

Islamic Finance for European Muslims: The Diversity Management of Shari'ah-Compliant Transactions

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I. INTRODUCTION

This Article investigates the market potential of and legal constraints on Shari'ah-compliant retail products in Europe, focusing in particular on the English and the German markets. "Retail products," for the purpose of this Article, refer to finance and investment products that target primarily consumers (in other words, the product range of the "high street bank" as opposed to investment banking services). Compared to the development of Islamic retail finance in the UK, it is fair to conclude that the developments in Germany are significantly lagging. For several years, Islamic retail products, especially Islamic home finance products, have been an integral component of the product range of most English High Street banks. Further, the Islamic Bank of Britain, set up as an Islamic bank to serve Muslims in the UK, commenced operation in 2004 and became the first fully Shari'ah-compliant bank in Europe.¹ In contrast, Germany, which has a Muslim population exceeding three million, currently lacks Islamic retail products.² Although there have been some deliberations regarding the establishment of an Islamic bank in Germany, all projects are presently far from the implementation phase. While the English market is

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¹ See <<http://www.islamic-bank.com/islamicbanklive/History/1/Home/1/Home.jsp>> (visited Jan 15, 2007).

² To the best of my knowledge, the only exception is the Noriba Global Equity Fund (formerly called the UBS (Lux) Islamic Fund), an equities fund that is registered for public distribution under the German Investment Act (*Investmentgesetz*). See <<http://www.ubs.com/2/e/files/0794830pg.pdf>> (visited Jan 15, 2007). The Fund mostly targets institutional and private investors from the Arab Gulf States in search of a German regulated Shari'ah-compliant investment. It does not primarily target German Muslims.

booming, the German market is close to non-existent. The same holds true for most of the other European markets. Islamic retail finance in Europe is largely confined to the UK.

In light of the existence of Islamic retail products in the UK, why do countries such as Germany and France fail to widely offer Islamic retail products? Considering the attention Islamic finance has attracted in Germany over the past few years and the extensive coverage the issue has received in the media, the shortage of Islamic retail products cannot be due to either disinterest or a lack of information. There has been extensive media coverage both in the general and the financial press focusing on how German institutions could take advantage of the economic potential of Islamic finance.³ There must be other reasons for the slow development.

This Article argues that developments in Islamic finance must be analyzed within a broader framework. First, Islamic financing transactions must be integrated with and adapted to the overall legal and regulatory framework of the prospective jurisdiction in which the transaction will take place. Islamic financial services, in most jurisdictions, are subject to state law. Integrating and adapting transactions is of particular importance with regard to retail products that are based on an industrialization of the banking business. In Germany, regulation works differently from the UK and may be less susceptible to catering to the needs of ethnic and religious minorities. Second, and perhaps more importantly, Shari`ah-compliant retail products must also mirror the needs of the respective Muslim communities they serve. While there may be a global market for “big ticket” Islamic financing transactions, this is not the case for retail products, which are not based on globally uniform standards. What is deemed to comply with Islamic principles will depend on who interprets them and in which jurisdiction the transaction is implemented. Therefore, the success of Islamic retail products depends on a double cultural accommodation: adjusting the respective product to both the requirements of local laws and the specificities of local Muslim communities. This depends on certain institutional arrangements that, in the past, have been more favorable in the UK than in Germany.

³ See, for example, Michael Gassner, *Islamic Banking: Expansion in Europa*, Die Bank 8 (Nov 2004); Michael Gassner, *Islamic Finance*, Die Bank 732 (Nov 2003). See also Sonia Kolesnikov-Jessop, *Islamic Banking Seeks New Customers as Wealth Expands; Growth Potential Looks Strong for Financial Products that Meet Shariab Requirements*, Intl Herald Trib 13 (May 24, 2006); Rahman Al Baker, *Key Steps Take Islamic Finance into Mainstream*, Fin Times 8 (July 4, 2005); Barbara Wall, *Europe Draws Islamic Funds; Private Banking: A Special Report*, Intl Herald Trib 8 (May 21, 2003).

II. WHY CARE ABOUT IT?

The assumption underlying this Article is that it is indeed a good idea to pursue the development of Islamic retail finance in Europe. This assumption may be widely shared within the Islamic finance community and certain public bodies—including the British Financial Services Authority (“FSA”) and international organizations such as the World Bank—have also taken a supportive view more recently. This view, however, is not uncontested.

In the German setting, one often encounters the argument that the development of Islamic retail products is neither required nor desirable and may even be harmful. The latter opinion is particularly prominent among those who have difficulty viewing Germany as a multi-ethnic and multi-religious society and who, instead, clearly advocate a “hegemonial culture” (*Leitkultur*).⁴ From this perspective, there is no need to foster the pluralization of the financial system by offering products targeting Muslims and other ethnic or religious minorities. In contrast, the financial system should be one and the same for all in order to prevent the development of so-called parallel societies (*Parallelgesellschaften*). Financial services, from this perspective, are one means of promoting integration by compelling people to adapt to the mainstream of society. The proponents of integration tend to refer to several *fatawa* issued over the last decade in which European Muslims were exempted from the prohibition of interest (*riba*) as far as consumer finance was concerned.⁵ The proponents further conclude that Islamic retail finance is not only undesirable, but also unnecessary because European Muslims, if following the “correct” or

⁴ For a summary of the German debate see Mathias Rohe, *The Legal Treatment of Muslims in Germany* (2003), available online at <http://www.fieri.it/ktml2/files/uploads/attivita/convegna_seminari/convegno%20islam/rohe.PDF> (visited Jan 15, 2007). The German concept of *Leitkultur* is similar to the ideas put forth with regard to the US by Samuel Huntington. See Samuel Huntington, *Who are We?: The Challenges to America's National Identity* (Simon & Schuster 2004). To be sure, there is no universal understanding of what the core principles of the German *Leitkultur* are. While it is safe to assume that the values enshrined in the German Constitution (*Grundgesetz*) as well as the German language are among the core principles, approaches vary as to which integrative efforts should be required from ethnic and religious minorities. In any event, pursuant to my experience in public debates, the underlying concept of “integration” tends to be critical of Islamic finance. Although I do believe that some of the arguments must be taken seriously, this Article is not the appropriate forum to elaborate upon the debate.

⁵ There are a number of renowned European Islamic scholars who argue that European Muslims are exempt from the Islamic prohibition of *riba*, which is understood to prohibit the payment and receipt of interest when dealing with a European bank in Europe. This approach makes use of the distinction in Islam between Muslim and non-Muslim territories (*Dar al Islam* versus *Dar al harb*). Muslims residing outside Muslim territories are, to a certain extent, exempt from Shari'ah rules. For a general discussion, see Alexandre Caeiro, *The Social Construction of Shari'ah: Bank Interest, Home Purchase, and Islamic Norms in the West*, 44 *Die Welt des Islams* 351 (2004).

“progressive” interpretation of Islamic law, would not be barred from paying and receiving interest at all.

I nevertheless want to advocate the opposite approach and argue that developing Islamic retail finance is desirable. First, even if there is controversy among Islamic scholars regarding the scope of the prohibition of *riba* (both in terms of its intrinsic scope as well as its geographical application), I am not convinced that this is an issue that can or should be resolved by financial regulators. Second, viewing the issue from a straightforward business perspective, the German Muslim population has not, until recently, been the focus of any German retail bank. The market, however, has potential because of the number of Muslims living in Germany. Third, development of niche markets presently conforms to the predominant marketing strategy in the German financial services industry, where attention has shifted back to the domestic retail market. Here, banks are seeking to diversify their products in order to better reach consumer groups that have been neglected in the past. Fourth, and perhaps most important, there is a strong trend towards ethical finance that has also been endorsed by more recent legislative enactments.⁶ Financial services are no longer ethically neutral and are now expected to conform to certain non-economic criteria, such as environmental friendliness, sustainability, and other green or social criteria. This opens a window for financial transactions conforming to Islamic principles as well. Finally, from a policy perspective, the German government has recognized as an important goal, the need to grant wide access to financial services. In fact, such “financial inclusion” is increasingly perceived as a civil rights issue. Some argue that members of the Muslim community should not be barred from enjoying financial services simply because of their faith.⁷ In turn, financial institutions should not escape regulation because they have an Islamic orientation.⁸ Financial inclusion, therefore, also helps

⁶ For example, reform of German private pensions law in 2001 introduced for the first time an obligation of insurance companies and pension funds to disclose the extent to which they abide by “social and ecological guidelines” when investing. See *Altersvorsorge-Zertifizierungsgesetz* (private pension law) June 26, 2001, Bundesgesetzblatt (BGBl) I 1310, as amended §7 (1) ¶ 5.

⁷ An old theme in the US, the debate on financial inclusion has now reached Europe. See, for example, Institut Für Finanzdienstleistungen, *Access to Financial Services: Strategies toward Equitable Provision* (Hamburg 2001), available online at <www.iff-Hamburg.de/4/goeteborg/goeteborg.html> (visited Jan 15, 2007). For the UK perspective, see HM Treasury, *Promoting Financial Inclusion* (HM Treasury 2004), available online at <http://www.hm-treasury.gov.uk/media/8F9/37/pbr04_profininc_complete_394.pdf> (visited Jan 15, 2007).

⁸ “Informal” financing, outside the scope of official regulation, has played a certain role with regard to *hawala*-based (trust-based) remittance services (which caught regulators’ attention, as they can be susceptible to money laundering). As a general rule in Germany, it is prohibited to carry on banking activities without a formal banking license pursuant to Section 32 of the German Banking Act (*Kreditwesengesetz*), English translation available online at <<http://www.iuscomp.org/gla/statutes/KWG.htm#32>> (visited Jan 15, 2007).

promote effective regulation of the German market: the more participants who are included in the formal (regulated) market, the fewer who must seek the help of unofficial, unregulated providers. Thus, from a policy perspective, systematically developing the Islamic finance market is desirable.

III. STRUCTURING ISLAMIC RETAIL PRODUCTS

Islamic retail products must comply with very different, and at times contradictory, requirements from a variety of social and legal fields. This makes the structuring of Islamic retail products challenging. First, and most important from the customer's perspective, a product must conform to the principles of Shari'ah. This is the core principle of Islamic finance and gives it legitimacy in the eyes of the target group. Second, the product must comply with the laws and regulations of the jurisdiction where the product is offered. It must conform, for instance, to consumer protection laws, as well as to banking regulations. As will be discussed in more detail below, European legal systems make very few exceptions for Islamic financial products, and it is unlikely that more exceptions will be granted in the future. Third, the products must be competitive from an economic perspective. People might have a certain willingness to invest in their faith and may be prepared to deal with minor disadvantages provided that the respective financial product conforms to religious principles. The economic burden, particularly adverse tax effects, must not be excessive, as this deters potential customers.

From this, it follows that the development of Islamic retail products poses challenges in different areas. This section will look closely at some of these challenges, including the formulation of Shari'ah principles, the adjustment of Islamic finance to consumer protection laws, the avoidance of adverse tax effects, and the issue of dispute resolution. I will not focus on doctrinal details, but will instead emphasize the problem-solving procedure. In light of the experience in the English market, the aim is to discuss how to approach these issues in other jurisdictions. I argue that the success of structuring Islamic retail products depends on a certain institutional arrangement, which facilitates a dialogue among financial institutions, financial regulators, and Muslim communities. This also requires taking local regulations seriously, as institutional arrangements vary among countries.

A. LOCAL RETAIL PRODUCTS-GLOBAL ISLAMIC PRINCIPLES?: WHY THERE IS NO "ONE SIZE FITS ALL" IN THE ISLAMIC RETAIL MARKET

A bank intending to offer a Shari'ah-compliant product has various options to validate its claim of compliance with Islamic principles. The most straightforward method for an entrant into the market may be to simply copy a

successful product offered by a competitor in another EU market and bring it to Germany. This is indeed the origin of many (maybe most) conventional financial innovations that have evolved over the last decades in Germany. But for an Islamic financial product, copying is not a feasible alternative. The reason is that an Islamic financial product gains its competitive advantage not merely because of its commercial terms but also because of an ethical, non-economic compliance with Islamic law. Islamic legitimacy cannot be generated by simply copying a product. Legitimacy must be perceived by the target audience. Moreover, Muslim communities throughout Europe are different and, consequently, must each be approached differently.

With regard to consumer products, one alternative to copying the product of a foreign competitor is to seek guidance from one of the internationally accepted standards. The most prominent organization developing standards in the field of Shari`ah compliance is the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI"), a non-governmental organization based in Bahrain that has been active in formulating Shari`ah rules and other standards for the Islamic finance industry for approximately fifteen years.⁹ The AAOIFI has been extremely successful and its work is invaluable to those concerned with or involved in Islamic finance. The focus of the AAOIFI, however, has been the "big ticket" market and not the retail market. In addition, the AAOIFI does not develop products; it simply establishes a framework within which products can be developed. Furthermore, even institutions that heavily rely on the AAOIFI will normally also retain an internal or external Shari`ah board that supervises compliance with these principles. As a result, standardization in the fashion carried out by the AAOIFI may help provide some orientation, but it will not solve the problems encountered when structuring a concrete product. The global standardization efforts by themselves do not solve the problem at the local level.

What remains is to design a product tailored specifically to the German market. Normally, a product is developed in cooperation with a team of scholars, who in the end also approve a concrete model transaction. Over the last few years, a number of institutions and individuals have earned reputations as Shari`ah advisors. In addition, certain Shari`ah advisory firms that provide Shari`ah advice on a consultation basis have been established. But for centuries, the Islamic Shari`ah has been a discursive legal system with a fair degree of pluralism (or uncertainty) in terms of black letter rules. Diversity of opinion and pluralism has been essential to the Shari`ah, as it has allowed for flexibility to meet the demands of changing social and economic circumstances as well as regional demands. This also is reflected in the present day discourse among

⁹ For more information, see <<http://www.aoifi.com>> (visited Jan 15, 2007).

Shari'ah scholars regarding Islamic financial innovations. Consequently, the authority a certain scholar enjoys may also depend on affiliation with a particular school of law, a respected Islamic institution, or even ethnic background. This is not to negate the fact that "big ticket" Islamic financing transactions have generated a new kind of Islamic "transnational" *lex mercatoria* (law merchant). Nor do I intend to question the fact that there is a global discourse among Islamic scholars (particularly on the Internet) on topics such as Islamic banking. But on the local level—and this level is ultimately the most relevant when structuring Islamic retail transactions—regional and ethnic differences may actually play a role and must be taken seriously.

This means that, to some limited extent, Shari'ah certification also has a local component. Here, the differences between the English and Germany are relevant.¹⁰ In the UK, the setting can be defined by four characteristics:

- (i) A majority of Muslims are from Pakistan, a country that officially endorses Islamic economic principles and the prohibition of *riba*. Pakistan, for many years, has been at the forefront of efforts to comprehensively "Islamize" the financial sector;¹¹
- (ii) A fair number of Muslim think tanks exist as well as Shari'ah scholars versed in financial matters. There is also an indigenous British Shari'ah discourse. London, as both a financial and Muslim cultural capital, has fostered this development;¹²
- (iii) A tradition of academic research in Islamic law with a practical orientation affiliated, in particular, with the department of law at the School of Oriental and African Studies.¹³ The legacy of administering Islamic law in India, Africa, and South Asia persists such that Islamic law is perceived as a subject of practical application; and

¹⁰ For an informative overview of the factual situation of Muslim communities in Europe, as well as of the applicable legal framework (including in the UK and Germany) see Jan Rath, et al, *Western Europe and its Islam* (Brill 2001); Silvio Ferrari and Anthony Bradney, eds, *Islam and European Legal Systems* (Dartmouth 2000). The juxtaposition of the German and the UK institutional arrangement in this Article is informed by recent economic studies arguing that institutional arrangements vary from one economy to another and that such institutional arrangements also influence the shape concrete transactions take. See Peter A. Hall and David Soskice, eds, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford 2001).

¹¹ See, for example, Robert M. Hathaway and Wilson Lee, eds, *Islamization and the Pakistan Economy* (Woodrow Wilson Intl Ctr 2004), available online at <http://wwics.si.edu/topics/pubs/Asia.Pakistan_econ.pdf> (visited Jan 15, 2007).

¹² See, for example, Institute of Islamic Banking and Insurance, <<http://www.islamic-banking.com/index.html>> (visited Jan 15, 2007); Dar Al Istithmar, a joint venture between Deutsche Bank, Russell Wood, and Oxford Islamic Finance, information for which is available online at <<http://www.daralstithmar.com>> (visited Jan 15, 2007).

¹³ For more information, see <<http://www.soas.ac.uk/centres/centreinfo.cfm?navid=17>> (visited Jan 15, 2007).

- (iv) A widely understood language that helps incorporate Shari`ah knowledge from abroad. In addition to Arabic and Urdu, English is the leading language of today's Shari`ah discourse. This means that a rich reservoir of sources on Shari`ah issues is available in the English language.

By contrast, Germany differs in that:

- (i) A majority of the Muslim population is of Turkish descent and has, in the past, accepted living in a laic state with a non-Islamic economic order. Islamic finance in Turkey is limited to a minority subsector and at times officially discouraged, therefore any influence on its minority Muslim population is very limited;¹⁴
- (ii) Muslim think tanks came into being only recently.¹⁵ Islamic scholars normally are not interested in economic matters and there is only a very limited Shari`ah discourse. In terms of coherent organization and intellectual output, German Muslim communities are lagging behind British Muslim communities. The indigenous discourse on Islamic issues is in a rather nascent stage, as far as economic and financial matters are concerned;
- (iii) Islamic law is in the hands of scholars (not of practitioners), the majority of whom are not directly affiliated with the Muslim communities.¹⁶ There is a rich, mostly academic, tradition of scholarship in the area of Islamic law, including names such as Ignaz Goldziher, Gotthelf Bergsträsser, and Joseph Schacht. Very few Islamic law specialists, however, are interested in the practical application of Islamic law in Germany and do not shy away from legal policy debates;¹⁷ and
- (iv) Very few internationally renowned Shari`ah scholars speak German. Thus, the German discussions tend to be isolated from international developments. This makes it difficult to "catch up" by simply importing knowledge from abroad.

This comparison reveals the difficulty in trying to mimic the English experience in Germany. There is a shortage of local scholars who can lend a voice to the Muslim population, and it is difficult to bring in Shari`ah expertise from the outside. As a result, there is a lack of competent Shari`ah advisors who

¹⁴ For information on Islamic Finance in Turkey, see Fuad Al-Omar and Mohammed Abdel-Haq, *Islamic Banking: Theory, Practice, and Challenges* 63–83 (Oxford 1996).

¹⁵ See, most notably, the establishment of Muslimische Akademie in 2004, an institution which intends to provide a forum for German Muslims in order to discuss political and social issues. Information is available online at <<http://www.muslimische-akademie.de>> (visited Jan 15, 2007).

¹⁶ It is worth mentioning that recently the University of Münster has established a specialized chair for the Religion of Islam, which shall serve to train German Imams. The appointee, Professor Muhammad Kalisch, also is trained as a lawyer. Bibliographic information is available online at <<http://www.uni-muenster.de/ReligioeseStudien/islam/Personen>> (visited Jan 15, 2007).

¹⁷ Notable exceptions are Professor Mathias Rohe at University of Erlangen and Dr. Nadjma Yassari at the Max Planck Institute for Comparative and International Law in Hamburg.

could assist with the development of Islamic financial products. This situation can only be resolved by both increasing the awareness regarding financial issues and improving practical education in Shari`ah matters.

B. MANDATORY CONSUMER PROTECTION LAWS VERSUS ISLAMIC LEGAL PRINCIPLES: LIABILITY OF BANKS UNDER MURABAHA AGREEMENTS

In Germany, a country that features its *Autobahn* so prominently, the car is an important asset. This is why my first practical example will be taken from the area of automotive finance.

In countries with a fairly developed Islamic retail market, such as the UAE or Malaysia, most car finance schemes are based on a *murabaha* contract. The bank acquires the car selected by the customer, who, in turn, purchases it from the bank on a cost-plus basis, paying the purchase price in deferred installments.¹⁸ From a Shari`ah perspective, the transaction is a sales transaction in which the bank is engaged in trade, therefore justifying the profit margin. From an economic angle, this resembles a financing transaction where the bank facilitates the customer's acquisition. Since most banks do not intend to take on any responsibility for potential defects of the car, which was selected and inspected by the client, the structure depends on an exclusion of warranty claims against the bank. The bank in turn assigns the warranty claims to the customer who, if so required, can bring the claims directly against the car dealer.¹⁹ The arrangement is somewhat similar to the arrangement under a financial lease.

From the perspective of the European Union consumer protection rules, a *murabaha* structure based on a sales contract raises concerns. Pursuant to Article 3 of Directive 1999/44/EC of May 25, 1999 (Sale of Consumer Goods), a commercial seller acting in connection with his or her business may not exclude

¹⁸ The mechanics of this contract type are discussed at some length in Kilian Bälz, *A Murabaha Transaction in an English Court* - The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors*, 11 Islamic L & Socy 117 (2004). For a basic contractual model, see <http://www.iibu.com/buy_home/murabahahow.htm> (visited Jan 15, 2007).

¹⁹ A typical clause reads:

(i) Payment: The Customer shall pay the Installments on the Due Date as set forth in the Annex to this Agreement. (ii) The Customer had the opportunity to duly inspect the Asset and all and any of the Customer's claims and remedies with regard to defects, late delivery or non-delivery of the purchased Asset are excluded. The Customer explicitly waives all and any claims against the Financial Institution based on or related to the supply of the Asset. (iii) The Financial Institution herewith assigns all and any of its claims against the Supplier based on or relating to the supply of the Asset, existing and future, to the Customer and shall inform the Supplier of the respective assignment in an appropriate form. The Customer accepts such assignment.

its contractual warranty claims if he or she sells a new chattel to a consumer.²⁰ The rule is designed to safeguard the buyer's rights vis-à-vis the commercial seller by not allowing the latter to totally and unfairly exclude warranty claims. The seller also may not refer the consumer to a third party in lieu of attending to the warranty claims itself. From this it follows that the bank, under a *murabaha* structure, may have to fully assume the position of a car dealer by dealing with defects of the car during the warranty period. This is a risk banks are normally not willing to take. Banks are experts in assessing credit risks, but are normally unenthusiastic about trading in cars. Nor are the regulators excited if financial institutions engage in such activities, which are clearly outside the institutions' core competence. This is a typical example of how European consumer protection rules do not completely contradict, but still materially hinder, the dissemination of established Islamic financing practices.

In the UK, a Muslim seeking Shari'ah-compliant car financing presently has two options: the communal option and the commercial option. Under the communal option, offered, for example, by Ansar Finance, the person joins an association, makes certain regular contributions, and, upon expiration of a certain period of time, takes out a *qard hasan* (interest-free loan).²¹ This scheme seems to be an effective way of organizing credit within a defined community and resembles nineteenth century credit cooperatives. In addition, it is close to the social idea of Islamic banking, where the "cooperative" or "communal" element plays an important role. The downside of this scheme is that it is not suited to serve the community at large. It can only serve a limited number of people forming a local community, and the funds that are made available under this scheme are rather limited. In addition, it depends on personal trust and is not suited for the "industrialized" business of retail banking. A typical commercial scheme, in contrast, would be the one offered by Islamic Bank of Britain.²² Here, consumer credit is based on a *tawarruq* structure. The bank trades in commodities on behalf of the client, who receives funds for a purpose of his or her choice. On its face, this transaction is the same as a conventional consumer finance transaction. The difference, however, is that from the bank's perspective the transaction is asset-based. If it involves acquiring a car, the bank will not be involved in purchasing the car. Instead, it will carry out a commodity

²⁰ Council Directive 1999/44/EC, art 3, 1999 OJ (L 171), available online at <http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=31999L0044&model=guichett> (visited Jan 15, 2007).

²¹ For details, see <<http://www.ansarfinance.com/ServicesPersonalLoans.asp>> (visited Jan 15, 2007).

²² See Islamic Bank of Britain, *How Do We Generate Cash for the Personal Finance Facility?*, available online at <<http://www.islamic-bank.com/islamicbanklive/PFGenerateCash/1/Home/1/Home.jsp>> (visited Jan 15, 2007).

transaction with risks that are much easier to calculate and to control. Although this might be a pragmatic approach that Islamic banks can take towards consumer credit in general, the Islamic legitimacy of *tawarruq* transactions remains disputed.²³ The reason is that the permissibility of *tawarruq* is based on a rather formalist understanding of the principles of Shari'ah, whereas many Islamic scholars argue in favor of a more substantive approach, which requires the financial institution to take on at least a certain business risk and to be involved in the concrete transaction.

Approaching the issue from the German angle, there are two possible solutions. One is to search for a doctrinal exemption for *murabaha* transactions and employ the doctrinal concepts of German law in order to find a niche for an Islamic finance product. The predominant opinion is that the provision banning the exclusion of warranty claims does not apply to financial leases with a purchase option that effectively works like a sales contract.²⁴ As such, it would be possible for the bank to purchase the car on behalf of the customer and to then lease the car (under an Islamic lease agreement, a so-called *ijara*) during the warranty period to the customer, who, once the period lapses, would be under an obligation to purchase it. Furthermore, at that point in time the car is used and Article 3 of the 1999/44/EC Directive does not apply. This *murabaha-ijara* structure may help to get around the restrictions of consumer protection laws without offending either of the legal orders involved. The structure is based on an interplay between Islamic and secular legal principles that intends to use existing flexibility to bring both legal systems in harmony.

Alternatively, the issue could be addressed at the level of the bank-dealer relationship. Here, the bank could enter into an agreement with certain selected car dealers whereby the car dealers: (i) would indemnify the bank from any and all warranty claims raised by the customers; and (ii) provide required repair and maintenance services for free during the warranty period. The latter approach has the downside of the bank relying on ongoing relationships with selected car dealers. This may be an option for certain banks specializing in car finance. Such banks are often institutions affiliated with a certain manufacturer.²⁵ It may be

²³ See, for example, Shaykh Nizam Yaquby, Presentation at the Sixth Harvard University Forum on Islamic Finance, Harvard Law School (May 9, 2004), paper available at the Islamic Legal Studies Program at Harvard Law School and on file with the author. In any event, there seems to be a consensus within the Muslim community that *tawarruq*, being a subterfuge rather than a real asset-based transaction, is not desirable and should be used in exceptional circumstances only. Nevertheless, its use is widespread in Islamic finance, both on the "big ticket" and the retail level.

²⁴ See Walter Weidenkaff, in Otto Palandt, *Bürgerliches Gesetzbuch* (German Civil Code) § 457 ¶ 6 at 656–57 (Munich 66th ed 2007).

²⁵ It should be noted, however, that the bulk of the car financing business in the German market is probably carried out by specialized financial institutions, which are affiliated with certain car

less attractive for a commercial bank that does not wish to get involved in automotive financing.

C. LEGISLATIVE EXEMPTIONS VERSUS SHARI`AH INNOVATIONS: THE ISSUE OF DOUBLE TRANSFER TAXES

Islamic retail transactions are most at odds with the secular legal order with regards to the issue of double transfer taxes, or double stamp duty, as the issue is referred to in the UK. This issue is normally triggered by Islamic home financing schemes, at least if based on the *murabaha* model.

The underlying issue is straightforward. Under a *murabaha* transaction, there is a double transfer of property: first from the seller to the bank and then from the bank to the customer. Shari`ah scholars, moreover, usually insist that the bank must acquire "ownership" of the financed property,²⁶ which normally translates to "legal title" in secular property law. Although the bank will normally own the house only for a moment, this suffices to trigger transfer taxes, both under UK tax laws and the German Real Estate Transfer Tax Act.²⁷ The result is that under an Islamic home financing scheme, double transfer taxes will be due, which makes such transactions less economically competitive. As long as an Islamic home financing scheme triggers double transfer taxes, it is difficult to market them on a large scale as they are at a material competitive disadvantage compared to conventional modes of finance. Few customers will be willing to make such a financial investment in their faith knowing that money paid as taxes will end up in the pocket of the relevant tax authority rather than an Islamic charity.

The English approach to this issue is well-known. In order to resolve this and other issues raised by Islamic financing transactions in the UK, the Financial Services Authority ("FSA") created a working group consisting of regulators, Shari`ah scholars, bankers, accountants, lawyers, and representatives of the Muslim communities. The FSA working group discussed how to integrate Islamic financing transactions into the English legal framework. Consequently, an amendment to UK tax law was enacted, which explicitly exempts Islamic home finance from the double stamp duty.²⁸ The result is a partial exemption of

manufacturers (auto banks). This may make this solution feasible. However, specialized car financing banks normally focus on standard mass transactions based on rather low margins. Specialized auto banks therefore may shy away from the additional transaction costs triggered by setting up Shari`ah-compliant schemes, which will only target a niche market.

²⁶ AAOIFI, *Shari`a Rules for Investment and Financing Instruments* 1422H 11 (AAOIFI 2001)

²⁷ Grunderwerbsteuergesetz (GrEStG) Feb 26, 1997 BGBl. I at 418, § 1 (1) no. 1.

²⁸ See United Kingdom Finance Act, pt 4, § 73 (2003), available online at <<http://www.opsi.gov.uk/acts/acts2003/30014--e.htm#73>> (visited Jan 15, 2007).

Islamic financing transactions from selected provisions of English law. This exemption is restricted to well-defined, singular matters and is not the starting point of a parallel regulatory system for Islamic financial institutions as exists, for instance, in Malaysia and Bahrain.²⁹ Rather, the exemption is limited to specific provisions of English law that happen to have an unintended discriminating effect on Shari'ah-compliant structures, thus restoring their competitive standing with respect to conventional products.

Under German law, however, the double taxation issue remains to be solved, and there are several avenues that can be pursued. First, one might consider an approach similar to the one in the UK and create an ad hoc exemption. This is consistent with the approach German law has taken regarding Muslim minority affairs in other areas such as ritual slaughtering (so called "*schächten*"). For example, although slaughtering outside the conventional methods is prohibited by German law, the German Animal Welfare Act (*Tierschutzgesetz*) provides for an exemption if it is required by the needs of members of certain religious communities "whose mandatory rules require ritual slaughter."³⁰ Ritual slaughtering, to the extent required by Islam, is therefore permissible to the extent required by mandatory Shari'ah principles, although *ritual slaughtering*, as a matter of principle, is deemed to be in conflict with animal welfare protection rules.³¹ A similar exemption could be introduced into the Real Estate Transfer Tax Act. Because there is no equivalent to the FSA working group in Germany, it may be difficult to get the parliamentary and ministerial support required to enact that solution. To date, the dialogue in Germany among professional groups regarding Islamic finance is little-developed. This makes it difficult to coordinate efforts to amend existing tax laws. As a result, it may be worth considering other ways of approaching the issue. In particular, one can consider whether the Islamic notion of "ownership" is the same as the notion of legal title in German civil and tax laws. If it is possible to argue that the bank acquires legal title only under Islamic law, but not pursuant to German law, then it is possible to argue in favor of an exemption of the transaction from double stamp duty without amending existing tax laws. The transaction would take advantage of the regulatory arbitrage between the Islamic and the German

²⁹ For more information on Bahrain's regulatory system, see Bahrain Monetary Agency, available online at <<http://www.cbb.gov.bh/cmsrule/bmaindex.jsp>> (visited Jan 15, 2007).

³⁰ *Tierschutzgesetz* (German Animal Welfare Act), May 25, 1998 BGBl. I at 1094, § 3 art 4(a)(2)(2).

³¹ For details of the debate, the development of case law, and a discussion of the question of how to reconcile Muslims' freedom of religion (found in Articles 4(1) and 4(2) of the German Constitution) on the one hand with the constitutional obligation of the state to "protect the natural bases of life" (found in Article 20(a) of the German Constitution) on the other, see Hans-Georg Kluge, *Das Schächten als Testfall des Staatszieles Tierschutz*, 25 *Neue Zeitschrift für Verwaltungsrecht* 650 (2006).

legal system. It would make productive use of the diverging views of different legal orders on the same set of facts.

D. SHARI`AH APPELLATE BODIES VERSUS STATE COURTS: DISPUTE RESOLUTION

Among the unsettled issues in Islamic finance is that of dispute resolution. Although there is some scattered case law from English and Malaysian courts,³² the question of how to deal with disputes arising out of Islamic financing transactions remains. There are two reasons for concern. First, Islamic financing transactions are structurally different from conventional transactions, making it difficult for a court that is neither versed nor interested in Shari`ah matters to adjudicate any legal disputes. Second, in retail matters, the parties may enter into Islamic transactions with a special expectation that the transaction conforms with Shari`ah rules. It is questionable whether a state court will be suited and prepared to give an opinion on Islamic legal issues to the extent they arise. Both peculiarities of Islamic financing transactions may counsel against submitting respective disputes to the state judiciary. Nevertheless, especially where consumer transactions are concerned, there is also a good argument to ensure the same level of protection that would exist if the dispute were handled by a state court. This suggests that the possibility of obtaining recourse from the state courts should remain available.

There are three possible solutions to this dilemma. The first and most obvious option is to vest state courts with the authority to rule on Islamic financing disputes. This is consistent with the general approach in consumer matters. But a problem with this approach is that, at least as far as Germany is concerned, there is little knowledge of Shari`ah law among the members of the judiciary. There are, however, certain precedents that suggest judges are willing to take Shari`ah rules seriously and spend considerable effort in determining their content, particularly in family disputes.³³ This case law, thus far confined to matters of personal status and inheritance, may serve as a basis on which a comparable corpus of rules for commercial transactions can be built. But in disputes involving foreign commercial law, outcomes are rather difficult to predict in the absence of any established case law.³⁴ In addition, previous

³² For a detailed analysis, see Kilian Bälz, *Islamic Financing Transactions in European Courts*, in Syed Nazim Ali, ed, *Islamic Finance: Current Legal and Regulatory Issues* 61 (Harvard: Islamic Fin Proj 2005).

³³ For a good overview, see Mathias Rohe, *Islamic Law in German Courts*, 1 *Hawwa* 46 (2003).

³⁴ One may question whether Shari`ah rules will, from the perspective of English and German law, formally qualify as foreign law. Under the established doctrines in private international law, the notion of law is synonymous with state law. This means that transnational legal principles, such as

experience suggests that the courts will not attempt to go into the details of any Shari'ah issues. As a result, courts may settle the individual dispute on a commercial level, but it cannot be expected that the decision will necessarily enjoy authority in the relevant Islamic communities.

The second option is to refer the dispute to arbitration. Arbitration tribunals typically have more freedom regarding the rules they apply to the dispute. If the parties wish, an arbitration tribunal can decide a dispute according to the principles of the Islamic Shari'ah. Further, there are a number of precedents in which arbitration tribunals have applied Islamic legal principles to a dispute. Overall experience suggests that it has worked well.³⁵ A state court, in contrast, cannot be expected to apply anything but state law.³⁶ With regard to consumer affairs, one crucial aspect counsels against this approach. In most jurisdictions, consumer matters are exempt from arbitration, seriously curtailing dispute resolution.³⁷ The legislature is usually concerned that arbitration tribunals are not well-suited to protect the interests of the weak, given the reluctant and at times arbitrary application of consumer protection laws by tribunals. This would make mandatory arbitration in Islamic retail transactions inconsistent with the overall system of consumer protection. It would, in particular, foster concerns that members of the Muslim community would not receive the full protection of state law. This issue has attracted much attention recently, especially with regard to the application of Muslim family law.³⁸

The third option represents a middle-ground position: a permanent appellate body dealing with Islamic financial disputes, whose decisions are subject to scrutiny and review by the courts. Such an appellate body would be advantageous because, as an arbitration tribunal, it would be less restrained with

the Shari'ah principles applied by Islamic banks, would not qualify as law at all. Nevertheless, in determining the substance of those rules, the courts would rely, both in the UK and in Germany, on experts. The major difference may be that an English court would expect the parties to present expert evidence, while a German court may also appoint a respective expert *ex officio*.

³⁵ See Almas Khan, Development, *The Interaction between Shariah and International Law in Arbitration*, 6 Chi J Int L 791, 793 (2006).

³⁶ This, at least, is the predominant opinion under both English and German law. See Bälz, *Islamic Financing Transactions* (cited in note 32) (discussing English and German case law).

³⁷ See United Nations Commission on International Trade Law, *Model Law on International Commercial Arbitration* at art 1 (1), UN Sales No E.95.V.18 (2004), available online at <http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671_Ebook.pdf> (visited Jan 15, 2007) (confining arbitration to "commercial" matters, hereby excluding consumer transactions).

³⁸ For example, there has recently been a great deal of debate in Ontario regarding Premier Dalton McGuinty's decision to rescind the authority of faith-based arbitration tribunals in settling family disputes. For a general discussion, see Mike Funston, *Muslims Vow Fight to Keep Sharia Law*, Toronto Star A23 (Sept 15, 2005).

respect to the legal principles it applies and more flexible with respect to the judges it appoints. Nevertheless, it would be a permanent body and expected to be well-equipped to adjudicate consumer complaints. It would be expected to publish its decisions, and its proceedings would, as in a court, be open to the public. The Shari`ah appellate body could be set up by the banks involved in Islamic finance and staffed with specialized lawyers who are versed in both banking matters and Shari`ah law. It could provide for "mixed" benches presided over by an experienced civil judge versed in procedural matters along with a Shari`ah scholar and a banking law specialist. Such an appellate body would be well-suited to bring together the different perspectives that are required in order to decide Islamic financing disputes in a way that is both fair from the perspective of consumer protection law and legitimate in the Muslim community. The activity of the appellate body would be supervised by the state courts, to which any party may appeal if it feels aggrieved by the decisions of the appellate body.

IV. CONCLUSION

In conclusion, let me summarize the findings of this Article and make some concrete proposals on how to take things forward.

There is no "one size fits all" approach in Islamic retail finance. Islamic retail finance transactions must always be adjusted to the local environment in which they are supposed to operate. Certain institutional arrangements can help the growth of the Islamic finance industry as illustrated in the comparison between the English and the German cases.

To successfully implement Islamic retail financing transactions, it is necessary to carefully analyze the local environment in which these transactions shall operate. The local environment is composed of the state regulatory framework and includes tax laws and mandatory consumer protection rules. It goes without saying that an Islamic retail transaction must be compliant with the mandatory rules of the jurisdiction in which it is implemented. In view of the different requirements of different jurisdictions, the simple transfer of a transactional form from one jurisdiction to another is not feasible and may, in fact, require substantial amendments and adaptations to the transactional form. Paying tribute to local peculiarities, moreover, also extends to Shari`ah issues. An Islamic retail product must be tailored with a view to a specific Muslim community. It depends on local Shari`ah scholarship reflecting the needs of the respective community. Although the Shari`ah is a global ideal, it hosts different local interpretations which need to be born in mind when designing a Shari`ah compliant retail product. As a result, Islamic retail products depend on a double acculturation, namely the adaptation to the requirements of mandatory state law

and the target Muslim communities. In that process, flexibility is required both on the side of the regulator and on the side of Islamic scholars.

In order to adjust Islamic retail transactions to local markets, it is advisable to initiate a process of “professionals in dialogue” also in countries such as Germany. Gathering problem solving capabilities will help foster innovative solutions, both in the area of Shari`ah law and the legal framework in which Islamic retail transactions work. Innovations can only be brought about by a simultaneous development of both state and Shari`ah law. Such a development is fostered by a dialogue which brings together the different perspectives. Innovation, moreover, will always depend on taking advantage of the specificities of both the Shari`ah and the respective national legal order. Using regulatory arbitrage can be a way to reconcile Shari`ah requirements with mandatory state law. Using regulatory arbitrage is a permissible tool when structuring complex transactions. Finally, the discursive development of Islamic retail products must be mirrored on the dispute resolution side. Shari`ah appellate bodies, established by the industry and supervised by the state judiciary, may be the most efficient way to tackle that issue.