

Islamic finance: what concrete steps is Italy taking?

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Abstract

Purpose – *The purpose of this paper is to analyze the compatibility of Islamic banking with the Italian banking system, to report what Italian legislators are currently doing to accommodate Islamic finance in the Italian banking system, and to explore solutions to the obstacles that have been identified.*

Design/methodology/approach – *The paper provides background on the Italian banking system as it works within the European Union (EU); shows some analogies between ethical and Islamic banking; traces the development of Islamic finance; explains the principles of Islamic finance and their impact on common transactions; describes the development of the Islamic finance industry; and analyzes the compatibility of Islamic finance with the Italian banking system.*

Findings – *Although Italy offers a fertile and flexible legal environment, dedicated banking laws and regulations and, consequently, Islamic banks have not yet been established in Italy. Further research is needed on how to reconcile Islamic banking with EU regulations and the Italian banking system.*

Originality/value – *The paper presents practical analysis from an experienced Italian financial services lawyer.*

Keywords *Islam, Finance, Banking, Regulation, Italy*

Paper type *Technical paper*

1. Introduction

What is Islamic finance? Definitions range from the very narrow, i.e. “interest free banking”, to the very broad, i.e. “financial operations conducted by Muslims”, but both are really too simple. Islamic financial institutions are those that are based in their purposes and operations on Koranic principles, conventional finance is not. This last definition goes beyond simply equating Islamic finance with interest-free banking, but the truth is that no definition of Islamic finance is completely satisfactory and all seem not to encompass the real extent.

What is a certainty is that Islamic finance has become a significant source of investment activity in both in the Muslim world and more broadly in the global marketplace. It is worth remembering is that Islamic finance involves more than banking. It includes mutual funds, securities firms, insurance companies and other non-banks.

Taking the above into account, there have been certain mental obstacles in welcoming Islamic structures and the Islamic way of thinking into the Italian banking system. What should be assessed is whether those obstacles represent real incompatibility with the Italian banking system regulation or whether they arise from mere prejudices against, or simply ignorance of, a different way of thinking due to a different culture, system, religion and, basically, approach.

This paper intends to analyze and refer theoretically as to the compatibility of Islamic banking with the Italian banking system, reporting what Italian legislators are currently doing

in order to admit and introduce Islamic Finance in the Italian context and researching possible concrete solutions to obstacles, if any.

2. The Italian context

The Italian banking system played an extremely important role in Italy's industrialization process, which arrived later than in other countries such as France, Germany, and the UK. It is grounded on a model that follows the rules of both public and business law. One can identify various periods characterizing the regulatory needs in banking fields.

The major reform of the entire financial market began in Italy in the second half of the 1980s.

Legislative Decree no. 385 of September 1, 1993 introduced the so-called "Consolidated Law on Banking" implementing the reform of the Italian banking system.

Through Legislative Decree no. 481 of December 14, 1992, the national and the European banking system melt and the principle of "mutual recognition of banking licenses" was generally accepted. As a result, the process of reorganization of the credit and financial system in Italy began.

The business model was used as a central frame of reference for activity while recent economic and financial developments in Europe created the emergence of a new model of credit brokerage more based on ethical, social and religious steps. Therefore, to meet the needs of client highly sensitive to ethical-social problems, the so-called ethical bank developed in Italy.

EU Directive on banking no. 646 of December 15, 1989 played an important role in the context of Italian banking system setting forth two important principles that bring stability and efficiency to the banking system:

1. *Mutual recognition*. EU lending entities can freely establish a branch or offer services directly from the country of origin, in accordance with the activities listed in the annex to the directive itself.
2. *Prudential vigilance*. It works over the activities of a branch established in a host country, carried out by the control authority in the country of origin.

3. Ethical and Islamic banking: some analogies

It is worth noting that despite theoretical, historical and practical differences, analogies can be found between microfinance and Islamic banking.

In Italy in the 1990s new legal rules forced the MAG ("*mutua auto gestione*") cooperative societies (self-management mutual associations – a financial co-operative), whose traditional aim is to raise savings among their members and to finance "socially oriented projects", to reorganize. This development led to the foundation of an "ethical bank", Banca Etica, which has the legal form of a popular banking institute. Specialized microfinance institutions (MFIs) can now be found in Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Poland, Romania, Slovakia, Spain, Sweden, the UK, and Turkey.

First, there are similarities in their nature, since both forms of finance represent unconventional solutions to financial needs, focusing on cash-poor but promising business activities. Both of them start from egalitarian approaches as they are open to all customers with different and sometimes coinciding needs (as in the case of microcredit projects fitting Islamic tenets which are increasingly developing within Islamic countries) without setting any apparent restriction to different categories of clientele.

While Islamic finance can be defined as a "viewpoint" way of banking, as it rests on religious principles, microfinance is more based on socio-cultural bases where operations are made possible through a system of social collateral embedded in the local context and environment.

A further similarity between the two systems is that they both advocate financial inclusion, entrepreneurship and risk-sharing through partnership finance. Moreover, from a mere operational point of view, both microfinance and Islamic finance require a high degree of innovation and creativity to survive and stay competitive in the market.

4. The development of Islamic finance in the world

Since the mid-fifties, a debate on the possibility of a finance model consistent with the Sharia law (Sharia compliant) has been opened in Muslims societies.

Islamic finance originated in the Egyptian village of Mit Ghamr. It was the year 1963 when an agricultural bank, created to copy German agricultural banks, started to provide small private entrepreneurs with micro loans, thus also promoting the individual habit of saving. Both the recipient of funds and the investor were members of the bank and shared its profits in accordance with Islamic ethic. The economist Ahmar El Najjar, founded the first religious oversight board composed of "ulama" (i.e. Muslim legal scholars). The first oil crisis in 1973-1974 provided Arab countries with the necessary capital to found Islamic financial institutions. In 1975 the Islamic Development Bank was created by the Organization of Islamic Conference. The aim was to promote the development of all Muslim communities in accordance with the principles of Sharia. In the same year, the Dubai Islamic Bank, the first Islamic commercial bank not owned by a government, was established. Other Islamic banks were then established in Arab countries, the Philippines, Malaysia and so on. In 1979, Iran Islamized the entire national banking system, followed by Pakistan in the early eighties and then the Sudan in 1992. The previous year had witnessed the bankruptcy of the Egyptian Islamic Bank of Credit and Commerce International. Since then, the Islamic financial service sector, also thanks to the sensitivity of the younger generation to religious ethic, has grown at a rapid pace. Today, it includes almost all financial sectors. In 2003, the first Islamic bonds (sukuk) were issued in dollars by sovereign countries and then by companies. In 2004, the German state of Saxony-Anhalt issued the first €100 million sukuk outside a Muslim country. The same year, the commercial bank Islamic Bank of Britain was established, while the first bank in Europe of this type was established in 1978 in Luxembourg. In 2006, the first investment bank of the continent, the European Islamic Investment Bank, was fully operational.

Today, there are more than 20 traditional institutions offering Islamic products in London. In addition, there are several Islamic credit banks in the US, but not yet in Italy.

The sector is increasingly open, innovative, sophisticated and competitive. The major western banks operate in Muslim countries either with traditional and Sharia-compliant credit or through branches dedicated to Islamic financial products. In short, the importance of Islamic finance in the world depends on its extraordinary growth rate and its management model, which is subordinate and/or competitive with the traditional one.

5. The principles of Islamic finance and their impact on common transactions

It may be regarded as difficult to understand the principles of Islamic finance. The way to understand them is to understand the sources and application of Islamic law. Islam law is based on Sharia, a set of principles – mainly a way of life – that provides guidance on a variety of issues for Muslims. Two are the main sources of Sharia: the first one is the Koran; the second one is the "Sunna", i.e. the sayings and actions of the Prophet Mohammed. One of the main precepts that the Koran and the Sunna support is the importance of justice and equality, which imply that in a financial transaction the balance of risk must be fairly allocated. Sharia provides a set of general principles; it does not provide for every conceivable case. Scholars may construe and apply the principles of Sharia in the light of community consensus and reasoning. It is for example important to understand that whilst interest is prohibited by Sharia, the profits of trade are not, provided that is carried on in a lawful manner. That implies apportioning or sharing risk to justify the transaction between the parties – regardless of the identity of the contracting parties – and ensuring that one party does not exploit the other. Any excess risk is forbidden because it exposes the parties to

undue liability. The central principle of Sharia of justice and equality is always taken into account. For example, Sharia forbids gambling, alcohol, and pork. Illegal substances cannot be the basis of a trade or transaction being conducted in accordance with Islamic finance. All the above implies that some contractual agreements used by lawyers and international banks are already suitable in their terms and conditions to be used in an Islamic transaction. That is because they do not refer to interest and by their nature they are not referring to transactions that are unduly speculative or risky. Other agreements may be subject to amendments or they need to be prepared afresh. Nothing, as a result, prevents the carrying out of a financial transaction provided that the principles of Sharia are respected.

6. The Islamic finance industry

The Islamic finance industry has increased exponentially in recent years in both western and Muslim countries. It offers a wide range of products and services often comparable with those in the conventional world, including Islamic structured bonds, convertibles, exchange-traded funds, equities, alternative assets, project finance and private equity. The quality of service has also increased tremendously over the last few years. The Islamic finance industry has also been working closely with the conventional finance industry to help accelerate its growth, and therefore most financial products have an Islamic equivalent. For example a car loan may be replaced with a car murabaha facility, a mortgage with an ijara facility, a conventional bond with a sukuk, an interest rate swap with a profit rate swap. This type of conversion may be useful to offer Islamic finance services in every country. In principle, the Islamic finance industry has grown exponentially over the last few years and the industry is no longer specific to the Middle East or other traditional Islamic financial centers. Given the rate of growth of this industry one would expect that other jurisdictions, including Italy, will enact legislation or simply permit the creation of a friendly environment for Islamic finance investments.

7. Abstract compatibility of Islamic finance with the Italian banking system

7.1 What are the main challenges for Islamic institutions wishing to set up in Italy?

In answering this question, it is important to stress first of all that Italy is undoubtedly attractive as a viable market for Islamic consumer financing, home financing, and insurance retirement plan and investment products. Its geographical position in the middle of the Mediterranean Sea gives it a pivotal role in the Mediterranean region. It also plays a key role in the Euro-Arab dialogue, since it has always been an important aspect of the improved political and economic relationship with the Arab world. Currently, the discussion as to the compatibility of Islamic activities with the current Italian banking regulatory system is focused on the important interpretative issues concerning the legal classification of those activities. More precisely, it aims to determine whether the current legal structure can encompass the Islamic model of banking activity or whether it is more appropriate to identify other regulatory provisions which may permit the legal regulation of the Islamic model. Specifically, the debate focuses on the difference in the level of risk that the depositor undertakes in the Islamic vs. the conventional system and the fact that the Islamic model does not permit interest when providing financing. At stake, the first applicable solution is the use of the so-called "EU passporting" in which an institution authorized in a EU country may offer products throughout the EU without the need to have separate authorization in each member country.

Widespread crises and scandals (Cirio, Parmalat, and Argentina) have affected the credibility of the Italian banking sector, reducing Italian investors' initiatives. The general background of crisis can be seen as one of the causes leading the banking sector to seek new solutions supporting increasing flexibility on investment-grade-rated paper supply in order to cover the new needs of ethnic communities with special financial requirements, such as the Islamic community. Apart from increasing the level of market shares, these operations hit new customers, meet the clients' needs and renew the market image of banks

consolidating a stable business confidence relationship with banks in contrast with recent disaffection tendencies. On the other hand, institutions are aware of the profit opportunities offered by capital flows to the euro area. In conclusion, it seems as if Islamic finance is at an important turning point, particularly for Latin cultures like the Italian one. However currently none is bringing substantial initiatives to implement Islamic finance in Italy.

In view of the above, what are the main challenges for Islamic institutions wishing to set up in Italy?

The main one is undoubtedly that the Italian banking system must overcome the merging of the models of credit brokerage based on religious principles. The development of Islamic finance in Italy is mainly prevented by the fact that financial products and concepts that are behind Islamic finance are basically unfamiliar to both regulators and the business community. Clients still have difficulty understanding Islamic banking. Also the need to have a Shariah Supervisory Board as a sole authoritative body to advise the central bank on Islamic Banking is most likely still seen as an obstacle. Although there is growing interest in Shari'ah compliant investment funds in Italy, the economic climate has seen investors look for safety in conservative assets. The typical Italian investor is very conservative and volatility averse and hence the first and superficial perception is that Islamic funds would not fit this outlook.

Though at an early stage, a new wave of interest for unconventional modes of finance is arising in the Italian banking sector. In particular, the pros and cons of introducing Islamic banking services in Italy were attentively weighted during the Conference on Islamic Banking organized by ABI, with the support of the Islamic Development Bank, Islamic Research and Training Institute and the Arab-Italian Chamber of Commerce, in December 2002.

From a mere accountability approach, incompatibilities arise where the national and international accounting principles are not apt to find the operative technicalities of the Islamic model. Moreover, the rules issued by the Shariah Boards are sometimes not homogeneous, existing different opinions, and as a result it is difficult to standardize the offering of products. In such respect, certain entities such as the Accounting and Auditing Organization for Islamic Institutions (AAOIFI), the Islamic Financial Services Boards (IFSB), the Liquidity Management Centre (LMC), and the International Financial Markets (IIFM) are trying to find a solution. The development of the Islamic financial market has been strongly limited from transparency problems and compliance with the international anti-money laundering rules. The adoption of a common framework discipline is still difficult to achieve.

Currently a specific committee has been set up by ABI to study and investigate on the compatibility between Italian banking system and Islamic Finance. Up until now, Italy has had no direct practical expertise with Islamic financial institutions. In order to investigate whether these institutions are compatible with the Italian system, we must consider the standards and basic supervisory rules that cannot be altered at the national level because they are established at the EU level. It is worth noting that the entry of Islamic finance cannot be accomplished by building a specific regulatory discipline either for or against. Its entry must rather be considered and treated as integration with, rather than separation from, conventional finance.

The UK experience shows that the setting-up of an Islamic bank is admissible in a context where there are supervisory rules based on EU directives. The obstacle may be found in the fact that operations of Islamic financial institutions may also involve the application of local private law and commercial law, which may reveal differences in the operating conditions granted to Islamic financial institutions in other countries. The perspective for considering the possible entry of Islamic finance in Italy departs from that used to study conventional banking. The religious ban on the payment or charging of interest means that Islamic banks must resort to models of fund raising and lending that are different from the ones used by conventional banks (i.e. loans and deposit agreements). However, the fact that the economic function of Islamic finance remains financing economic activity answers to the

query whether it could be admitted in Italy. Since, however, the risks are those that characterize financial intermediation, prudential supervision results to be a key issue.

7.2 Business models and prudential regulations

Two abstract models may be applied to explain the risks inherent in the activities of Islamic banks.

Islamic financial institutions operating under the so-called “conceptual model” are characterized by the predominance of directly participatory agreements based on *mudaraba* and they can be considered as investment banks. Islamic financial institutions operating under the so-called “operational model” are more highly diversified on the fund-raising and lending/investment side. The *mudaraba* and the *musharaka* schemes prevail and fund raising allows a significant portion of sight deposits and short-term funds or funds available to customers on short notice. These institutions are mainly considered as to the allocation of risks in-between banks and depositors/investors and therefore they imply a number of different types of risks: credit risk, counterparty risk, market risk and liquidity risk.

As for the asset and liability composition that is likely to characterize Islamic banks in practice, it could be useful to examine the indications of Bank of Italy on “associazione in partecipazione”. In fact, under certain respects, the type “associazione in partecipazione” is similar to *mudaraba* (investment deposit) practiced by Islamic banks. The bank as associator conventionally assigns to third parties as associates the possibility of participating in the profits deriving from banking activity, in exchange for an economically measurable contribution.

As far as the approach of the Bank of Italy is concerned, two potential problems may arise.

One is that the association in participation contract could lead to interference in the management of the bank by non-banking persons, which would result in an unauthorized persons engaging in banking activity. In this regards the Bank of Italy states that association in participation as governed by the Italian civil code does not give associates any decision-making or managerial power and thus does not violate the terms for the exercise of banking as long as there are no additional contract clauses giving non-banking third-party associates the right to take part in management.

The second problem concerns the fact that through the mechanism of transfer of profits and losses, non-financial, third-party associates may acquire a position of control in the form of dominant influence in violation of the national law requiring separation between banking and all non-financial business enterprises. To avoid the risk that association in participation could be used to evade the limits to acquisition of equity by non-financial persons, all the elements relevant for banking supervision must be submitted in advance to the Bank of Italy.

8. Conclusions: concrete prospective for the entry of Islamic finance in Italy

In practice, the success of a financial model in a market must not be allowed to depend on market rules. Market participants must observe market rules but it will be the market itself that decides whether or not a kind of institution may enter into the market, providing that its products are complying with standards of contractual and market transparency as well as investor protect legislation.

An Islamic bank, unlike in almost the all of Europe and the US, is far from appearing in Italy, despite the fact that investors are saying they are ready for it and that Italy shares ethical and religious principles with the Islamic world. For example, Italy has anti-usury laws including limits and disincentives to gaming and betting as well as sanctions applicable to certain transactions which may involve speculation or non-transparency. As a result, although not entirely free of obstacles, the adaptability of the Italian system to Islamic principles of financing renders Italy a fertile and flexible legal environment. Meanwhile, since a dedicated tax law in respect to finance products does not exist yet, it is necessary to tailor transactions on a case-by-case basis to properly respect and meet the interests of both investors and related regulatory and supervision authorities. In doing that, a good guide or at least

inspiration could be found in the solutions set forth by the legal system of other European countries referring specifically to banking and investments. One should not however forget that a dedicated banking law and regulation in respect of Islamic finance products is still missing in Italy and that the current Italian legal banking framework is not yet suited for fully harmonized Islamic banking. Nevertheless, provided that there are no insurmountable barriers to establishing an affiliate of a EU Islamic bank in Italy, basically thanks to EU regulations, the concrete way to foster the entry of Islamic Finance into the Italian context is to sponsor the in-depth analysis of the Italian legal system to find alternative forms of contractual models.

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