards
 - ✓ Harmonization



European Strategy

A three fold strategy may help out the industry to ensure Shariah compliance on an ongoing basis:

- 1. Standardization of Shariah Compliance Regulations for Islamic Finance**
- 2. Improved governance and Shariah Compliance Assurance for Islamic Financial Institutions**
- 3. Shariah Compliance Rating of Islamic Financial Institutions and Products**

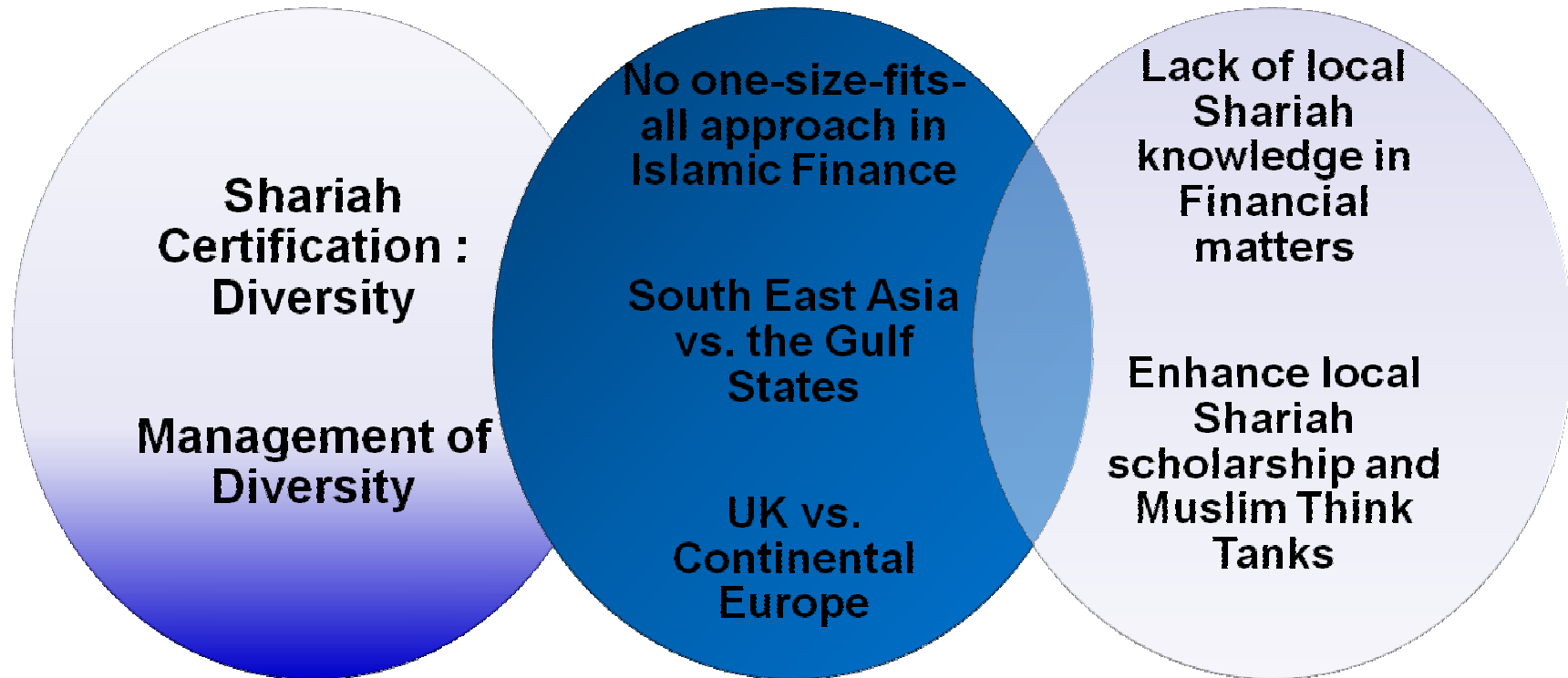


Standardization of Shariah Rules

- Long history of *fiqh* under various schools—diversity of legal opinions
- Variety of rules introduces legal risks—affect growth of Islamic financial industry
- National level—*Shariah* rules standardized by a National *Shariah* body
- European level—European body needed for issuing standardized rulings (to enable growth of global transactions)



Standardization of Shariah Rules





Standardization of Shariah Rules

OIC

- 1969
- IFA
- Mecca

IDB

- 1973
- IRTI
- Jeddah

AAOIFI

- 1990
- SSB
- Bahrain

IFSB

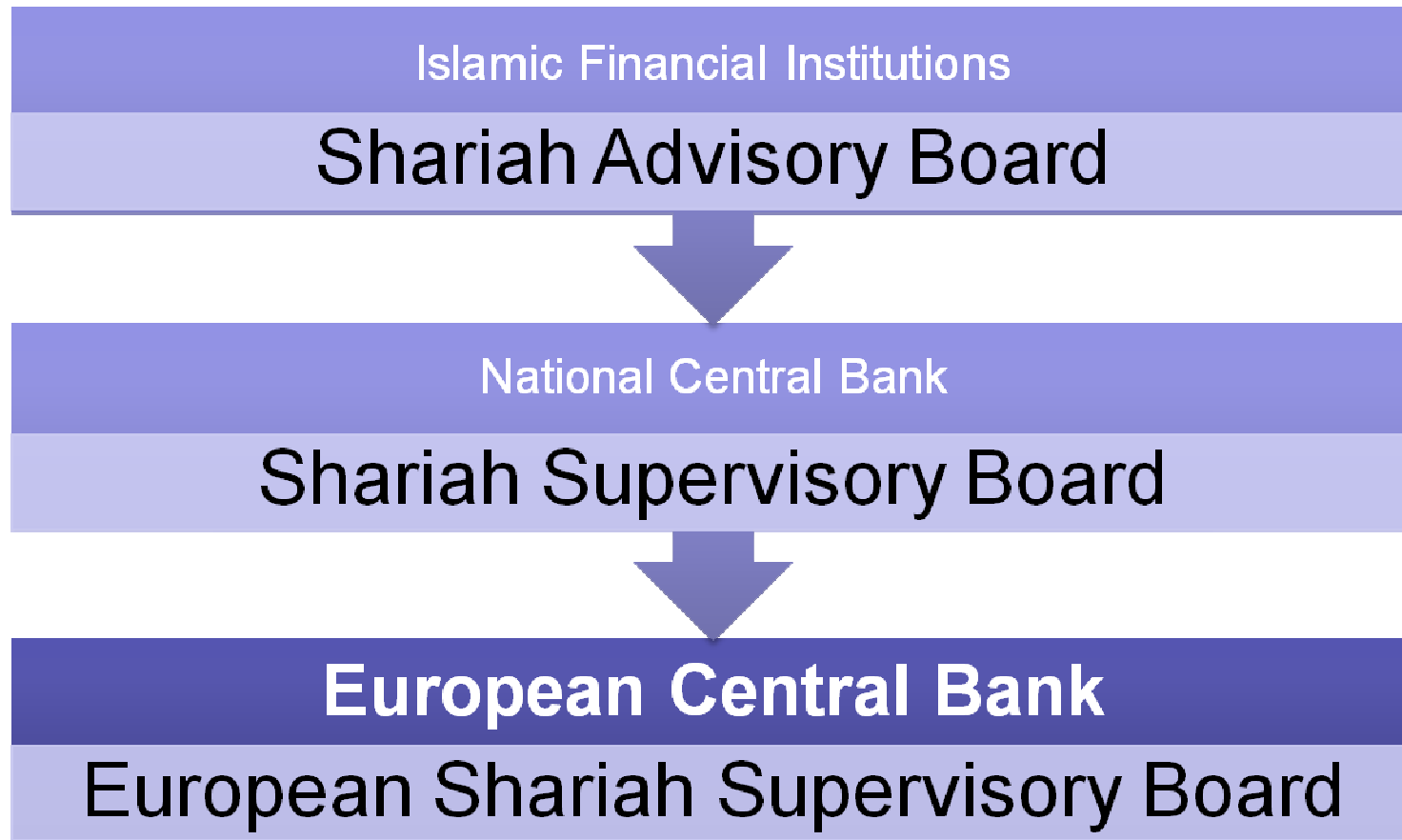
- 2002
- SGWG
- Kuala Lumpur

IIRA

- 2005
- SB
- Bahrain



Establishment of ESSB





Establishment of ESSB

- Independent:

In order to be effective ESSB must be independent authority.

- Authoritative:

The decision of ESSB must be binding on national SSB.



Duties

- Harmonize the different views on Shariah rules and principles applied to products and services:
- ✓ Not declare any Fiqh opinion right or wrong
- ✓ Codify different opinions being used in the industry
- Issue and ensure European compliance to Fiqh rulings



Duties

- Generic Standards for the good practice of an Islamic financial institution in managing its activities.
- In the context of diversity of Fiqh opinions, the ESSB will not only help an IFI decide which Shariah opinion to use, but will also specify what requirements to be met in the application of the particular Fiqh opinion.



Dispute Settlement

- Lack of courts to enforce Islamic contracts increases the legal risks
- In case of disputes—law of the country will prevail over principles of *Shariah*
- ‘Choice of law’ and ‘dispute settlement clauses’ included in contracts
- *Shariah* as governing law—disputes settled by commercial arbitration
- Dispute settlement institutions (Islamic Finance section at arbitration centers) needed to reduce legal risks



Conclusion

An effective ESSB will harmonize the Shariah interpretations, strengthen the regulatory and supervisory oversight of the industry and will also foster and nurture a pool of competent Shariah advisers.



THANK YOU

mohamad@bakkarlaw.com