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ISLAMIC BANKS AND REGULATORY ADAPTATION: IMPLEMENTATION OF SHARIA-COMPLIANT BANKING SERVICES IN THE EUROPEAN UNION

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Abstract

This article analyzes the regulatory adaptation and practical implementation of Islamic banking services in the European Union. The study examines how Western financial centres — particularly the United Kingdom, France, Germany, Luxembourg, and Ireland — have incorporated Sharia-compliant financial instruments into their national financial systems. The paper highlights the mechanisms used to legalize Islamic banking operations: tax neutrality, licensing reforms, introduction of sukuk markets, and the establishment of "Islamic windows" within conventional banks. The results show that integration is driven by two major factors: (1) increasing Muslim population and demand for Islamic financial products, and (2) economic interest of European capital in attracting investments from GCC countries. The article concludes that Islamic banking in Europe has shifted from being a religious alternative to becoming part of competitive financial market infrastructure.

Keywords: Islamic banking, Sharia-compliant finance, regulatory adaptation, sukuk, Islamic windows, European Union, financial regulation.

Introduction

The United Kingdom was one of the first Western countries to embrace Islamic finance, and Islamic banks have been operating there since 2004. By 2006, the

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UK Treasury issued an official statement announcing a policy of creating a "level playing field" for the Islamic finance sector.[1] This accelerated the adaptation of Islamic contractual institutions within the legal system.
Within the European Union, the number of institutions working with Islamic financial instruments is also increasing. Banks and insurance companies offering Islamic financial services operate in Germany, France, the Netherlands, and Sweden.[2] In these countries, Islamic sale contracts are implemented through credit agreements, lease-based financing (ijara), and contracts such as istisna and salam. This demonstrates that Western countries are open to the economic institutions of Islamic law.
Islamic finance and contractual mechanisms are attracting interest in developed countries not only among Muslim populations but also among investors seeking socially responsible investment and sustainable economic activity. For example, in the United States, Islamic contracts are implemented mainly through private investment funds, venture capital projects, and Islamic insurance (takaful) mechanisms. According to the 2019 Islamic Finance Development Report, Islamic finance assets in the United States and the United Kingdom exceeded USD 20 billion, and this figure has been growing every year.
Countries of the Asia-Pacific region such as Japan and South Korea are also paying attention to Sharia-compliant instruments. In particular, the introduction of Sharia-compliant instruments in Japan's financial market has helped to strengthen Japan's economic ties with ASEAN[3] countries. The Tokyo Stock Exchange and major banks are currently piloting the introduction of Islamic financing.
These processes show that developed countries are keeping their economic and legal systems open to Islamic financial principles and are seeking ways to adapt them in mutually beneficial ways. This proves the competitiveness of contractual institutions of Islamic law—especially sale contracts—within the global financial system.
Islamic finance is a distinctive form of monetary and credit relations between parties that does not contravene traditional Muslim law (Sharia). Today, the geographical reach of Islamic finance (hereinafter—IF) is not limited to the Arab world or Muslim countries. IF is applied, to varying degrees, almost worldwide

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by local financial institutions as well as by transnational banks and investment companies.

This type of "ethical finance" is spreading increasingly across Europe, supported by two externally unrelated yet mutually reinforcing factors:

a) the desire of European financial business to expand into Muslim countries and the wish of exporters of Arab oil and gas resources to invest surplus funds in Europe—including through diversification of major banking capital's financial products and target market segments; and b) demographic change in many European countries, namely the rapid growth in the share of Muslim populations, which is becoming an important source of solvent demand for such financial services.

By the early 2000s, the specific features of IF had been studied in considerable detail in Western academic literature.[4] In particular, scholars examined problems of defining the boundaries of the IF sector (from a narrow definition limited to Islamic banking to the broadest definition encompassing all financial operations conducted by Muslims) and issues of unreliable statistics. At the same time, most of the foundational literature on IF that emerged in the last quarter of the twentieth century belonged to the fields of theology, finance, or law. There were few studies that approached IF comprehensively, especially those based on up-to-date empirical facts.

Over the past fifteen years, general review publications on IF have continued to appear,[5] authored by both foreign and Russian researchers[6]. Studies focusing on the specific features of IF in different regions of the world have begun to emerge. In the case of Europe, the analysis primarily concerns the history of Islamic banks entering the United Kingdom and other countries; the specific nature of "Islamic windows" within conventional banks;[7] the role of Islamic banking in economic relations between European and Arab states;[8] the spread of various IF instruments; and the regulation of IF in certain EU countries. Finally, in 2013 the European Central Bank presented a detailed review of the state of IF in the EU.[9]

Our article includes new data on the scale of IF in the EU, which is relevant in light of the influx of Muslim refugees, and it also analyzes how realistic it is for secular European countries to host more or less developed elements of an Islamic

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economy. Particular attention is paid to new aspects of IF regulation—both purely financial elements related to the introduction of Basel III standards to improve risk management in banking following the global financial crisis and measures aimed at combating the criminalization of the economy.

The share of Muslims in Europe's population has risen from 4% in 1990 to more than 7% today. It is true that in the countries that have accepted the largest numbers of Muslim migrants, their share of the population is still lower than in countries with indigenous Muslim minorities. For example, the share of Muslims in France is less than 8%, in Germany approximately 6%, in the United Kingdom 5%, while in Bulgaria every seventh citizen adheres to Islam.[10]

In recent decades, Muslims have been playing an increasingly active role in the EU economy, joining the ranks of entrepreneurs and skilled employees. At the same time, Islamic banks—which maintained their stability during the global financial crisis and became attractive sources of investment—have been growing more active. According to Thomson Reuters, of the 1,143 IF institutions worldwide in 2014, Europe (excluding Russia, which is considered part of Asia) had 15 Islamic banks, 13 "Islamic windows" within conventional banks, 19 other Islamic financial institutions or "Islamic windows" of conventional investment funds, and 3 takaful (Islamic insurance) companies. At the beginning of 2015, the share of Islamic banking in total banking assets in Europe stood at 0.15%.

In economics and law, there is no precise definition of "Islamic finance," since its principal characteristic is religious in nature. In the constitutions of the most widespread Eastern states, religious legal sources such as the Qur'an and the Sunnah are granted supreme legal force. The role of the Qur'an is defined by the Holy Book itself. The development of Qur'anic rules governing commercial transactions is reflected in the Sunnah, which describes the life of the Prophet Muhammad. The Sunnah, together with the Qur'an, is the second pillar of Islam and serves as an example and guide for every devout Muslim. The Prophet's remarks and guidance on conducting commercial transactions constitute fundamental principles for IF as well.

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The structural elements of IF include:

– a system of prohibitions: riba—prohibition of usury/interest; gharar—prohibition of uncertainty in contractual terms; maysir—prohibition of speculation and gambling; haram—prohibition on participating in forbidden activities;

– a set of financial institutions engaged in attracting and placing funds (banks and non-bank financial institutions);

– principles for conducting financial operations in accordance with Sharia norms: musharakah—partnership or participation; murabaha—trade-based financing; mudarabah—trust-based investment; mufawada—mutual trust; ijara—an analogue of leasing; and others;

– the Muslim tax system: zakat—a levy aimed at ensuring the fair distribution of blessings, and jizya—a tax collected from adherents of other faiths. The uniqueness of IF lies precisely in its tax system, which stems from the religious duty of every believer to pay a levy in favor of the needy to ensure the fair distribution of public goods. European researchers often overlook this point and tend to equate IF with Islamic banking. Notably, funds from zakat historically went to the caliph's treasury as the head of the religious community and could be spent only for purposes specified in the Qur'an—namely "for relatives, orphans, the poor, travelers, those who ask, and for the freeing of slaves…".

The first Islamic financial institutions in Europe appeared in the late 1970s. As national legislation gradually changed, fully fledged Islamic banks or "Islamic windows" in conventional banks began to be established. For example, as early as 1978 a financial institution called the Islamic Banking System (later renamed Islamic Finance House Universal Holding) was founded in Luxembourg, and in December 1982 the first takaful company, Takafol, was established (both with funds from investors in the Gulf states). In Geneva in 1978, at the initiative of the Saudi royal family, the first Islamic financial structure in the West in the form of a joint-stock company—Islamic Banking System International Holding—was established, and in 1981 the Dar al-Mal al-Islami Trust financial group was set up with an authorized capital of USD 1 billion. The latter succeeded in creating a number of Islamic banks in Europe in the 1980s; however, most of them proved

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unsuccessful, and some were converted into investment companies. In Switzerland itself, due to legal restrictions, the first fully fledged Islamic bank (Faisal Private Bank) was opened only in 2006.

Another Islamic banking project in Europe was the 1982 acquisition in the United Kingdom of Hargrave Securities—a company licensed to accept bank deposits—by the Saudi investment group Al-Baraka. In 1987, after changes in British legislation and with sufficient demand for Islamic financial products, it was transformed into an Islamic bank.

To this day, the United Kingdom remains among the most advanced countries for both Islamic banking and other areas of IF. In the late 1990s and early 2000s, HSBC, Lloyds TSB, and other banks opened divisions known as "Islamic windows," which provided financial services in accordance with Sharia norms within the framework of ordinary British banking law. From 2003, an advantageous tax regime was introduced for Islamic finance organizations to enhance their competitiveness. In August 2004, the Islamic Bank of Britain (IBB) was licensed—the first retail Islamic bank in Europe created "from scratch," unlike other financial institutions that were subsidiaries of banking groups from the Gulf states. In October 2014, IBB was acquired by Masraf Al Rayan of Qatar, the fifth largest Islamic bank in the world, and was renamed Al Rayan Bank. In 2006, the first Islamic investment bank—the European Islamic Investment Bank—was launched, and in 2008 the independent Islamic insurance company Salam Halal Insurance was established. From 2006, HSBC also began offering Islamic insurance.

More than 60 universities and colleges in the United Kingdom offer education in IF (nearly two-thirds of such institutions in Europe). In 2012, the government established a special working group on IF to maintain London's status as the "Western hub" for Islamic finance. By the end of 2015, the London Stock Exchange—successfully competing with leading financial centres in the Muslim world—had listed 57 sukuk issues with a total value of USD 51 billion. Under an infrastructure development program involving IF, the Shard skyscraper and the Olympic Village were built in the capital. Nevertheless, the City of London does not always prevail over Luxembourg, Dublin, or Britain's offshore centres in Guernsey and Jersey in competition for IF.

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France could also become one of the leading centres for Islamic banking in Europe. This is primarily due to the growth of the local Muslim diaspora and its demand for IF, as well as traditional trade and investment ties with the Maghreb. Surveys indicate that 41% of French Muslims—most of whom are middle-class and strictly observe Islamic customs—and 45% potentially show interest in Islamic financial products.

In 2007, Paris Europlace—an organisation that promotes Paris's role as a global financial centre—established an Islamic Finance Commission to support the creation of Sharia-compliant investment funds and sukuk issuance. A sukuk segment already exists on the Paris exchange. The French financial markets regulator, the Autorité des Marchés Financiers (AMF), issued two regulations allowing sukuk issuance. Four guidance documents have been published on IF regulation, confirming a tax regime for these operations equivalent to that for conventional transactions.

For the past 30 years, France has actively attracted banks from Middle Eastern countries; yet none had officially approached the French authorities specifically to explore the use of Islamic products in the country. Only in 2011 did some French banks introduce the first Islamic deposit scheme through "Islamic windows." Only Chaabi Bank, a subsidiary of Morocco's Banque Populaire, offers, through its 17 branches, murabaha contracts for financing real estate transactions and Islamic deposit accounts. In addition, French companies have begun to participate in projects in some Maghreb countries through joint ventures that use IF and investment (for example, in Tunisia, Alliance International and Bahrain's Gulf Finance House Holding).

In terms of the scale of IF's presence, France lags not only behind the European "front-runners"—the United Kingdom, Luxembourg, and Switzerland—but also behind Ireland. The main reasons are: (1) the absence of unified standards for Islamic financial products; (2) insufficient state support; (3) underdeveloped financial markets in the Maghreb countries that form the Muslim diaspora in France; (4) the predominance of the principle of secularism in key laws; (5) rising anti-Muslim sentiment; and (6) low profitability of investments, which dampens the interest of conventional banks in developing IF (after all, even if they belong to Muslims, conventional banks are not prohibited from developing Franco-Arab economic relations).

In Germany, IF is also not highly developed, although given current migration flows the number of Muslims may soon surpass that in France. Germany experienced negative episodes in Islamic banking in the 1990s, when several Turkish companies (Kombassan Holding, Jet-Pa, Yabitas Holding, Yimpas Holding) entered the German market with Islamic financial products and attracted around 300,000 customers (mainly through mosques). Their funds were misused, and most depositors lost their savings (losses ranged from EUR 5 to 50 billion), which nevertheless indicates significant potential demand for IF in Germany.

In 2004, Islamic bonds (sukuk) were issued in Germany (the issuer was the federal state of Saxony-Anhalt) and were purchased by investors from Bahrain and the UAE (60%), as well as from Germany, France, and other EU countries (40%). In 2006, Deutsche Bank, together with Bahrain's Ithmaar Bank and the UAE's Abraaj Capital of Dubai, established a joint Sharia-compliant financial fund of USD 2 billion. In 2015, a fully fledged Islamic bank—Kuveyt Türk Beteiligungsbank (KTB)—was opened in Frankfurt. It primarily serves SMEs and real estate traders. Branches were opened in Cologne and Düsseldorf, where Muslims constitute a large proportion of the population. In addition, the bank conducts financial operations between Germany and Turkey, the Gulf states, and the countries of the southern Mediterranean. German financial organisations have been actively involved in IF through their branches in London, Dubai, and Kuala Lumpur, using appropriate instruments in trade with Muslim countries.

Against the backdrop of France and Germany lagging behind—and the near absence of IF in Italy and many other EU countries—Luxembourg, which has long focused on developing its financial sector, is striving to become a major IF hub in Europe. First and foremost, various private-sector organisations began supporting tools and strategies related to the development of Sharia-compliant business, as Luxembourg enjoys good political relations with the Gulf countries and Malaysia. In 2002, Luxembourg became the first European country to list 16 different sukuk on its stock exchange. In 2009, the Central Bank of Luxembourg was the first in Europe to join the International Islamic Liquidity

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Management Corporation, headquartered in Malaysia. More than 130 Sharia-governed investment funds and their sub-funds already operate in the country.

The difficulties in developing IF in Luxembourg are associated with the small size of Muslim diasporas in the country, insufficient awareness among potential clients of the features of Islamic banking, as well as the political, socio-economic, and cultural traditions of Muslim countries, and the relatively high costs of promoting these services compared to other financial centres.

In recent years, Ireland has become a competitor to Luxembourg. Although the proportion of Muslims in its population is small, IF is supported at the state level. Tax incentives exist to develop Islamic financial instruments related to leasing (ijara), trade financing contracts (murabaha), and insurance (takaful). The government also instructed the financial regulator to form a group to explore the establishment of Islamic investment funds. Ireland accounts for 5% of all Islamic funds in the world; among those domiciled in Ireland, 63% are globally oriented, 23.4% are focused on the United States, 6.4% on the Middle East, and only 2.1% on Europe. In 2015, with state support and private-sector initiative, the Islamic Finance Council of Ireland (IFCI) was established to disseminate information on the basic principles and operations of IF.

Around the world, research is underway to identify optimal forms for integrating IF into national financial systems and to develop effective models of regulation and supervision that, on the one hand, meet current global trends and requirements and, on the other, do not contradict the essence of IF—that is, remain compliant with Sharia norms. This task is being addressed with varying degrees of success across different countries and jurisdictions.

Moreover, Islamic finance is one of the few areas of the global economy whose governance is conducted without a conspicuous and unequivocal dominance by the leading Western states. At the same time, Islamic financial institutions—embedded directly or indirectly (through the external relations of national financial systems) in the international monetary-credit and broader economic relations system—are obliged, wherever they operate, to be oriented toward accepted financial regulatory standards and to meet the requirements imposed on participants in financial circulation.

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The question of whether legal relations can be governed by religious norms (Sharia) in a secular state remains contentious. In practice—for example in Turkey, Egypt, and several EU countries—IF in finance and banking law is treated as a special case of an innovative financial product that has, in effect, been stripped of its original religious content. Emphasis is placed on its financial safety and on ensuring that it does not introduce additional destabilizing effects into the financial system of the jurisdiction in which it is supervised. However, due to historical-cultural stereotypes and differing value approaches, the question arises in Europe whether IF requires additional or special measures for regulation, supervision, or liberalization compared to ordinary monetary-credit institutions.

In Islamic legal practice, the institution of zakalat functions as a mechanism ensuring the performance of obligations under sale contracts. This mechanism operates as a form of security similar to a pledge, with its primary purpose being to guarantee the fulfilment of contractual terms. Accordingly, zakalat may not be used as an instrument for calculating interest, as a punitive payment, or as a mechanism for imposing compulsory compensation on a contracting party. In the event of contract termination, zakalat must be returned to the party in accordance with a court decision or withheld only to the extent of the actual damage effectively incurred.

This provision is proposed as an amendment to Article 312 of the Civil Code of the Republic of Uzbekistan. The suggested legislative formulation aims to integrate the zakalat institution into the national civil-law system and to clearly define the rules governing its application within contractual relations.

In practice, the very designation of a financial institution as "Islamic" can create additional difficulties and burdens for it. In Muslim countries, these manifest as additional regulatory requirements and harsher penalties for non-compliance; in non-Muslim countries, they appear as lingering caution toward such institutions. All of this reduces the competitiveness and manoeuvrability of Islamic financial institutions compared to ordinary credit institutions and imposes additional restrictions on methods of earning profit. To mitigate the negative effects, some regulators are abandoning the legal use of the term "Islamic finance" within their monetary-credit systems. For example, in officially secular Turkey, Islamic

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financial institutions are formally called "participation banks"; in Bahrain, which is not legally secular, Sharia-based banking is referred to not as "Islamic" but as "interest-free banking." In Azerbaijan, references to its Islamic character are minimized. For instance, although the oldest Kauthar Bank in Azerbaijan is recognized by the global Muslim community as an Islamic bank and describes its activities as "Islamic banking" in its English-language brochure, in the Azerbaijani brochure the term "Faizsiz qazanç" ("interest-free banking") is used instead. Nevertheless, the bank is a member of the General Council for Islamic Banks and Financial Institutions and of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

In the context of the gradual integration of Islamic finance institutions into the national financial architecture, the necessity to revise and refine Article 5 of the Law of the Republic of Uzbekistan "On Banks and Banking Activities" has become increasingly evident. While the current wording of the article delineates the general scope of banking operations, it does not encompass the distinctive legal mechanisms and operational modalities inherent to Islamic finance. As a result, the existing legal framework remains insufficiently aligned with the functional and doctrinal features of Sharia-compliant financial activities.

Islamic finance is premised on the prohibition of interest (riba) and operates through asset-based, partnership-based, and trade-based transactions. Consequently, the structure, legal characteristics, and implementation mechanisms of Islamic finance operations diverge fundamentally from those of conventional banking. International regulatory practice demonstrates that the number of Islamic financial instruments and operational models exceeds thirty, necessitating detailed regulatory clarification in subordinate normative legal acts adopted by the Central Bank. Such clarification would ensure legal certainty and uniform application of Islamic finance standards across the sector.

In this regard, it is proposed to introduce a separate definitional component concerning Islamic finance operations into Article 5 of the Law. The inclusion of such a provision would, first, establish a clear legal basis for recognising the status, nature, and operational framework of Islamic finance institutions within the national legislative system. Second, it would enable commercial banks to lawfully introduce and expand Sharia-compliant financial services, thereby fostering a competitive and diversified financial market.

Furthermore, given that Islamic finance operates on a non-interest paradigm, the retention of the term "interest-based" within the current wording of Article 5 may create interpretive inconsistencies and impede the proper regulatory treatment of Islamic banking activities. In order to prevent such misinterpretations and ensure coherence between statutory norms and Sharia-compliant financial practice, it is recommended that the term be removed. This amendment would contribute to the alignment of the national banking legislation with internationally recognised Islamic finance standards and support the development of a robust dual banking system in Uzbekistan.

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