

Regulatory and Legislative Landscape for Islamic Financial Institutions: the Case of Italy

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Abstract

The paper examines the regulatory accommodation process of Shari'a-compliant financial institutions within the Italian legal framework. The paper is divided into four sections. The first two sections adopt a business-based approach drawing a comparison between the Islamic and the Italian banking models in terms of institutional and functional requirements. The third section suggests that Shari'a rules and, as a result, Shari'a-compliant financial operations, represent a cultural phenomenon, where "cultural" means that Islamic finance is a set of ways of thinking and behaving which every Muslim endorses step by step thanks to the educational process. In the conclusions it is argued that the Italian legal system poses no formal hurdles to the accommodation of Islamic financial entities.

Keywords: Shari'a, banking authorization process, financial institutions, Italy

1. Introduction

"Islamic finance" indicates *Shari'a*-compliant business: as in conventional finance, Islamic finance operates an intermediary and risk-transformation function, but additionally, it performs as an interest-free, real-asset-based and equity-based activity which refrains from taking on risks that could be equated to gambling. In recent years, Islamic finance has been spreading throughout Europe, while in Italy no *Shari'a*-compliant financial intermediary has been authorized as yet. While there is a continuous flow of immigrants from the southern countries of Mediterranean area, they are used to step by Italy just to reach northern European countries, like France, Germany or Finland. However, thanks to immigrant families the birthrate in Italy has been kept high until 2013.

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One might reasonably suppose that this depends on the small number of Muslims on the territory. However, the 2012 Caritas Statistic Dossier on immigration established that there are no fewer than one million Muslims in Italy and, from a religious point of view, they represent the second largest immigrant community. Therefore, there seems to be a potential demand for Islamic financial and banking activities. Alternatively, one might suggest that there are huge legal obstacles preventing *Shari'a*-compliant financial intermediaries from entering the Italian market. This sounds like a sensible argument.

This paper is far from being an overview either of Islamic banking principles or of *Shari'a*-compliant products and intermediaries. Rather, it endeavours to ascertain how Islamic banking may operate within the Italian legal system. There are two ways ahead: business approach and cultural based approach. I argue that when a Muslim living and working in Italy prefers a financial intermediary claiming to be *Shari'a*-compliant rather than a conventional one, he is trying not only to save or invest his money profitably, but also to fulfill his idea of money, property, and community relationships. Therefore, in an effort to incorporate Islamic finance within the Italian framework, this paper argues that both approaches are to be applied and addresses the legal issues to deal with on the premise that Islam shapes the financial system and, generally speaking, the whole economic system. Indeed, as Gohar Bilal wrote, "Islam, according to believers, is a social system imparted by Allah (God) to mankind. Allah is the creator and ultimate owner of the universe, and thus man and its institutions (financial and otherwise) have a vice-regent role to play"². At the core of Islam, *Shari'a* is the "way to the source of life" and, thus, covers every aspect of human life.

It is rooted in the Sacred texts, the *Qur'an* and the *Sunna*, but only through the interpretation of *Shari'a* scholars (*fiqh*), God's message, as embodied in the Prophet Muhammad, has been made *manifest*³ and translated (and is still being translated) into rules to be complied with.

² Bilal, G. (1999). Islamic finance: alternatives to the Western model. Fletcher F. World Aff. Journal (45), 109.

³Cattelan, V. (2010). Islamic finance and ethical investments: some points of reconsideration. In: Fahim Khan, M., & Porzio, M. (eds), Islamic banking and finance in the European Union. A challenge. (pp. 76 – 87). Cheltenham, UK: Edward Elgar.

The paper is divided into four sections. The first two sections adopt a business-based approach. Drawing a comparison between the Islamic and the Italian banking models and considering the institutional and functional requirements within the framework of the Italian Law on Banking (thereafter, IBL) and the Italian Law on Finance (hereafter, IFL), sections 1 and 2 analyze the authorization and functional requirements to be complied with in order to operate as a bank in the Italian legal system. The third section suggests that *Shari'a* rules and, as a result, *Shari'a*-compliant financial operations, represent a cultural phenomenon, where "cultural" means that Islamic finance is a set of ways of thinking and behaving which every Muslim endorses step by steps thanks to the educational process⁴. In the end, the paper presents the conclusions arguing that no legal obstacle is raised by Italian law-maker to the accommodation of Islamic banking in the domestic framework. Thus, the most controversial point is to ascertain whether Islamic finance may be legally enforceable in the Italian legal framework as a "cultural" phenomenon both in the enterprise-State and in the customer-service provider relationships.

2. The Business-Based Approach and Banking Activity

Complying with the European banking directives, the Italian framework establishes the banking business as a regulated activity: the pursuit of banking business may only be carried out by financial institutions with the proper authorisation, namely banks. However, thanks to the choice of the 1993 Consolidated Banking Act in favour of a general process of de-specialization, banks may be allowed to carry out not only banking business, but also other financial activities that have not been reserved to financial intermediaries others than banks by law.

This means, among other things, that in the process of examining any banking licence applications, the Bank of Italy ascertains also whether the applicant intends to set up an organization suited to providing banking services, even though it will *de facto* provide mainly, or even exclusively, other financial services⁵.

⁴ Abbagnano, N. (1971). *Dizionario di Filosofia*. Torino: Utet, 203 - 207.

⁵ As Donato and Freni (2010) wrote: "The concrete notion of 'bank' on which supervisory activity rests thus refers to a universal intermediary free to choose its particular entrepreneurial vocation. There is no banking supervisory rule setting a minimum amount of deposit-taking or lending in order to be a 'bank'. In any case, any such threshold limits would require prior classification of all transactions on the asset and liability side in order to define them as 'banking' or not, the sort of archaic regulatory approach that has long since been abandoned". See: Donato, L., Freni, M.A. (2010). *Islamic banking*

In the Italian legal framework, the banking business is founded upon a two-tier model: it consists of taking deposits and other repayable funds from the public to extend credit (article 10 CLB). Given that the financial disintermediation process has made the above-mentioned definition barely workable, the Italian Banking Act added that the core banking business covers the “raising of sight funds and any form of fund-raising related to the issue or administration of generally spendable means of payment” (article 11 CLB). Drawing a comparison between the above-mentioned definition of the banking business and the paradigm of Islamic banking, there emerge important differences to be addressed.

First of all, in Italian banking law the definition of deposit and reimbursable funds, and the legal concept of credit extension⁶ establish the banking business into a creditor-debtor relationship. On the other hand, the Islamic banking paradigm is based upon a partnership relationship according to a profit-and-loss sharing model (hereafter, PLS model)⁷. The *mudaraba*-approach provides for a capital provider (‘silent partner’) and an entrepreneur (‘active partner’) contributing either their own capital or their time and work to the venture. Therefore, both of them are entitled to a pro-rata basis return. Conversely, all losses fall solely on the capital provider, while in the case of returns lower than expected or no returns at all, the entrepreneur has already lost his time and efforts.

On the liability side, the conventional depositor or, generally speaking, the conventional financier is a *riskless* creditor: indeed, the funds placed in the bank are repayable either on demand or at the expired date. Instead, in the *mudaraba*-based approach, the depositor acts as silent partner who gives a bank title to a sum of money to be invested but takes on the risk of financial losses. Therefore, he/she will gain a pro rata-return if, and only if, there are real returns on the total investments made⁸.

and prudential supervision in Italy. In: Fahim Khan, M.&Porzio, M. (eds). Islamic banking and finance in the European Union. (pp. 189 – 206) A challenge. Cheltenham, UK: Edward Elgar.

⁶ There is no legal definition of credit extension either at the Italian framework or the Community level.

⁷ More details in Mirakhor, A., Zaidi, I. (2007). Profit-and-loss sharing contracts in Islamic finance. In: Kabir Hassan, M. & Lewis, M.K. (eds), Handbook of Islamic Banking. (pp. 49 - 63) Cheltenham, UK: Edward Elgar.

⁸ Piccinelli, G.M. (2010) The provision and management of savings: the client-partner model. In: Fahim Khan, M.&Porzio, M. (eds), Islamic banking and finance in the European Union. A challenge. (pp.23-39) Cheltenham, UK: Edward Elgar.

Turning to the asset side, the conventional borrower is a debtor and, most of the time he/she has to reimburse the capital according to a predetermined interest rate either in instalments or on the spot, whatever the actual returns may be. Indeed, generally speaking, the provision of funds covers any temporary accrual of assets in favour of a borrower against a duty of reimbursement, for example, a loan, a signature loan as well as the underwriting of bonds and other financial instruments. By contrast, in the PLS model, the *mudaraba*-based relationship makes the borrower an active partner who alone makes his own investment decisions, shares the total returns with the bank according to a profit sharing ratio, and bears the financial losses *investing* his time and his work without a remuneration⁹.

Additionally, with regard to the bank's role in both banking business models, in the process of taking funds from the public, both conventional banks in Italy and *Shari'a*-compliant institutions take title to the placed funds and invest them at their discretion (unrestricted *mudaraba*). However, while the conventional banks are obliged to reimburse the capital "borrowed", paying also a fixed interest rate on the capital (wherever an interest rate was agreed upon) either on demand or on the expiry dates, *Shari'a*-compliant banks acting as entrepreneurs share the returns with the PLS deposit holders (if any profits are yielded) on a pro-rata basis. In the provision of funds, both conventional banks in Italy and *Shari'a*-compliant banks use the funds collected from the public either as deposits (or other repayable funds), or as PLS deposits to extend credit.

However, conventional banks accept projects for funding primarily on the basis of the creditworthiness or solvency of the borrower, while in the *Shari'a*-compliant model the projects for funding are expected to be selected mainly on the basis of their probable profitability. It depends on the fact that conventional banks acting as lenders take on the liquidity as well as the credit risks.

⁹Vogel, F.E. (2010). Islamic finance: personal and enterprise banking. In: Fahim Khan, M. & Porzio, M. (eds), Islamic banking and finance in the European Union. A challenge. (pp. 40 – 60) Cheltenham, UK: Edward Elgar.

On the other hand, PLS assets are (or rather, should be)¹⁰ uncollateralized equity financing, where the banks take on not only the credit and liquidity risks, but also the investment risks with or without the possibility of pre-agreed arrangement for monitoring and managerial formula for capital provider.

Furthermore, PLS-operations are also carried out as *musharaka*¹¹. There, the Islamic banks invest the funds collected from the public through limited or unlimited *mudaraba* contracts to fund one or more *musharaka* projects. *Musharaka* has the appearance of a partnership in ventures where the bank and other partners contribute capital or work to the venture together with their client: all of them participate in the business management as well as in the profits and losses according to a predetermined ratio proportionate to their stakes.

However, equity participation gives very little certainty in terms of the reimbursement of capital; a *musharaka* operation is not the equivalent of an extension of credit in the Italian system, and widespread recourse to *musharaka* may end up being extremely *expensive* for Islamic banks. In fact, Italian banking law establishes a precise link between the amount of a bank holding in non-financial enterprises and the level of bank capitalization. Therefore, Islamic banks in Italy might be required to increase their own funds in order to take out qualified holdings in non-financial enterprises.

Provided a 'qualifying holding' is defined as a direct or indirect holding in an undertaking which represents 10 per cent or more of the capital or of the voting rights, or that makes it possible to exercise a significant influence over the management of that undertaking, it is established that a 'qualifying holding' in a non-financial enterprise is expected not to exceed 15 per cent of the bank's own funds and, additionally, the total amount of non-financial holdings of the same bank are expected not to exceed 60 per cent of the bank's own funds¹².

¹⁰ As Errico and Farahbaksh (1998) wrote: "(...) Islamic banks are allowed to use a degree of discretion in deciding if collateral is needed before granting their facilities, including the PLS modes of financing". See: Errico, L., Farahbaksh, M. (1998). Islamic banking: issues in prudential regulations and supervision. IMF Working Paper (30) 1-32.

¹¹ On *musharaka*, see: Mirakhor, A., Zaidi, I. (2007) 51.

¹² Benocci, A. (2010). Sub Art. 19. In: Porzio, M. et al. (Eds), Testo Unico Bancario. (p.188 - 207) Milano: Giuffrè.

In the end, there are significant differences between the Islamic and the Italian approach to the banking business. So, the question is: can the gap be convincingly narrowed? In general, the Islamic banking paradigm is centred around PLS models. However, it also caters for non-PLS operations establishing creditor-debtor relationships between a bank and its clients on the both the asset and liability sides.

Specifically speaking, on the liability side, a *Shari'a*-compliant bank provides not only investment deposits but also savings and demand deposits. The former are trustee finance contracts and are based on the PLS models mentioned above, while the latter are made for safekeeping under guarantee and establish a creditor-debtor relationship. *Shari'a*-compliant demand deposits are comparable to conventional demand deposits because both of them are repayable on demand at par value¹³.

With regard to *Shari'a*-compliant systems, when the demand or savings deposits are provided in a two-window system, there are two windows on the bank liability side, one for demand deposits/savings and the other for investment deposits¹⁴. The funds placed as demand deposits (the choice is left to the depositors) still belong to their holders and, for this reason, they are not considered as investable funds and they benefit from a mandatory hundred per cent reserve requirement.

However, when the demand and savings deposits are included in a full integrated asset-liability side (i.e.: a two-tier *mudaraba* system), the depositors transfer the bank title onto the placed funds and, as a consequence, the bank is empowered to invest such funds at its discretion in PLS-operations with no mandatory reserve requirements. Apart from being investable funds or not, and apart from being covered by mandatory reserve requirements or not, *Shari'a*-compliant and conventional demand deposits make their holders riskless creditors at least while the banks are solvent and both of them essentially perform a monetary function¹⁵.

¹³Piccinelli, G.M. (2010) 27; Errico, L., Farahbaksh, M. (1998) 6; IADI. (2006) Research Letter. [on line] 18th July. Available from <http://www.iadi.org>.

¹⁴ Islamic banking may operate either as a two-windows system or as a two-tier *mudaraba*-based system. In the latter, assets and liabilities are fully integrated. Therefore, both demand deposits and investment deposits represent investable funds. This means that demand deposits are repayable at par on demand, but the bank as active partner may use these funds to make profit-and-loss sharing investments.

¹⁵Errico, L. & Farahbaksh, M. (1998) 13.

Furthermore, on the asset side, Islamic banks can also provide non-PLS funding. Indeed, the provision of funding on a mark-up basis establishes a creditor-debtor relationship between the bank and the “borrower”.

One of the most common non-PLS financing modes is *murabaha*. In *murabaha*-based transactions, banks and customers enter into sale-based transactions. The bank finances the purchase of an asset by buying the item on behalf of the client and then resells it to the client adding a mark-up. It is a cost-plus profit contract: the mark-up is the service price¹⁶. Moreover, the bank provides funds entering into an *Ijara* financing: this resembles either an operating lease or a financing lease. In the *ijara*-operating lease, the bank-lessor transfers the usufruct of the item to the customer while the lessee is entitled to use it on payment of specified rentals over a certain period of time; otherwise, in the *ijara*-financing lease, the bank-lessor buys the asset and leases it to the borrower-lessor. If the latter opts to buy it, the monthly payments will cover both the rentals for their use and the instalments towards the purchase price. Finally, the ‘diminishing’ *musharaka* is becoming very common. This means that both the bank and the borrower have joint ownership of a property: the client-borrower will progressively purchase the equity belonging to the bank. Specifically, once joint ownership has been established, the bank leases its share in the asset to the client charging rent to him. Ownership remains undivided, but the bank’s share is mathematically divided into a number of units to be bought over time by the client¹⁷.

In addition to the creditor-debtor relationship, the comparison between the Italian and the Islamic banking models points to a *riba* prohibition reference, among other things, to any increase without a proper consideration. Provided that money represents a ‘monetized claim of its owner to property rights’¹⁸ created by assets obtained through either the combination of creative labour and natural resources or an exchange, Islamic banking allows the rate of return in PLS-operations and a service charge in non-PLS operations. Both of them put the capital provider – namely the bank – at risk from the point of view of investment.

¹⁶Another non-PLS provision of funds is *bai’salam* or prepaid purchase of goods. Here the bank pays the price immediately, precisely when the contract is made, and receives the commodity later. This kind of transaction is usually made to finance agricultural commodities, but it is applicable to manufactures as well.

¹⁷Vogel, F.E, Hayes, S.L. (1998). *Islamic Law and Finance: Religion, Risk and Return*. The Hague and Boston: Kluwer Law International (Chapter 6).

¹⁸Iqbal, Z., Mirakhor, A. (1987). *Islamic banking*. IMF Occasional Paper (49).

As I have already said, in PLS-operations, the bank-capital provider is entitled to a share of the profits based on a predetermined ratio, and earns a profit if, and only if, there are any profits. Conversely, in non-PLS operations, the bank-capital provider is remunerated by means of a charge fixed on the resale price or the leasing price, but this charge is based upon the risks the bank takes on over a period of time. This explains how in *murabaha* operations, the bank must take title of the asset until the borrower-acquirer pays back the resale price but it also explains how, in the case of default or delinquency by the borrower, nothing changes in the resale price, whereas in conventional lending, the interest will continue to compound until all principal and interest is paid¹⁹.

However, I am not really convinced that the *riba* prohibition represents such a tough obstacle as to prevent *Shari'a*-compliant financial institutions from entering the Italian market. Conversely it seems to make *Shari'a*-compliant banks less competitive in comparison with domestic or non-EU banks. In reality, in demand deposits, the provision of an interest rate is a *natural* factor and does not raise a regulatory obstacle *per se*.

Indeed, according to the European framework, no Italian law is entitled to prohibit the paying out of an interest rate on demand accounts²⁰, but the bank and the customer may agree to do so²¹. In addition, regarding the security-based collection of reimbursable funds from the public, it is worth noting that Italian banking regulations allow the banks to issue debt instruments where *amandquantum* reimbursement of the holder are based upon the results of the investments to be performed²². Such a choice may turn out to be a viable path for Islamic banking in Italy.

¹⁹ In Islamic leasing, the bank-lessor bears the risk of the leased asset and any attempt to shift the risk of loss to the lessee (as is commonly done in modern operating leasing) is void. This is on account of the maxim 'profit accompanies liability for loss'. If the lessor does not bear the risk, he cannot enjoy the profit. See: Vogel, F.E. (2010) 51.

²⁰ With demand deposits, the provision of an interest rate represents a natural feature. In the Caixa Bank case law (CaixaBank France v Ministère de l'Économie, des Finances et de l'Industrie.C-244/04 of October 5th 2004) the European Court of Justice stated that the European Court of Justice held that the prohibition by law of the remuneration of sight accounts would have damaged the proper functioning of the internal market, causing new legal barriers to the access of the subsidiaries of third countries' banks, because the rate of remuneration paid on demand accounts amounts to 'one of the most effective methods' for the subsidiaries of third countries' banks to compete with the incumbents.

²¹ *De facto* there is no *riba* at issue provided that, most of the times, the demand deposits in the Italian system are not remunerated any longer.

²² Comitato interministeriale per il credito ed il risparmio Act (19.07.2005).

Finally, on the asset side, one way of side-stepping the *riba* prohibition refers to non-PLS operations and so-called passported activities, i.e. financial activities other than banking business subject to the principle of mutual recognition. Some non-PLS transactions, the *jjara* especially - show some functional-based similarities in relation to passported activities with the sole limit of double stamp duty and having to invest in tangible assets, maintaining the proportion between their investments and their own funds in order to keep the risk of liquidity under control.

3. The Business-Based Approach and Institutional Aspects

In the Italian regulatory framework, a bank is an undertaking authorized to carry out banking business (article 1, § 1, lett. b, IBL). This means that a legal entity is a bank as long as it has the proper authorisation.

Generally speaking, authorization is an administrative act issued by a supervisory authority to allow a natural or legal person to provide a number of economic services. According to Italian Banking law, the Bank of Italy is in charge of authorising banks and ascertaining a set of objective conditions (article 14 IBL). The authorisation process as such does not make access to the Italian banking market difficult. Metaphorically speaking, one could imagine the Italian legal system as a building with three front doors and a back door.

The back door enables Islamic financial intermediaries to operate in the Italian legal system keeping either the control or a qualifying holding in Italy-based banks, where a holding is *qualifying* when it amounts to 10 per cent or more of the capital or voting rights²³. It looks like a fairly straightforward solution because, although such an operation requires the authorisation of the Bank of Italy as the Home supervisory authority, the Bank of Italy is not entitled to refuse authorisation unless the holding of the qualified participation is likely to pose a risk for bank stability, i.e. to impede the operation of banking business and the proper exercise of prudential supervision (article 19 IBL). However, holding a qualified participation in an Italian bank would let the Islamic financial intermediaries influence or control the undertaking, but the banking business would be carried out within the framework of the original licence, namely a conventional model.

²³ The Bank of Italy authorisation is also required when the holder is going to increase his participation so that the proportion of the voting rights or of the capital reached or exceeds 20 %, 30 %, 50 % or so that the credit institution would become his subsidiary (article 19 CBL).

In such a case, through the qualified holdings, financial institutions could allow their Italian bank to provide a series of products for Muslim clients as a new line of business, but it is hardly credible that the provision of one or more Islamic-like banking services makes a banking business *Shari'a*-compliant. Indeed, Islamic banking is one approach to economic activity and deals with the way of funding, allocating risks or having recourse to financial leverage²⁴.

As for the front doors, an Islamic bank can enter the relevant Italian market as (i), a European credit institution, (ii) a non-EU Country bank, or (iii) a domestic bank. Situation (i) is based upon the existing legal framework at Community law level. An EU bank is a credit institution authorised by a competent authority in a Member State outside Italy according to the Consolidated Banking directive (dir. EU/2006/48).

The banking licence amounts to a European banking passport enabling the credit institution with their registered and head office in a Member State to operate the banking business and passported activities for which the authorisation had been released throughout the European Community according to the Home Country regime and under the supervision of the Home State authority²⁵. No further authorisation may be required in the Host Countries.

Metaphorically speaking, this is the biggest door into the Italian jurisdiction. European banking directives are based on a minimum harmonization approach and, as a consequence, every Islamic bank licensed as an EU credit institution may easily take advantage of regulatory competition among Member States. Moreover, Islamic banks should deal with the sole Home regulator. Thanks to the mutual recognition principle of the licence and supervision regimes, the Home regulator is responsible for micro-prudential supervision upon access and, later on, in the pursuit, of the banking activity. In fact, it is the Home regulator who must assess whether a bank, already provided with the European passport, really does have structural organisation and the financial resources to be allowed to set up branches or provide services in Italy. This was the case for the European Islamic Investment Bank, the Bank of London and the Middle East, and the European Financial House, all *Shari'a*-compliant banks authorized in the United Kingdom as EU credit institutions allowed to provide trans-border services and set up establishments throughout the European Union.

²⁴It goes without saying that the establishment of the so-called Islamic windows would better serve the accommodating objective.

²⁵Dalhuisen, J.H. (2002). Home and Host Country regulatory control of trans-border banking services in the EU. In: Alpa, G. & Capriglione, F. (Eds), *Dirittobancariocomunitario*(pp. 20). Torino: Utet.

Situation (ii) deals with a non-EU bank, namely a branch of a financial institution set up in a third country. It is authorized to operate as a bank by the Bank of Italy²⁶.

This looks like the narrowest door for entry into the Italian banking system. Indeed, the authorisation process is much more cost-expensive. Non-EU financial institutions need the non-opposing opinion of the Italian Ministry of Foreign Affairs and the authorisation of the Bank of Italy to create the first branch and any further branch, or provide services from abroad.

Furthermore, the Bank of Italy not only ascertains whether the *Shari'a*-compliant institution meets three objective threshold requirements – capital adequacy, an approved business plan and good reputation, knowledge and experience of the directors of the branch – but also assesses the soundness of the parent institution and the proper functioning of the Home supervision banking system²⁷. In this situation, the political and social conditions or, generally speaking, contextual factors can influence the outcome of the Islamic banking authorization process. For example, it is questionable whether Sudan, Pakistan or Iran, or the Countries of the so-called Arab Spring can ensure a proper flow of information from the Home regulator to the Bank of Italy nor whether they can ensure an appropriately functioning system guaranteeing stability and anti-laundering controls.

Situation (iii) addresses the case of an Islamic bank authorised as an Italian bank. This is the middle door. A banking licence is issued when the following requirements have been met: (1) registered office and “mind and management” in Italy; (2) a specific legal status; (3) paid up capital never below the amount required by the supervisory authorities; (4) a good reputation, knowledge and experience of the directors and the persons who control the undertaking (5) suitability of persons holding directly or indirectly qualifying holdings; (6) an approved business plan and (7) non-existence of close links being obstacles to the supervisory activity (article 14 IBL).

Looking at the authorisation requirements, neither of them seems to be an obstacle for the access of Islamic banking to the Italian banking system.

²⁶Costi, R. (2012). L'ordinamento bancario. Bologna: Il Mulino (Chapter 4).

²⁷ According to the Bank of Italy regulations, the banking regulations for Italian banks are also applied to non-EU banks.

Indeed, as pointed out by Luca Errico and MitraFarahbaksh (1998) among others, in Islamic banking "(...), as in conventional banking, an appropriate regulatory framework for an Islamic system should aim at reinforcing banks' operating environment, internal governance, and market discipline"²⁸.

The Bank of Italy is entitled not to issue a banking licence if the applicant does not fit the "sound and prudent management" rule. It suggests that authorisation is not the sum of factors, but implies a certain degree of discretionary power, i.e. a *technical* discretionary power.

In fact, the Bank of Italy is empowered to ascertain qualitatively and quantitatively whether the structural features of the applicant, the services to be provided and the qualities of shareholders are likely to obstacle the sound and proper pursuit of the business. This is relevant to the authorisation process because, according to qualified economics studies, Islamic banking is highly likely to challenge the sound and prudent management rule at least because of its increased investment risk²⁹, while the Basel principles and prudential supervision rules for conventional banks are not suitable as such for the Islamic banking paradigm and its heterogeneous applications. However, the active role of the Bank of Italy in the authorization process is conducive to achieving a workable solution based upon a case-by-case approach. Indeed, the process of setting up a bank requires prior authorisation from the Bank of Italy. This means that, among other things, the Bank of Italy can ask for some changes whenever there are reasons to believe that, for example, the organization, proposed plan, or the financial resources do not fit the sound and prudent management rule.

Whatever the type of authorization is, the provision of banking business and other financial services must be compliant with the business conduct rules in the service provider-customer contracting relationships (art. 115 – 120 IBL) and join a deposit-guarantee scheme.

²⁸Errico, L. &Farahbaksh, M. (1998) 13.

²⁹In fact, Islamic banks are entitled neither to monitor their 'investments' participating in the management of the investment project nor to require collaterals or other guarantees. Moreover, stability regulations should also address the ability of Islamic banks to reduce the capital value of investment deposits in case of loss: this possibility introduces strong incentives for moral hazard that could result in systemic risks.

The information framework in the Italian legal system attempts to redress the information asymmetries between the service provider and the customer. Indeed, according to transparency rules, every banking institution operating its own business in the Italian jurisdiction – credit institutions based in Italy or providing cross-border services – must disclose to the general public the information on the interest rate as well as any contract conditions economically relevant, and where no information is disclosed or published either in the branch office or on the website, nothing is owed to the service provider. Additionally, any service contract is to comply with the information disclosed and any clauses not complying with the information disclosed are null and automatically substituted by the ones issued.

Lastly, no reference to trade customs is admitted and, whenever it is made, it is automatically replaced by the interest rate of the treasury bonds issued in the year before³⁰.

Generally speaking, there is a general agreement among *Shari'a* scholars on the need for information disclosure not only between the banking institutions and the supervision authorities, but also in bank/customer relationships. Indeed, in unrestricted *mudaraba* relationships, information disclosure helps to reduce information asymmetries and give proper incentives for keeping moral hazard under control³¹. However, while the standardisation process of the economic conditions is far from placing juridical obstacles according to *Shari'a* rules, the information disclosure of non-economic contracting conditions may clash with the Islamic hermeneutical approach and *Shari'a* sources of law³² where Islam lacks a hierarchical structure and 'each scholar's opinion is equally valid'³³.

This is the reason why independent international organizations like the Accounting and Auditing Organization for Islamic Financial Institutions (hereafter: AAOIFI) carrying on a process of standardization and harmonization of Islamic finance practices are performing a pivotal role on the international stage.

³⁰Porzio, M. (2002). La disciplina generale dei contratti. In: Angelici, C. et al. I contratti della banca, (pp. 47 – 55) Torino: Utet giuridica.

³¹Errico, L. & Farahbaksh, M. (1998) 23 ff.

³² It is worthy of mentioned that *Shari'a* rules usually fall outside a State-based, positive legal system.

³³Khan, B., Aly Crowne-Mohammed, E. (2009-2010) The value of Islamic banking in the current financial crisis. *Review of Banking and Financial Law* (29) 441-464.

The AAOIFI is, for example, a not-for profit organisation, and its members (Islamic financial institutions as well as central banks) voluntarily comply with the accounting or corporate standards legitimately adopted according to the Articles of Association. What might be the role of organizations like AAOIFI in the Italian jurisdiction? And what effect can AAOIFI-like standards have in the Italian banking framework?

AAOIFI standards are based on the agreement of the organization's members and, therefore, they may be compared either to the Basel standards or to banking association agreements. However, while the former imply the formal filter of a legislative act (either community or domestic), the latter are more easily enforceable even though it is arguable that the Italian Antitrust Authority might take action against them as cartels.

In the end, the Italian banks, the EU credit institutions or the non-EU banks in Italy must join a deposit insurance system. This is a private-based organization committed to reimbursing depositors in the event of a bank's insolvency. Joining a certified deposit-guarantee scheme is deemed to be a condition for operating the banking business. Indeed, the Bank of Italy is entitled to revoke the banking licence where the bank either does not adhere to, or is excluded from, a deposit insurance system. On the question of whether a *Shari'a*-compliant bank established in Italy may join a deposit insurance system, it is worth mentioning that both conventional and Islamic finance agree that joining a deposit-guarantee scheme can maintain reliable financial stability provided that the supervisory authorities control the moral hazard³⁴.

³⁴MdKhairuddinHj Arshad (2011).Implementation of an Islamic Deposit Insurance System for the Islamic financial services industry. Fourth Islamic Financial Stability Forum. Kuala Lumpur, Malaysia (17th November 2011); IADI (2010).Deposit Insurance from the Shariah perspective. www.iadi.org; BIS (2009). Core Principles for effective deposit insurance systems. 1-26.

Instead, it is a matter of debate how to establish the relationship between the single financial institution and a *Shari'a*-compliant deposit guarantee scheme without incurring in the *riba* or *gharar* prohibitions (on *riba* and *gharar*, see:Vogel, F.E. (2010) 40 ff.). Therefore, a *Shari'a*-compliant deposit guarantee scheme is hopefully based upon a donation from the Islamic banking institution to the deposit-guarantee scheme. However, a hybrid form has recently been proposed, namely a donation contract with some features of mutual cooperation whereby every Islamic banking institution joining a deposit-guarantee scheme agrees to make voluntary contributions to protect depositors of any other member becoming insolvent. See: ADI (2010) 8-10; 12 ff.

With regard to the eligible products, both Islamic and conventional financial systems agree on the protection of savings and current deposits. In fact, they are reimbursable on demand at par value both in the two-windows and in the two-tier *mudaraba* systems³⁵. But are the investment deposits, i.e. profit-and-loss sharing deposits, eligible for deposit-guarantee schemes?³⁶ There are three doctrines at issue. On one side there is the classical *Shari'a*; scholars argue that PSIA holders should not enjoy a guarantee because it would contradict the very nature of *mudaraba* contracts. On the opposing side, it is argued that profit-and-loss sharing operations allow a deposit-guarantee scheme to operate as a third party as happens in Malaysia where the guarantor protects the current value of PSIA and not its principal in the case of Islamic financial institutions' insolvency.

Finally, a distinction is drawn between restricted and unrestricted investment deposits (namely, PSIA deposits), contending that while in the former PSIA, account holders entrust the Islamic service providers to invest their funds under certain conditions (how, where and for what purposes), in the latter, PSIA holders entrust the Islamic financial institutions to use their funds without imposing restrictions and, for this reason, are comparable to the role of the Islamic financial institutions in savings and demand deposits and should be regarded as insurable financial products³⁷. Keeping in mind the above mentioned distinction, whenever the second or the third construction were applied, they would hardly be consistent with the Italian banking framework: in fact, it excluded the bonds and the bank's financial instruments where the right to reimbursement (*an* and *quantum*) depends on the investment results from the insurable deposits, despite both of them represent banking business and, precisely, as receipt of funds from the public with the duty to reimburse (art. 96 ff. IBL)³⁸.

³⁵Errico, L. & Farahbaksh, M. (1998) 9ff; IADI (2006). Research letter: update on Islamic Deposit Insurance issues [on line] Volume 1(3). Available from: <http://www.iadi.org>.

³⁶ In Islamic-based deposit-guarantee schemes, a distinction is made between the one and the other depositors' claim according to the underlying contract of deposit. More precisely, non-profit sharing has priority over profit-and-loss sharing ones. See: IADI (2010) 16.

³⁷MdKhairuddinHj Arshad (2011) 9 ff.; IADI (2010) 10 ff.

³⁸See: Mecatti, I. (2010). Sub artt. 96 – 96 quarter. In: Porzio, M. et al. (Eds), Testa Unico Bancario. (pp.772 - 782) Milan: Giuffrè; Maccarone, S. (2010). Sub artt. 96 – 96 quater. In: Belli, F. et al. (Eds), Testa Unico delle leggi in materia bancaria e creditizia. (pp.1625 - 1640) Bologna: Zanichelli (vol. II).

4. A Cultural Approach to Accommodation Issues

An analysis of Islamic banking basics shows that *mudaraba*, *musharaka*, *ijara* and *murabaha* operations turn out to be something more than a means of business. Namely, they are the operative instruments of a community culture.

Indeed, Islamic economics is treated as a science helping human beings to perform their obligations to Allah and society in order to prevent injustice in the management of natural resources and the pursuit of prosperity and welfare³⁹. The framework is based upon the idea of Man as a social being who needs the cooperation of others to get what he is lacking for.

But, according to Muslim tradition, man is also very likely to be greedy and tends to hoard⁴⁰. Therefore, in order to keep man's basic instincts under control, *Shari'awas* granted through the instrument of His Prophet Muhammad covering every aspect of social life from worship duties to the family and commerce⁴¹.

Shari'a legal order is centred around the pivotal role of the community. It is said that *Shari'a* or the Divine Law sets limits on property rights and on one's freedom of trade because everything belongs to God and *Shari'a* allocates the right portion of the common bulk of resources owed to everyone. Indeed, it is argued that "(...) while in the Western tradition property rights are basically conceived as jural inter-personal relations aimed at an *equal division* in social and economic justice, in the Islamic universe, in contrast, they belong to a social reality shaped around an *equal sharing* of economic resources"⁴².

³⁹Therefore, the so-called *economic problem* deals with stimulating the advancement of "human civilization", the progress of society, and allowing every man in the community to develop his own personality and fulfil his capacities and aptitudes at best.

SayyidAbulA'laMaududi, one of the founding fathers of Islamic economics, argued that "So the main reason for the difficulty encountered in understating and correctly solving the economic problem of man is that some people look at this problem from the point of view of economics alone". See: AbulA'laMaududi, S. (1947) *The economic problem of man and its Islamic solution*, Lahore, Pakistan p. 10.

⁴⁰AbulMaududi, S. (1947) 37.

⁴¹Uthman, U.(1998).A short outline of the foundations of Islamic economics. Proceedings of the Second Harvard University Forum on Islamic Finance, Harvard University Cambridge.

⁴²Cattelan, V. (2013). Introduction. Babel, Islamic finance in Europe: preliminary notes on property rights pluralism. In:Cattelan, V. (ed),Islamic finance in Europe.(pp.1-12) Cheltenham, UK: Edward Elgar.

Therefore, prohibition of *riba* and *gharar* as well as profit-and-sharing or sale-based models are the means of fulfilling a system of social and economic values and is supposed to be applied consistently. Indeed, *Shari'a* provides that any contracts or operations not complying with *riba* or *gharar* prohibitions – just to take some examples- are not legally enforceable.

Additionally, the Muslim community plays an essential role in the construction of *Shari'a* precepts and sources of law. According to the sacred texts, it is said that, in the beginning, the message of God-Allah was spread through the Prophet Muhammad's words and testimony with the help of the Gabriel Angel. Once the Prophet was dead no heir was indicated but for the community as a whole entrusted with *fiqh*. The "community" at issue is made up of a selected group of people, precisely *Shari'a* scholars, while *fiqh* has been compared to the *iurisprudentia* of the Roman tradition. Quoting Ulpianus, Santillana referred to *fiqh* as *divinarum atque humanarum rerum notitia, iustiatque iniustis scientia*.

This sounds like a very interesting parallelism to shed light on the role of the community of scholars. In fact, in the Roman tradition *iurisdictio* was initially performed by *pontifices* and assessed as a distinguished declaration of *ius* (instead of a religious practice). In turn, *pontifices* were recognized as having the experience needed to draw a distinction between *fas* and *nefas* in social practice.

Later on, until the *ius publicer respondendi* of Augustus' reign, *iurisprudentes* were entrusted with issuing juridical opinions (*responsa*) and each opinion prevailed over the others in and out of private litigation thanks to the prestige of its author⁴³. The same holds for *Shari'a* scholars and schools, and no hierarchical structure is entrusted with officially validating *Shari'a* constructions. *Shari'a* scholars and schools provide historical support because they form *igma* or general, distinguished, approval. *Igma* became much more important when the Prophet, His companions and anyone who had been a direct or indirect eyewitness disappeared: in fact, this is the way that the Holy Books are linked to the development of times and situations and it represents the third source of law⁴⁴.

⁴³Guarino, A. (1990). L'ordinamento giuridico romano. Napoli: Jovene (Chapter 11).

⁴⁴Santillana, D. (1926). Istituzioni di diritto malachita. Roma (vol. I) p. 36. This conclusion is much more important in so far as *Shari'a* is essentially an orally based system.

In the end, Islamic banking and finance goes beyond the business product and is a cultural phenomenon at least. Therefore, any accommodation process of Islamic finance in the Italian jurisdiction should deal with *i)* a precise approach to property rights (*sharing* instead of *dividing*) and *ii)* a construction of rules according to *igma*.

This means, among other things, that any shareholder, investor or contracting party approaching a financial entity claiming to be *Shari'a*-compliant legitimately expects that the entity will operate consistently with *i)* and *ii)* above-mentioned. Does this expectation become legally relevant in the Italian law?

The point is whether *Shari'a* rules can become legally binding and, as such, enforceable in the Italian legal system.

One might argue that there is the Rome I regulation on the governing of contractual obligations. Indeed, this regulation establishes that the parties to a contract must choose the governing law and when the law chosen is that of a country other than that most closely to the contract, the provisions of the latter law must be respected. The point is that *Shari'a* does not represent a law of a country. Of course, it sometimes does, but not often. In fact *Shari'a* is basically a law of a community, precisely a Muslim community wherever it is based. Instead, assuming that *Shari'a* precepts are social in nature, there seem to be three ways ahead: the enforcement of *Shari'a* according to the incorporation principle, and the enforcement of *Shari'a* rules as a special legal system.

First of all, all *Shari'a* rules pertaining to relevant operations are fully incorporated in the contract, whether it is a company contract or investment contract. This approach is fascinating. Indeed, the contract for the provision of financial services is, in Italian law, a master contract whereby a financial service provider is entrusted with performing a series of investment operations on behalf of a client. Master agreements in themselves provide a general legal framework for the operations and establish a long-standing relationship. However, the contracting parties must reach an agreement on each investment operation. Therefore, historic-based concepts, like *riba* or *gharar* for example, might be updated in line with the evolution of a community's sensibilities. However, such an approach starts from the questionable premiss that the financial intermediary and the client have the same contracting power in order to bargain the interpretation of *Shari'a* rules.

Moreover, it does not clarify how the weak party, i.e. the client, may revise the construction or the application of the contract whenever he/she assumes that it is contrary to the good faith principle (with regard to Shari'a fiqh). In the end, this interpretative approach ends up the informative asymmetries between the service provider and the client.

Secondly, assuming a pluralistic approach, *Shari'ama* may be considered at least to some extent as a special legal system. The scholarly references are essentially based on Santi Romano's studies. Santi Romano is one of the leading experts of public and administrative law and he is still addressed as the main source on the concept of special legal systems.

According to Santi Romano's theory⁴⁵, a legal system ("diritto" or "ordinamentogiuridico") is made up not only of rules of conduct, but first and foremost, of rules of organization. He began by contending that a legal system amounted to a sum of norms, and consequently, objectivity and enforceability through sanctions, which were commonly thought of as characteristics of norms, were to be considered as the distinguishing features of the legal system as whole. Therefore, objectivity should not be based on a neutral process of laying down rules of conduct, a process where the grounds for community life are laid down.

Likewise, the enforceability of rules of conduct should be justified not by the sanctions mentioned in some rule of conduct – it goes without saying that not every norm has its own sanction - but by a general mechanism of enforcement. It is clear that at the heart of Santi Romano's theory, there is the "community" and it is assessed as an organization embodying a social order. It means that where there is a group of persons, with or without legal personality, displaying a vague or a complex organisation, there is a legal system and, as a consequence, there is an institution. Therefore, the concept of legal system departs from any religious, ethical or political purposes pursued and becomes a matter of *form*: it needs organizational rules, namely, rules addressing the authority entrusted with legislative power, the procedures to lay down and enforce the rule of conduct and, finally, the conditions of membership of social organization. The concept of legal system as institution and Shari'a financial law have in common the idea of community but one might argue that the latter does not reach "enough" level of organization like Catholic Church or football league do, for example.

⁴⁵Romano, S. (1962). *L'ordinamento giuridico*. Firenze: Sansoni.

Lastly, Shari'a may be applied as a *clausola generale*. Indeed, "clausole generali" refer to any juridical prescriptions – such as good faith, fair trading, the precautionary principle, artistic value – to be applied through reference either to other legal precepts or to notions falling outside the general normative framework. For example, it allows us to refer to social rules as well as, in technical contexts, to drive the juridical interpretation to one result or another⁴⁶. The enforcement of *clausole generali* can be judicially reviewed both by trial judges with regard to the substance of a decision and by *corti di legittimità* on the consistency of the ratio decidendi⁴⁷.

There are good arguments in favour of treating *Shari'a* like *clausola generale*, but two questions come to mind.

Firstly, in the case of disagreement, Italian judges are entrusted with identifying the most popular or widespread opinion of Shari'a scholars (or Shari'a schools) but they are not entitled to examine the truth or validity of such opinions.

This, however, is much more important in so far as the provision of financial services represents an ongoing economic activity able to put new products on the market and raise new critical issues.

Secondly, it does not give certainty about the consistency of application of such a rule for the whole length of the contracting relationship or the financial life of the company. Therefore, it can encourage entrepreneurs' opportunist behaviour, in contrast with the fair trading principle.

5. Conclusions

Coming to our conclusions, comparison between the Italian legal framework and *Shari'a*-compliant financial or banking business models shows that there is no juridical obstacle to accommodating Islamic financial institutions as banks in the Italian legal system⁴⁸ despite some doubts in terms of stability⁴⁹.

⁴⁶In the sixties of the last century, some distinguished authors argued for the crucial role of "clausole generali" because they allowed the Italian legal system to develop according to its own social values in a pluralistic approach.

⁴⁷It would make it possible to comply with the principles of unity and certainty– pivotal principles in the Italian legal system –.

⁴⁸Donato, L., Freni, M.A. (2010) 189.

However, the accommodation process turns out to be a costly operation. It is likely that Islamic banks will be required to apply higher capital ratios even though they are not able to benefit from all the possibilities the universal banking model allows the conventional banks to perform. Therefore, from the outset, Islamic credit institutions might suffer a competitive disadvantage.

Apart from any competitive disadvantages, the business-based mode turns out to be a convenient way of reasoning thanks to its teleological approach. It is a Community-based approach establishing the meaning of European norms in the light of their fundamental purposes⁵⁰. The teleological approach allows us to overcome some formal differences between Islamic and conventional financial business and to address the domestic legal institutions more consistent with the peculiarities of Islamic finance.

Taking on such a standpoint, some authors have consistently argued that it would be advisable that the *Shari'a*-compliant banking institutions operating in Italy to be licensed as investment companies or funds or, once they had been authorised as banks, they should concentrate their business on the financial market providing services including the negotiation of financial instruments and portfolio management on an individual or collective basis, given the similarities between such activities and restricted and unrestricted PLS operations⁵¹.

Additionally, functional-based interpretation may settle the dispute on the insurability of restricted profit-and-loss sharing deposits in the conventional financial system. Actually, the professional operation of investment services is allowed as far as the financial institutions with an establishment, or operating, in Italy from abroad join a certified compensation scheme (article 59 s. IFL).

⁴⁹Montanaro, E. (2010). Islamic banking: a challenge for the Basel Capital Accord. In Fahim Khan, M. & Porzio, M. (Eds). Islamic banking and finance in the European Union. A challenge. (pp. 112-127) Cheltenham, UK: Edward Elgar Publishing.

⁵⁰Indeed, Italian banking and financial laws are essentially the transposition in the domestic jurisdiction of rules harmonised at the Community law level. With regard to teleological approach see: Judgment of the European Court of Justice, 14 October 1999, c-223/98, § 24). See also Fennelly, N. (1996) Legal interpretation at the European Court of Justice. *Fordham International Law Journal* 20(3) 655 – 679.

⁵¹Abbadessa, P. (2010). Islamic banking: impression of an Italian jurist. In Fahim Khan, M. & Porzio, M. (Eds), Islamic banking and finance in the European Union. A challenge, (pp. 207 - 2011) Cheltenham, UK: Edward Elgar.

Indeed, the compensation scheme is a mutual-based agreement and, in the event of opening up an insolvency procedure, is committed to reimbursing investors for any sum of money or financial instruments arising from the investment activity once it has been judicially established⁵². The above remarks suggest that *Shari'a* scholars and Italian lawmakers agree that *i*) the mandatory participation in a compensation scheme can minimize the stability risks of the financial system, *ii*) compensation schemes have a mutual-based structure, *iii*) financial products, covered by the compensation system, may also appear to receive funds from the public with the duty of reimbursement but the *an* and *quomodo* of the reimbursement are a function of the financial result. Thus, the legal form of the contracting relationship between each member and the system seems to be a secondary problem⁵³.

In the end, the business-based approach seems to be a persuasive method unless it points to Islamic banking as a trade product. A cultural-based approach would be much more consistent with Islamic economics and juridical roots. However, none of the above-mentioned legal constructions is fully applicable to Islamic financial law. The “*clausolagenerale*” approach is addressed as an interesting *second best* to meet the expectations of Muslim customers and investors in the Italian legal framework or alternatively there is a market-driven approach.

While the enforcement of compulsory transparency rules in customer-provider relationships as well as in investor-issuer relationships may let the general principle of correctness and fair trading fully operate preventing market distortions, the market will address the credibility gap between what Islamic institutions claim to be and actually are.

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⁵²Annunziata, F. (2010). *La disciplina del mercato mobiliare*. Torino: Giappichelli (Chapter 11).

⁵³ See: MdKhairuddinHj Arshad (2011)4 ff.

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