

The Regulatory Environment for the Establishment and Operation of an Islamic Bank in Germany

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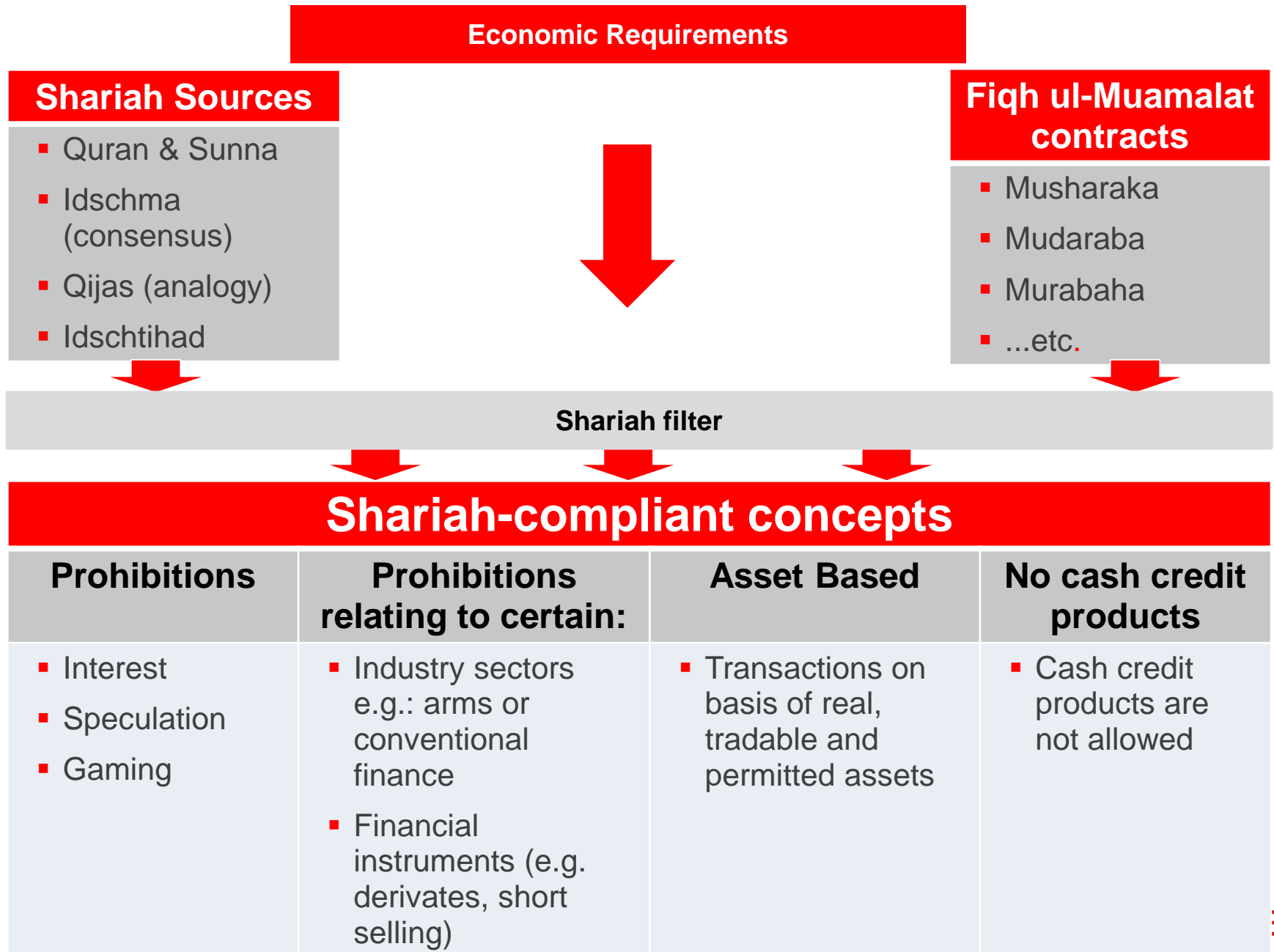
Introduction

What makes a bank Islamic?

Banks are Islamic when they carry out their business exclusively in compliance with the values and norms of the Shariah.

This requires that banks make use of certain types and processes recognised by the Shariah.

Islamic Finance Overview



Overview of German financial supervisory system

Who is subject to supervision?

- Credit institutions = companies that carry out banking business (§ 1 I *KWG*)
- Financial services institutions = companies that carry out financial services (§ 1 Ia *KWG*)
- Securities and fx trading for own and for third party account
- Asset managers
- Other finance institutions = companies that carry out other finance business (§ 1 III *KWG*)
- Insurance companies and pension funds

Who supervises?

BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht)

- 3 supervisory pillars:
 - banks
 - insurance companies and pension funds
 - securities and asset management
- Cross sectional duties and internal administration
 - special duties (e.g. money laundering and terrorist financing)
- International
 - cooperation with supervisors or other states

What is supervised?

Commencement of business

- Execution of banking business and financial services requires a licence from *BaFin*
- Conditions for a licence
 - sufficient equity capital
 - 2 competent and trustworthy managing directors
 - trustworthy owner
 - organisational provisions for orderly business

=>Applicant is entitled to licence unless there is good reason to refuse it.

What is supervised?

Organisation of business

- Regulatory capital and liquidity
- Provision of loans
- Risk management
- Outsourcing
- Membership in a deposit protection system
- Further organisational precautions (e.g. KYC, anti-money laundering etc.)
- Accounting

What is supervised?

Conduct of business rules

- Reporting requirements (§ 24, 25 *KWG*, *MonatsausweisVO* – German Monthly Returns Regulation)
- Confidentiality obligation (banking secrecy) + data protection [*BDSG*, *TDSG*]
- Securities trading
 - insider surveillance (§ 12 *WpHG* – German Securities Trading Act)
 - prohibition of market manipulation (§ 20 *WpHG*)
 - notification of voting rights (§ 21 et seq. *WpHG*)
 - obligations to provide information and other rules of conduct (§ 30a et seq. *WpHG*)
 - stock exchange trading [*BörsG* – German Stock Exchange Act]
 - safe custody [*DepotG* – German Safe Custody Act]
- Issuance and offer of financial products
 - securities [*WPPG* – German Securities Prospectus Act]
 - other financial investments [*VerkProspG* – German Selling Prospectus Act]
- Reporting obligations under *AWV* (Foreign Trade and Payments Regulation)
- Long-distance selling [§ 312b *BGB* - German Civil Code]
- Fair competition [*UWG* - German Act against Unfair Competition]
- Money laundering [*GeldwäscheG* – German Money Laundering Act]

Powers of BaFin to intervene

- Issuance of regulatory administrative acts (§ 6 III KWG)
- Administrative fines (§§ 56 et seq. *KWG*)
- Dismissal of managing directors; revocation of licence to conduct business (§§ 35, 36 *KWG*)
- Moratorium, filing for insolvency (§ 46 *KWG*)

Is *Islamic banking* “banking”?

How do Islamic banks fit into the German financial supervisory system?

- No privilege for Islamic banks in Germany
- General principles of supervision of financial institutions apply both to Islamic and conventional banks
- The challenge is to integrate Islamic financial products into a regulatory scheme based on conventional principles

Regulated financial transactions under the *KWG*

A licence of BaFin is to be obtained by those who carry out or offer

- banking business pursuant to § 1 (1) sentence 2 *KWG*, such as
 - deposit business
 - lending business
 - principal broking business
 - underwriting business

or

- financial services pursuant to § 1 (1)(a) sentence 2 *KWG*, such as
 - investment brokerage
 - investment advice
 - financial portfolio management
 - financial leasing

Qualification of Islamic financial transactions

- Murabaha loan [-]
- Musharaka joint venture [-]
- Ijara – leasing [+]
- Qard Hassan current account [+]
- Mudaraba savings account [+]

Islamic accounts as deposits?

One of the major challenges for supervisory authorities is to qualify Islamic deposits under the regulatory definition of “deposits”.

Can holders of Islamic accounts benefit from deposit protection schemes?

Islamic banks as members of deposit protection schemes?

- German banks are obliged to protect their deposits (and liabilities arising from securities transactions) by joining a deposit protection scheme (§ 2 *Einlagensicherungs- und Anlegerentschädigungsgesetz* - Act on the Protection of Deposits and Investor Compensation). This obligation could conflict with the obligation to bear losses under the *Mudaraba*.
- One way to avoid this conflict could be a model already applied in Great Britain under which the bank is required to offer to its customers the protection provided by a deposit protection scheme while giving them the possibility not to use such system.

Prospectus requirement for Islamic accounts under the *VermAnlG* (German Capital Investment Act)?

No, but:

- Offerors of Islamic financial products are required to ensure that they inform about all risks inherent in the products.
- It may be helpful that the regulatory principle of transparency is not dissimilar to the Islamic concept. Also Islamic law requires Islamic banks to disclose risks and disadvantages and refrain from making false representations.

Responsibilities of bank managers

Role of Shariah Board

- Under German banking supervisory law, the managing directors are required to take all important business decisions.
- In this connection, the Shariah Board is of importance:

While, under German law, a Shariah Board is permitted to advise on Islamic finance transactions, all relevant business decisions are to be taken by the managing directors.

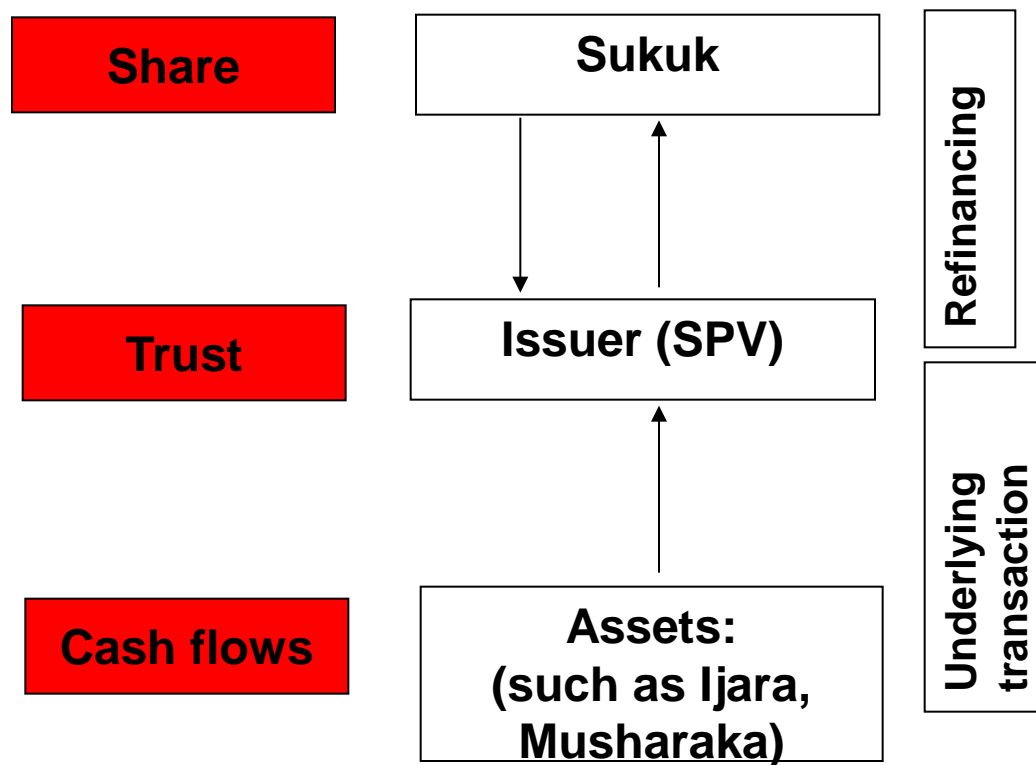
[Independent management!]

What are Sukuk?

What are Sukuk?

- AAOIFI: “Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity.”
- Capital-market eligible securities that do not grant their holders any right to interest, but grant a share in the underlying transaction:
 - co-ownership in assets
 - income from underlying transaction

Sukuk – basic structure



How do Sukuk qualify under German law?

- Investment units?
- Bonds?
- Stock?
- Participation certificates?

Excursus: Prospectus liability for alleged Islamic products?

- Several English cases – including *Shamil Bank v Beximco* – will not judge Shariah issues
 - High Court – Religious Supervisory Board – court will not look behind Shariah Board certification
 - Court of Appeal – reaffirmed the High Court

Tax issues in the context of Islamic finance

Tax

- Taxation of income from Islamic transactions and accounts?
- Trade tax in case of Sukuk?
- Double real-estate transfer tax in case of Murabaha or Ijara?
- VAT on income of Islamic banks?

Situation in England and France

England – regulatory issues

- Under the Financial Services and Markets Act 2000, everyone who exercises “regulated services” is required to obtain a licence. The Act contains a list of examples which – other than in Germany – is not exhaustive
- The following issues are of particular importance for FSA:
 - correct regulatory qualification of Islamic products
 - restriction of Shariah Board to advisory (non-relevant) function
 - specific requirements as to the quality of the distribution of Islamic products
- Depending on the context, Sukuk are qualified as collective investment schemes (for tax purposes) and as securities (for stock exchange purposes)
- The problem of the qualification of Islamic accounts as “deposits” is solved by urging Islamic banks to offer their customers to compensate them for any loss

England – taxation issues

- The main issues were:
 - Tax treatment of profit generated by Islamic accounts
 - Double stamp duty on property transactions
 - VAT treatment of the profit charged by the banks

Instead of going down the legislative route, the taxation issues were gradually resolved by way of annual amendments in the Financial Acts.

- The main approach was to officially recognise that whilst Islamic financial products have significantly different structures and processes, they achieve similar financial objectives as their conventional counterparts
- The objective was to allow providers to offer Shariah-compliant products without facing commercial disadvantage, and to enable customers to take up these products without encountering uncertainty or disadvantage over tax treatment

France – regulatory issues

- Regulatory requirement of having a European bank as “Sponsor” (with minimum 20% shareholding) for incorporating a new Islamic bank in France (banks authorised in the EU are exempt of this restriction and remain subject to simplified “Passporting” formalities)
- The “Fiducie” may serve as the equivalent of the “English Trust” for the issuance of Sukuk and structuring real estate transactions -> change of article 2011 of French Civil Code to facilitate this
- The authorities are working to resolve the issue of Capital Guarantee (the UK solution is not acceptable for the French). They are quite likely to accept the “Capital Protection” mechanism offered by Wakala contracts as the solution
- Statements of the Autorité des Marchés Financiers (AMF) on Shariah compliant investment funds (providing for financial assets screening and purification techniques)

France – taxation issues

- Taxation issues:
 - Double stamp duty
 - Tax treatment of profit
 - VAT treatment of Islamic transactions
- Several tax reforms were introduced in 2009 to abolish Double Stamp Duty in Murabaha transactions and provide level taxation framework to Sukuk holders
- Further tax reforms have been adopted to provide a specific tax regime for Murabaha, Ijara, Istisna, Wakala, Musharaka and Salam based structures

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