

# The Regulation of Islamic Finance in the UK: A call for change

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## ABSTRACT

*For decades, the UK has been the leading nation in the Western world when it comes to Islamic finance. Despite this fact, the Islamic banking industry within the UK is still far behind conventional finance in terms of growth and development. This article argues that a major obstacle in the path of this industry's growth is the regulatory framework which it is currently subject to. As it stands, Islamic banking is regulated by the Financial Conduct Authority and the Prudential Regulation Authority in the same way as its conventional counterpart. This represents an obstacle for the growth of the industry since it subjects Islamic finance to rules created with only conventional banking in mind. This article posits that the current regulatory framework should change so that it accounts for the unique features of Islamic banking. Chapter 1 of this article contextualises the debate by describing the operation of Islamic banking before going on to highlight how the risks involved in this type of banking differ from those inherent in conventional banking. Chapter 2 builds on this analysis by examining the interplay between Islamic banking and two regulated aspects of banking: capital adequacy ratios ('CARs') and guaranteed deposits. Chapter 3 concludes the discussion by pointing out a number of issues which could undermine the adoption of a more industry-specific approach by the UK regulators and offers starting points from which these issues could be resolved.*

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## INTRODUCTION

Having only begun in the 1970s, Islamic finance is still a relatively new industry compared to the longstanding history of conventional finance. Despite that, the Islamic finance industry has grown considerably and continues to be on an upwards trajectory. By 2019, it had amassed \$2.4 trillion in assets,<sup>1</sup> which represents an 11% increase from the year prior and a 33% increase from 2015. Noteworthy is the fact that banking assets represent the largest share of assets at 72.4%.<sup>2</sup>

A common misconception is that Islamic finance is only prevalent in Muslim-majority countries. On the contrary, Islamic finance not only exists in Western countries, but it also represents an ever-growing part of these countries' financial markets.<sup>3</sup> This is especially so in the UK. An explanation for the growth of Islamic finance in the UK includes the fact that it is a way to diversify the financial markets and gain access to capital held by potential customers (especially devout Muslims) who are hesitant to make use of conventional banking.<sup>4</sup> For these reasons and more, the Islamic finance market in the UK has grown to make it *'the pre-eminent centre for Islamic finance'* outside the Muslim world.<sup>5</sup>

The financial industry in the UK is regulated by two bodies: the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA).<sup>6</sup> The FCA's responsibilities include promoting effective competition and conduct of business regulation while the PRA is responsible for ensuring 'the safety and

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<sup>1</sup> Andrew Hauser, 'Why Islamic finance has an important role to play in supporting the recovery from Covid – and how the Bank of England's new Alternative Liquidity Facility can help' (Bank of England Speech, 2 December 2020) 2 <<https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/why-islamic-finance-has-an-important-role-to-play-in-supporting-the-recovery-from-covid.pdf>> accessed 1 July 2021.

<sup>2</sup> *ibid.*

<sup>3</sup> Arshadur Rahman, 'Islamic banks and central banking' (2017) Q3 Bank of England Quarterly Bulletin 155, 156.

<sup>4</sup> Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia* (Routledge 2013) 153.

<sup>5</sup> Hauser (n 1).

<sup>6</sup> Though they are two separate bodies, this article uses 'UK regulators' as a shorthand.

soundness of the financial system'.<sup>7</sup> Regarding Islamic finance, the UK regulators have understandably never attempted to supervise the Shariah compliance of the products offered by Islamic financial institutions, as this is a socially sensitive issue best dealt with by more capable bodies, such as the Shariah Supervisory Boards ('SSBs') typically employed by Islamic banks.<sup>8</sup> Beyond that, the general policy of the UK regulators when it comes to regulating Islamic finance has been (and continues to be) 'no obstacles, no special favours'.<sup>9</sup> The rationale for this approach is 'to ensure a level playing field for Islamic finance products and conventional instruments'.<sup>10</sup> While such a seemingly non-discriminatory approach appears fair and justifiable on paper, a deeper examination of the operation of Islamic finance calls this approach into question.

Given the UK's current approach to regulating Islamic finance, this article argues that, because of how different Islamic finance is from conventional finance, a new approach to the regulation of Islamic finance which accounts for these differences is needed in the UK. It argues so on the basis that this would be fairer and better commercially for Islamic financial institutions and the Islamic finance industry as a whole. For the purposes of this article, a 'fair' regulatory framework is one which accounts for the specific features of the entities and activities it seeks to regulate. Though fairness entails more than this, the goal of narrowing its definition in such a manner is to directly address the fact that Islamic finance is currently at a disadvantage because it is constrained by regulation tailored to conventional finance.

In addition to being fairer, such an approach would also be better for the industry commercially, since, as will be elucidated throughout the article, it would diminish the impact of the current constraints on Islamic finance and

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<sup>7</sup> Jonathan Ercanbrack, *The Transformation of Islamic Law in Global Financial Markets* (Cambridge University Press 2015) 188.

<sup>8</sup> Ercanbrack (n 7) 203.

<sup>9</sup> Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (*Financial Services Authority (FSA)*, November 2007), 11 <[https://www.isfin.net/sites/isfin.com/files/islamic\\_finance\\_in\\_the\\_uk.pdf](https://www.isfin.net/sites/isfin.com/files/islamic_finance_in_the_uk.pdf)> accessed 18 June 2021.

<sup>10</sup> John Dewar and Munib Hussain, 'United Kingdom' in John Dewar (ed) 'Islamic Finance & Markets 2020' (*Lexology Getting the Deal Through*, September 2019), 30 <<https://www.milbank.com/images/content/1/2/v3/122311/edition-800-chapter-22-191015144948908-islamic-finance-markets-2.pdf>> accessed 23 July 2021.

allow it to be more aligned with the theoretical model of Islamic finance which, in turn, will allow this industry to expand. Though finance entails much more than merely banking, this article focuses on Islamic banking and, more specifically, retail Islamic savings accounts, as these are the banking assets referred to the most in the literature consulted for this article. The reason for this is that, as mentioned above, banking represents the largest share of the Islamic finance industry in terms of assets.

Chapter 1 of this article begins by providing the context necessary to understand how Islamic banking operates as well as analysing how this is different from conventional banking in terms of risks. Next, Chapter 2 makes use of two case studies to advance the overall argument by analysing the interplay between Islamic banking and two regulated aspects of banking: capital adequacy ratios (CARs) and guaranteed deposits. Then, Chapter 3 discusses and provides starting points from which to resolve various issues which one could argue would undermine the ability of the UK regulators to adopt a more industry-specific approach to regulating Islamic banking.

## **CHAPTER 1: THE OPERATION AND RISKS OF ISLAMIC BANKING**

Before discussing the main subject of this chapter, it is important to understand why Islamic finance exists in the first place. In short, it came about because many of the instruments used in conventional financing have been deemed to contravene certain restrictions set by the Shariah. In particular, *riba* and *gharar* have long been recognised as the ‘main prohibitory rules which are unanimously acknowledged’.<sup>11</sup> Though the precise definition of both of these concepts could be the subject of a separate article, in a general sense, *riba* refers to ‘unlawful advantage by way of excess’ and *gharar* refers to excessive ‘uncertainty, risk and speculation’.<sup>12</sup> Many of the instruments commonly used in financial markets violate the Shariah’s prohibition of *riba* and *gharar*. For instance, interest payments violate the *riba* prohibition while insurance and guarantees violate the *gharar* prohibition.

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<sup>11</sup> Nabil A Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking* (1st edn, Cambridge University Press 1986) 3.

<sup>12</sup> *ibid.*

Given how central these instruments are to modern finance, it seems harsh that Islamic law prohibits their use. However, these restrictions have been put in place for several reasons. Principally, the activities which violate these prohibitions contradict an important maxim in the Shariah: 'liability justifies utility'.<sup>13</sup> In other words, according to Islamic law, tools like interest allow parties to earn money without putting in a justifiable amount of effort.<sup>14</sup> Nonetheless, the prohibition of *riba* and *gharar* have 'long been alleged to be the major impediment to the evolution of Islamic jurisprudence in line with the requirements of modern life'.<sup>15</sup> The development of Islamic finance represents an attempt by Muslim jurists to balance living life according to the Shariah and meeting the demands of modernity.

Despite the imposition of the restrictions on *riba* and *gharar*, Islamic law is not against engaging in economic activity and profit-seeking at all; on the contrary, it favours these activities.<sup>16</sup> These restrictions are only in place to ensure that such activities are done in a way that is in line with the spirit of the Shariah which calls for trust and mutual cooperation.<sup>17</sup> To that end, Muslim jurists and scholars throughout the centuries have laboured to find a way to align economic activities with the Shariah. The result of these efforts is the creation of a plethora of financial contracts which shape the operation of modern-day Islamic finance.

This chapter will begin by elaborating on the Shariah-compliant financial contracts which have shaped the profit and loss sharing (PLS) mode of intermediation used in Islamic banking. Then, the chapter discusses how the risks attached to the PLS mode of intermediation are different from those of conventional banking to argue that Islamic banking should have a regulatory framework which accounts for these particular risks.

## **1) Shariah-Compliant Financial Contracts & the PLS Mode of Intermediation**

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<sup>13</sup> Sami Al-Suwailem, 'Towards an Objective Measure of Gharar in Exchange' (2000) 7 (1&2) *Islamic Economic Studies* 61, 71.

<sup>14</sup> Nayla Comer-Obeid, *The Law of Business Contracts in the Arab Middle East. A theoretical and practical comparative analysis (with particular reference to modern legislation)* (Kluwer Law International 1996) 41.

<sup>15</sup> Saleh (n 11) 3.

<sup>16</sup> Comer-Obeid (n 14) 40.

<sup>17</sup> Al-Suwailem (n 13) 63.

According to Lewis and Algaoud, the existing literature on this area divides the design of bank contracts into debt-based financing contracts and equity-based financing contracts.<sup>18</sup> In a debt-based financing arrangement, lenders are promised payment in the form of specified, interest-based returns (barring default) as well as priority access to the borrower's collateral in the event of default. In equity-based financing contracts, repayments depend on profit performance and the lender has a claim in the borrower's income therefrom. The contracts used in Islamic banking centre on the latter rather than the former since debt-based financing contracts rely on interest, which contravenes the *riba* prohibition. This is the root of the differences between Islamic banking and conventional banking.<sup>19</sup>

Though modern conventional banking makes considerable use of debt-based contracts, the lack of debt-based contracts in Islamic finance should not be viewed as a limiting factor. This is because Islamic jurisprudence has been utilised to 'facilitate an efficient and transparent execution of transaction and financing contracts'.<sup>20</sup> Of these contracts, none is more important to Islamic banking than the *mudarabah* contract. Indeed, Iqbal and Mirakhor go so far as to call it 'the corner-stone of Islamic finance' for its role in the PLS mode of intermediation used in Islamic banking.<sup>21</sup>

The *mudarabah* is a financial contract based on a partnership between two actors: the *rabb al mal* and the *mudarib*.<sup>22</sup> The *rabb al mal*, or the economic agent with capital, provides the funds to the *mudarib*, or the skilled agent. The *mudarib* then uses the funds provided to engage in economic activity with the aim of realising profits. Once the funds are forwarded, the *rabb al mal* is barred from controlling how the *mudarib* uses them, which indicates the need for trust between the two parties.<sup>23</sup> Importantly, the two agents agree at the outset of the

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<sup>18</sup> Mervyn K Lewis and Latifa M Algaoud, *Islamic Banking* (Edward Elgar Publishing 2001) 72.

<sup>19</sup> *ibid.*

<sup>20</sup> Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2nd edn, John Wiley & Sons 2011) 101.

<sup>21</sup> *ibid.* 123.

<sup>22</sup> *ibid.* 103.

<sup>23</sup> Inwon Song and Carel Oosthuizen, 'Islamic Banking Regulation and Supervision: Survey Results and Challenges' (2014) International Monetary Fund Working Paper

arrangement to divide the returns amongst themselves according to a set ratio. If losses are suffered, these must be borne by the *rabb al mal*; the *mudarib* only loses the time and effort they exerted.<sup>24</sup>

The above contract constitutes the basis for the ‘two-tier *mudarabah*’ structure used to facilitate the PLS mode of intermediation which is characteristic of Islamic banking.<sup>25</sup> The first tier consists of the *mudarabah* contract between the bank and the depositor. The depositor in this tier is the *rabb al mal* since they provide the bank with funds to engage in economic activities via the depositing of money. As mentioned above, the two parties will have agreed on a set ratio to divide the profits (usually 80% for the depositor and 20% for the bank).<sup>26</sup> Since the *rabb al mal* is barred from controlling how the *mudarib* uses these funds, the depositor has to trust that the bank ‘has developed a certain expertise in the financial markets and in identifying profitable projects’.<sup>27</sup>

The second tier comes into the equation when the bank, in its capacity as the *mudarib* of the depositor, has found a project it can invest in using the money provided by the depositor. This tier represents the *mudarabah* contract between the bank and economic agents seeking funds (i.e. entrepreneurs).<sup>28</sup> The bank provides these agents with funds it received from the depositor in the first tier so that they may engage in activities which generate profits for themselves as well as the bank. The range of activities these funds can be used for includes the ‘purchase shares in a publicly traded company or privately held equity or [investment] in a specific project, portfolio or through a pooled investment

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14/220, 24 <<https://www.imf.org/external/pubs/ft/wp/2014/wp14220.pdf>> accessed 20 June 2021.

<sup>24</sup> Iqbal and Mirakhor (n 20) 103.

<sup>25</sup> *ibid* 110.

<sup>26</sup> Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, ‘Regulating Islamic Financial Institutions: The Nature of the Regulated’ (2004) World Bank Policy Research Working Paper 3227, 12  
<<http://documents.worldbank.org/curated/en/918931468761945251/pdf/wps3227isla mic.pdf>> accessed 21 June 2021.

<sup>27</sup> Iqbal and Mirakhor (n 20) 103.

<sup>28</sup> *ibid* 110.

vehicle'.<sup>29</sup> The bank then funnels the profits made from these activities back to the *rabb al mal* in the first tier according to the predetermined ratio.

The profit sharing in this 'two-tier *mudarabah*' structure is a feature which is not typical in conventional banking. This means that conventional retail banks do not have nearly as much of a stake in the profitability of the projects they finance as their Islamic counterparts; rather, the profits of conventional retail banks rely on the interest payments made by borrowers. Islamic banks, on the other hand, are much more concerned about the profitability of the activities they fund since their own profits, as well as their ability to provide depositors with returns, are contingent on the profits made by these projects.<sup>30</sup> While this structure is certainly more onerous on its participants, it is necessary since it brings financial intermediation in line with the aforementioned idea that profits can only be earned in a justified way, according to the Shariah, if the party receiving said profits puts in the necessary level of effort.<sup>31</sup> Merely receiving interest payments is considered by Islamic jurists to be a 'source of enrichment without justification'.<sup>32</sup> So, by making its actors have a stake in the investment, the 'two tier *mudaraba*' model ensures that profits earned therefrom are compliant with the Shariah. This unique method of banking gives rise to specific issues around risk, to which this article now turns.

## **2) The Unique Risks of PLS-based Banking**

As shown above, the PLS mode of intermediation used in Islamic banking is different from the interest-based mode of banking used by conventional banks. A consequence of this is that the risks inherent in Islamic banking differ from those in conventional banking, not only in type, but also in scale. For example, credit risk is a type of risk which, though not unique to Islamic banking, is a more pertinent risk in Islamic banking.<sup>33</sup> On the other hand, equity investment risk is a unique risk which arises due to the PLS-based mode of

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<sup>29</sup> Islamic Financial Services Board (IFSB), 'IFSB-1: Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services' (December 2005) 12 <<https://www.ifsb.org/published.php>> accessed 14 May 2021.

<sup>30</sup> *ibid* 112.

<sup>31</sup> Comer-Obeid (n 14) 41.

<sup>32</sup> *ibid* 54.

<sup>33</sup> Aldohni (n 4) 157.

banking described earlier.<sup>34</sup> Using these two risks as examples, this section aims to show that a regulatory framework which is fair and more commercially sensible for Islamic banking is one which accounts for its unique risks.

Credit risk can be defined as ‘the potential that a counterparty fails to meet its obligations in accordance with agreed terms’.<sup>35</sup> With regard to the PLS-based mode of deposit taking, credit risk exists ‘to a degree that is unusual for conventional banks’.<sup>36</sup> When an Islamic bank, in its capacity as *rabb al mal* in the second tier of the two-tier *mudaraba* structure, provides funds to an entrepreneur, what Song and Oosthuizen call an ‘enhanced credit risk’ is created.<sup>37</sup> One reason is that, following the requirements of a *mudaraba* contract, the bank is proscribed from controlling how the entrepreneur uses the funds it receives from the bank. Another reason for this enhanced credit risk is that, unlike conventional banks, Islamic banks are prevented by Shariah from charging defaulters’ interest or imposing other penalties unless delay on the part of the borrower is proven to be deliberate.<sup>38</sup> The heightened level of credit risk which exists in Islamic banking means that it has more potential to cause greater losses in the income of Islamic banks and their customers. Thus, while credit risk is not idiosyncratic to Islamic banking, it is clear that it is a greater concern for Islamic banks than for their conventional counterparts.

As Hassan and Chowdhury note, ‘[t]he Islamic financial system exposes depositors to risks that traditional bank depositors do not face’.<sup>39</sup> Equity investment risk is one such risk since it is a risk that is ‘exclusive to Islamic banks’.<sup>40</sup> It can be defined as the risk ‘arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk’.<sup>41</sup> The existence of this risk in the context of Islamic banking is a direct result of using equity-based instruments like

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<sup>34</sup> *ibid.*

<sup>35</sup> IFSB (n 29) 1-2.

<sup>36</sup> Mohammad Kabir Hassan and Muhammad Abdul Mannan Chowdhury, ‘Islamic Banking Regulation in Light of Basel II’ (2004) 27 *The American Journal of Islamic Social Sciences* 74, 88.

<sup>37</sup> Song and Oosthuizen (n 23) 24.

<sup>38</sup> *ibid.* 25.

<sup>39</sup> Hassan and Chowdhury (n 36) 82.

<sup>40</sup> Aldohni (n 4) 157.

<sup>41</sup> IFSB (n 29) 12.

*mudaraba* as a mode of intermediation. More specifically, the characteristic of *mudaraba* which gives rise to this risk is that ‘the capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to impairment in the event of losses’.<sup>42</sup> This is the crux of the risk inherent in using equity instruments as a financing tool: the risk that investors are not guaranteed profits, or even the capital they provided initially. This differs from conventional financing where such guarantees exist. Depositors in Islamic banks act like ‘pseudo-equity holders’ such that all the risks associated with being a partner in an investment project are borne by them without the voting rights enjoyed by actual shareholders.<sup>43</sup> So, the existence of unique risks like equity investment risk is something regulators in the UK must take into account.

Based on the above, it is clear that Islamic banking and conventional banking do not carry the same risks. Because of this, it is argued that it would be fair and better for Islamic banks commercially if Islamic banking was subject to regulation which takes its unique risks into account. Regarding fairness, the current framework is unfair because, despite its unique risks, Islamic banking is subjected to a regulatory framework designed to address the risks of conventional banking. This directly impacts the commercial viability of Islamic banks, as it gives conventional banking an unfair advantage over Islamic banking in that, unless the risks of Islamic banking are addressed by the regulator, it will appear to consumers to be riskier than conventional banking. Therefore, the current regulatory framework undermines this still burgeoning market and denies it the chance to grow. Subjecting Islamic banking to a framework which addresses its specific risks is not only fairer, but also gives the Islamic finance market the chance to build public confidence and expand.

## CHAPTER 2: CASE STUDIES

Having laid out the way in which Islamic banking operates, this article now considers how this special mode of intermediation interacts with certain aspects of banking regulation. Under the current regulatory framework, certain measures, such as the ones discussed in this chapter, are imposed upon all banks in the UK. Many of these regulatory measures are underlined by a lack of trust

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<sup>42</sup> *ibid.*

<sup>43</sup> Iqbal and Mirakhor (n 20) 306.

in financial institutions to conduct their activities while adequately protecting the interests of their customers. In contrast, the spirit of Islamic finance is rooted in trust and ‘promoting cooperative behaviour and avoiding conflict of interests’.<sup>44</sup> As will be seen, the two-tier *mudaraba* model which encapsulates this spirit means that certain aspects of Islamic banking warrant less regulatory attention than others. With that in mind, this chapter seeks to use two regulated aspects of banking, CARs and guaranteed deposits, as case studies to further prove why Islamic banking should be regulated differently than conventional banking.

### 1) CARs and the Basel Accords

An important tool in financial regulation is the requirement to maintain an adequate level of capital by setting aside a percentage of a financial institution’s assets, also known as CAR requirements. This provides these institutions with a buffer with which they can absorb short-term losses, which ultimately works to protect the stability and safety of the whole financial system.<sup>45</sup> The drawback of mandated CAR requirements is that financial institutions have a lower volume of assets which they can use to engage in profit-seeking activities. Capital adequacy is one of the few areas with a truly global regulatory framework. The Basel Committee on Banking Supervision (BCBS) was created in the 1980s by the Bank for International Settlements (BIS) with the goal of developing an international framework for determining capital adequacy requirements.<sup>46</sup> Interestingly, no developing countries were involved in either the Basel I or Basel II negotiations, ‘let alone those in which Islamic finance is prevalent’.<sup>47</sup> This has led authors like Ercanbrack to argue that the Basel Accords promote ‘an Anglo-Saxon model of capitalism, since they help consolidate the dominance of global finance’.<sup>48</sup> Nonetheless, the Basel Accords are undeniably significant since more than 100 countries have adopted them into their regulatory frameworks.<sup>49</sup>

The Basel Capital Accord of 1988, also known as ‘Basel I’, set out the framework for regulatory capital and provided guidance as to the measurement

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<sup>44</sup> Al-Suwailem (n 13) 63.

<sup>45</sup> Ercanbrack (n 7) 212.

<sup>46</sup> Iqbal and Mirakhor (n 20) 305.

<sup>47</sup> Ercanbrack (n 7) 214.

<sup>48</sup> *ibid.*

<sup>49</sup> Iqbal and Mirakhor (n 20) 305.

of the risk exposures of a range of asset classes.<sup>50</sup> Basel I introduced the idea of ‘assigning risk weights to different asset classes based on the riskiness of the asset and defined the minimum levels of capital and reserves that a bank should maintain in order to meet the risk-weighted exposures’.<sup>51</sup> The standard initially set by Basel I was focused mainly on credit risk. Basel II was introduced in 2004 in order to take into account market and operational risks.<sup>52</sup> Following the financial crisis of 2008, Basel III was developed with the aim of increasing the quality and liquidity of assets banks had to set aside as per the CAR requirements.<sup>53</sup> Though the Basel Accords are generally seen as a positive aspect of banking regulation, some authors, including Iqbal and Mirakhor, have noted that, due to the differences between Islamic financial intermediation and its conventional counterpart, ‘the same capital requirements may not apply’.<sup>54</sup> The article now turns to an examination of this argument.

While this article does not call for a total abandonment of CAR requirements for Islamic banking, it does advocate for a significant easing of these requirements due to the special characteristics of the PLS-based mode of intermediation. The reason for this can be traced back to the main rationale for having CAR requirements in place at all. As mentioned above, this is to enhance the capability of banks to absorb losses. This justification is weakened in the context of Islamic banking because of the customer’s unique position. As Song and Oosthuizen note, Islamic bank account holders are ‘quasi-liability holders and are expected to absorb all losses on the investments made with their funds, unless there is evidence of negligence or misconduct on the part of the bank’.<sup>55</sup> As a result of the expectation of customers to absorb losses on investments made using their funds, Islamic banks have a useful buffer to withstand the impact of negative shocks, thus enhancing ‘the solvency of [Islamic banks] compared to conventional banks’.<sup>56</sup> While this expectation does raise issues (as discussed later on), for the purposes of this section, it shows that the PLS-based

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<sup>50</sup> *ibid.*

<sup>51</sup> *ibid.*

<sup>52</sup> *ibid.*

<sup>53</sup> Ercanbrack (n 7) 220.

<sup>54</sup> Iqbal and Mirakhor (n 20) 305-6.

<sup>55</sup> Song and Oosthuizen (n 23) 19.

<sup>56</sup> *ibid.*

mode of intermediation employed by Islamic banks weakens the justification for CAR requirements in the context of Islamic banking.

Given the above, it is submitted that subjecting Islamic banks to decreased CAR requirements which cover only potential negligence and fraud would be a better approach in terms of both fairness and the growth of the Islamic finance market. With regards to fairness, the current CAR requirements represent a case of overregulation since the mode of intermediation used in Islamic banking is structured to address the risks CAR regulations are meant to cover. This is expounded by the fact that, as mentioned above, the Basel Accords were negotiated with only conventional, Western banking in mind. Thus, the blanket-rule method of enforcing CAR requirements is unfair since they are enforced without regard for the possibility that other modes of banking, like Islamic finance, can and are meant to function without these excessive requirements.

The result of this unfair regulation is that Islamic banks are forced to tie up capital to meet these regulatory requirements. But for these CAR requirements, this capital could be going towards investments which would help Islamic banks and the Islamic finance industry as a whole expand even more. One could argue that reduced capital adequacy requirements would actually hinder the growth of these banks since '[a] well-capitalized bank can boost the confidence of the depositors and creditors'.<sup>57</sup> It must be kept in mind, however, that the main factor hindering the progress of Islamic banking in the UK, especially among British Muslims, is 'related to their highly sceptical opinion concerning the sharia-authenticity of Islamic financial products or the basic difference between them and conventional products'.<sup>58</sup> Given that fact, it stands to reason that enhancing the Shariah-authenticity of products offered by Islamic banks would boost confidence in Islamic banks, thereby helping them grow. So, if excessive capital adequacy requirements make the practice of Islamic banking stray from the Shariah vision of banking by interfering with the fact that customers are meant to absorb losses, the best solution in terms of attracting customers wishing to use more Shariah-compliant modes of banking would be to reduce CAR requirements to what is necessary to cover instances of fraud and negligence.

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<sup>57</sup> Iqbal and Mirakhor (n 20) 305.

<sup>58</sup> Ercanbrack (n 7) 204-5.

Even then, however, one could argue that this would not be sufficient since it does not directly address an even more significant hinderance to the growth of Islamic banking; that being the claim that many of the instruments used in Islamic banking are actually un-Islamic. For instance, in 2007, Sheikh Taqi Usmani famously stated that 85% of *sukuk* (Islamic bonds) were not Shariah-compliant.<sup>59</sup> Using such points to rebut the above argument for relaxing CAR requirements for Islamic finance misses a central point of this article: that regulating Islamic finance in a way which acknowledges its vast differences from its conventional counterpart can give it the space to develop in a manner which is closer to a Shariah-compliant mode of finance. A major reason why the instruments used in Islamic finance have strayed from a completely Shariah-compliant image is that the competitive pressure from the conventional financial industry has necessitated the use of measures which hinder their Shariah-compliance.<sup>60</sup> Subjecting these two modes of finance to the same regulatory framework perpetuates this competition by failing to acknowledge their differences and pressuring the Islamic finance industry into implementing measures like CAR requirements, which impair the Shariah-compliance of the instruments used in this industry. If Islamic finance were to be dealt with separately from conventional finance at the regulatory level, this would serve to reduce said competitive pressure. Doing this would allow the Islamic finance industry to shape the instruments it uses in a way which is closer to a Shariah-compliant vision of finance. So, even if the instruments used in Islamic finance presently are not perfectly Shariah compliant, it is argued that a different approach to the regulation of this industry is itself a step in the right direction.

## 2) Guaranteed Deposits

One of the principal ways the UK financial regulator seeks to protect bank customers is through the Financial Services Compensation Scheme (FSCS). This scheme was put in place through Part XV of the Financial Services and Markets Act 2000 in order to fulfil the requirements of the Deposit Guarantee Scheme

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<sup>59</sup> Jonathan Ercanbrack, 'Islamic Financial Law and the Law of the United Arab Emirates: Disjuncture and the Necessity for Reform' (2019) 33(2) Arab Law Quarterly 152, 166.

<sup>60</sup> El-Hawary Grais and Iqbal (n 26) 34.

directive<sup>61</sup> implemented by the EU.<sup>62</sup> Under this scheme, all deposits and retail investments in the UK are guaranteed ‘up to £85,000 per eligible person, per bank, building society or credit union’.<sup>63</sup> While this is seen as an indispensable tool in conventional banking, as authors like Ercanbrack note, ‘[t]he UK deposit guarantee scheme is a further impediment to the application of sharia-authentic modes of PLS investment’.<sup>64</sup>

The use of the FSCS is problematic in the context of Islamic banking for a number of reasons. Foremost among these reasons is the fact that providing guarantees is a direct contravention of the *gharar* prohibition outlined earlier. As can be recalled, *gharar* includes contracts which contain an excessive degree of uncertainty. Guarantees violate this prohibition, since it is excessively difficult for either party to calculate the chances of actually profiting from this contract because this is based on an unforeseeable occurrence.<sup>65</sup> Therefore, if the event upon which the guarantee is based occurs, the income therefrom is not Shariah-compliant since it arises from mere chance.

Related to this point is the aforementioned central maxim of Islamic finance, which is that ‘liability justifies utility’. Guarantees contradict this maxim because the element of chance undermines the idea that the receiver of profits needs to put in work to justify the monetary reward. In other words, guarantees represent unjust enrichment according to Shariah principles because ‘the winner has not earned that which he has won, and the loser loses on mere chance’.<sup>66</sup> The two-tier *mudaraba* model ensures that deposits are in line with the above maxim. As El-Hawary *et al.* remark, ‘[t]he essence of Islamic financial intermediation being symmetrical risk as well as profit and loss sharing, introducing a guarantee on the downside would run counter to the core

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<sup>61</sup> Council Directive (EC) 94/19 of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes [1994] OJ L135/94.

<sup>62</sup> Eliahu Peter Ellinger, Eva Z. Lomnicka and Richard Hooley, *Ellinger’s Modern Banking Law* (4th edn, Oxford University Press 2006) 49.

<sup>63</sup> Financial Services Compensation Scheme (FSCS), ‘What We Cover’ <[www.fscs.org.uk/what-we-cover/](http://www.fscs.org.uk/what-we-cover/)> accessed 22 July 2021.

<sup>64</sup> Ercanbrack (n 7) 196.

<sup>65</sup> Comer-Obeid (n 14) 54.

<sup>66</sup> Susan Elizabeth Rayner, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates* (Graham & Trotman 1991) 281.

objective'.<sup>67</sup> More specifically, the fact that the depositor in an Islamic bank accepts the risk of absorbing losses justifies the profits they earn. Additionally, the operation of the FSCS specifically represents yet another problem in the context of Islamic banking. This is because the scheme invests 'its funds in interest-bearing accounts and is not structured to segregate Islamic funds from conventional banks' interest-bearing funds'.<sup>68</sup> This creates an issue because interest-based finance is an unequivocal violation of the *riba* prohibition. Thus, the UK regulators' use of guarantees in deposit-taking represents a problem for Islamic banking.

Despite this conflict, Islamic banks have had to adapt to this regulatory requirement in order to operate in the UK. The measures taken by the Islamic Bank of Britain ('IBB', now called Al Rayan Bank) to earn its license can be examined to exemplify this point. Established in 2004, the IBB was the first entirely Islamic retail bank to gain authorisation, not only in the UK, but 'in a country where most of the population is non-Muslim'.<sup>69</sup> In order to earn its license, it had to find a compromise between following the Shariah principles on finance and meeting the regulatory requirements in place regarding guaranteed deposits. To that end, one of the measures it adopted was the use of profit stabilisation reserves (PSRs).<sup>70</sup> When an investment ends up causing losses, appropriations are funnelled to the PSRs before the bank's share as *mudarib* is deducted with a view to essentially guarantee that depositors do not suffer these losses. Though this is clearly not in line with a totally Shariah-authentic vision of banking, this is one of the compromises banks like IBB had to make just to operate in the UK.

PSRs, however, were thought to be insufficient on their own, so in addition to PSRs, the IBB adopted a policy of shifting the Shariah-compliance of their activities onto their customers.<sup>71</sup> This means that, if loss of a depositor's capital occurs, the bank would inform the depositor that they are legally entitled to full repayment (thus meeting the regulatory requirement). The customer

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<sup>67</sup> El-Hawary Grais and Iqbal (n 26) 31.

<sup>68</sup> Ercanbrack (n 7) 196.

<sup>69</sup> Ainley (n 9) 14.

<sup>70</sup> Simon Archer S and Rifaat Abdel Karim, 'The Structure, Regulation and Supervision of Islamic Banks' (2012) 13 *Journal of Banking Regulation* 228, 231.

<sup>71</sup> Aldohni (n 4) 162.

would then be given the choice to ‘turn down deposit protection after the event on religious grounds, and choose instead to be repaid under the Shariah-compliant risk sharing and loss bearing formula’.<sup>72</sup> Authors, such as Aldohni, have criticised the UK regulators’ approach, noting that, though it is not a religious regulator, Islamic banking and the religious-based restrictions their activities entail are a reality that the regulator needs to consider more carefully and work with instead of opting for the easier approach.<sup>73</sup>

In light of the foregoing, this article argues that the requirement of guaranteed deposits by the UK regulators is unfair on Islamic banking and hinders the potential growth of the Islamic banking industry. The existing unfairness is exemplified by the fact that Islamic banks even have to adopt measures like PSRs and shifting Shariah-compliance to the customer in order to balance following the principles of the Shariah and meeting UK regulatory requirements. This is something that conventional banks do not have to do since the current regulatory framework is centred on the features of conventional banking. This is a reflection of how the regulator would rather try to fit Islamic banking within the boundaries of conventional finance rather than put a genuine effort to better understand and accommodate for the different mode of intermediation Islamic banking utilises. As discussed in Chapter 3, solutions that are more in line with the Shariah, like the use of the concept of *takaful* (Islamic insurance), do exist and can be used to better address these issues, if the regulator is willing to put in the effort. So, the current framework is unfair on Islamic banks as it asks them to compromise and sacrifice some of their Shariah-authenticity in order to comply with guaranteed deposit requirements.

In addition to being unfair, the requirement of guaranteed deposits acts as an obstacle to the growth of the Islamic financial industry. At first, this seems counterintuitive, since one would think that the lack of a guaranteed deposit would dissuade a depositor from risking their capital. However, that line of thinking is a consequence of conventional banking rationales being the default basis in financial regulation. A better approach should focus on the mindset of Muslim depositors as the target audience of Islamic banking. This is because, as stated earlier, the biggest obstacle to the commercial growth of Islamic banking is these depositors’ scepticism when it comes to the Shariah-authenticity of

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<sup>72</sup> Ainley (n 9) 14.

<sup>73</sup> Aldohni (n 4) 162.

Islamic banking practices. This point is not necessarily meant to exclude the possibility of non-Muslims from participating in Islamic banking, but since Islamic banking is still a burgeoning industry and Muslim depositors are the biggest users of Islamic banking, it makes sense to cater to them to facilitate the growth of the industry. To that end, echoing the argument made earlier in the article, the Islamic banking industry's best chance at expanding is not trying to fit into the framework created for its conventional counterpart; rather, its potential for expansion is enhanced if it is allowed to stand on its own two feet as a Shariah-authentic system, since this would foster confidence from the industry's target audience who are clearly seeking Shariah-compliant means of banking. Thus, the focus of regulation should shift away from non-Shariah-compliant measures like guaranteed deposits in order to address the issues these measures are meant to resolve.

Though problematic in the context of Islamic finance, it is recognised that guaranteed deposits represent an important way for the UK regulators to fulfil their objectives. In general, these objectives centre on '(1) sustaining systemic stability; (2) maintaining the safety and soundness of financial institutions; and (3) protecting the consumer'.<sup>74</sup> Guaranteed deposits address the final objective in particular by providing consumers with a measure which reduces potential losses in the event of a major incident within their bank or within the financial markets at large. Despite their importance, if guaranteed deposits impair the Shariah-compliance of instruments used in Islamic finance, then alternative measures are required to protect consumers in this unique industry. One such alternative measure that the regulators can implement would be to increase transparency measures (discussed in detail below). While this may not afford the same level of protection as guarantees, such measures better equip consumers to make more informed decisions and simultaneously allow the regulators to fulfil their objectives without the need to impair the Shariah-compliance of the instruments used in Islamic finance.

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<sup>74</sup> Ercanbrack (n 7) 175.

### CHAPTER 3: ISSUES IN A NEW APPROACH TO REGULATING ISLAMIC BANKING

While this article has painted regulation in a negative light thus far, the regulation of Islamic banking is not only desirable, but also necessary for the operation and growth of this industry. As El-Hawary *et al.* pointed out, ‘an efficient regulatory framework would help Islamic banks reduce their exposure to risks and enhance their ability to compete with conventional banks’.<sup>75</sup> The point this article aims to emphasise is that the current approach to regulating Islamic banking in the UK is inadequate and, at times, inappropriate considering how this kind of banking functions. What is needed is a framework which can facilitate the industry’s growth rather than hinder it. As will have been made clear, that entails taking into account the unique characteristics of Islamic banking and working with the tools that are compliant with the Shariah instead of imposing the framework used for conventional banking upon Islamic banks. Some may argue that such an approach would come into conflict with the UK regulators’ broader ‘no obstacles, no special favours’ approach to regulating the financial system, as described earlier. However, if the regulators’ goal in taking this approach is to level the playing field and avoid placing obstacles in the way of Islamic finance, a framework like the one being argued for in this article would actually help accomplish this goal by not putting the Islamic financial industry at a disadvantage for the reasons outlined in the previous chapters.

Admittedly, implementing such a regulatory framework will not be problem-free, which is why various issues must be addressed before the regulator can pursue this endeavour. Though this article does not presume to know the best ways for the regulator to resolve these issues (as this would require a deeper study), it can at least provide some starting points for the regulator to begin dealing with the issues raised. This chapter begins by discussing where the role of regulation should be, given that the typical regulatory tools like CAR requirements and guaranteed deposits are so problematic in the context of Islamic banking. Then, the problems arising from the fact that there is a religious element involved in this type of banking are analysed.

#### 1) The Role of Regulation in Islamic Banking

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<sup>75</sup> El-Hawary Grais and Iqbal (n 26) 17.

In order to know what the regulator's focus should be on, we must first identify what the most significant issues which arise from the PLS-based mode of intermediation are. As mentioned in Chapter 1, a feature of the two-tier *mudaraba* model is that the depositor, being the *rabb al mal*, cannot control how the bank, as *mudarib*, uses the funds it receives; yet, the depositor is the party responsible for bearing losses. Thus, the bank's management is given significant freedom with regards to its fund management decisions. This can give rise to 'a general lack of transparency with respect to management's investment choices' among other things.<sup>76</sup> In light of this, various authors have emphasised the fact that 'the need to improve the transparency of bank operations is particularly relevant for Islamic banks'.<sup>77</sup> Hence, it is argued that the main focus of the regulator should be on enhancing the transparency of the operation of Islamic banks.

Hassan and Chowdhury define transparency as 'the public disclosure of reliable and timely information that enables those who are familiar with it to form an accurate assessment of a bank's financial condition and performance, business activities, risk profile, and risk management practices'.<sup>78</sup> Enhancing transparency and imposing disclosure requirements are desirable in banking generally, as they 'can help reduce the frequency and severity of financial crises by encouraging macroeconomic policy adjustments to begin earlier, occur more smoothly, and resolve crises by reducing uncertainty'.<sup>79</sup> In the context of Islamic banking, enhancing transparency is even more desirable because the depositor's capital is left in the hands of the bank and, if losses occur, the depositor is meant to bear them. By giving the customer access to more information about the bank, regulation focused on transparency can help depositors make a more informed decision beforehand. In particular, the bank's overall soundness and risk management protocols should be made clear to potential depositors.<sup>80</sup> One way to achieve this, Hassan and Chowdhury suggest, is through external credit assessments.<sup>81</sup> Such assessments should make the specific risks depositors are taking by investing in a particular bank more transparent, thus allowing them to

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<sup>76</sup> Ercanbrack (n 7) 185.

<sup>77</sup> Hassan and Chowdhury (n 36) 74.

<sup>78</sup> *ibid* 91.

<sup>79</sup> *ibid*.

<sup>80</sup> *ibid* 96.

<sup>81</sup> *ibid* 93.

make a rational and informed decision on whether to invest their money with a particular bank. Therefore, even though the depositor is at risk of bearing losses, regulation focused on increasing transparency will help them better understand beforehand exactly what risks they are taking.

While increased transparency measures may prove helpful, they are not without their drawbacks. For instance, one can argue that, no matter how well-informed a customer may be, they are still at risk of having their capital misused by the bank due to fraud or negligence. For the regulator, this represents a deficiency with regards to the fulfilment of one of its primary objectives: namely, protecting consumers. A solution to this lies in a point made earlier, which is that CAR requirements should not be eradicated completely in the context of regulating Islamic finance; rather, they should be kept at the minimum level required to deal with such instances, as is sanctioned by Shariah.<sup>82</sup> So, although increasing transparency measures is certainly not a panacea, the shortcomings of these measures can be alleviated by other measures which do not impair the Shariah-compliance of the instruments used in Islamic finance.

The IFSB briefly discusses some of the ways in which transparency measures can address the increased credit risk and equity investment risk discussed in Chapter 1 of this article. With regards to credit risk, the IFSB says that regulators should ‘maintain a detailed description of each financing instrument used by [Islamic banks] in their jurisdiction and the risk exposures to which each instrument gives rise’.<sup>83</sup> So, the aim here is clearly ensuring that the regulator is better informed about the particular credit risk faced in Islamic banking. On equity investment risk, the IFSB invites regulators to ‘develop regulatory guidelines for measuring, managing and reporting the risk exposures when dealing with non-performance financing’.<sup>84</sup> Here, the IFSB asks regulators to actively create guidelines to address the equity investment risk unique to Islamic banking. These measures have the advantage of enhancing the availability of information to customers and regulators while not crossing the threshold of regulating the religious aspects of this mode of banking. Though these may be minor actions, they at least give regulators a starting point from which they can develop an adequate regulatory framework for Islamic banks.

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<sup>82</sup> Song and Oosthuizen (n 23) 19.

<sup>83</sup> IFSB (n 29) 29.

<sup>84</sup> *ibid.*

Admittedly, the UK regulators might not find that increased transparency measures alone offer sufficient protection for depositors. A way to directly protect depositors' capital may be desired. The primary way this is done under the current framework, as outlined earlier, is through guaranteed deposits, which run contrary to the Islamic prohibition of *gharar*. Aldohni suggests the possibility of a scheme parallel to the existing one where compensation of losses is based on the Shariah-sanctioned concept of *takaful*.<sup>85</sup> A *takaful* arrangement entails policyholders agreeing to donate to what is essentially a fund. Policyholders are given access to the *takaful* fund when the risk which is insured against materialises using non-interest-bearing loans (*qard al hasan*). The act of agreeing to donate to the fund and assist those in need (in our context, depositors who suffer losses) eliminates the risk of *gharar* since it reflects 'the principles of compensation and shared responsibilities among the community'.<sup>86</sup>

*Takaful* is accepted in the Shariah, while conventional insurance mechanisms are not, because it is 'based on the cooperation and solidarity between the parties'.<sup>87</sup> The specific way in which a *takaful*-based parallel system of protecting depositors' capital should be designed requires a separate study entirely; the main purpose of mentioning it here is to provide a starting point from which UK regulation can begin to regulate Islamic banking in a more Shariah-authentic way. It should be noted that cooperating with Islamic banks, which are more familiar with this structure, to design such a parallel system of capital protection would be ideal. Doing so would address the criticism highlighted earlier that the UK regulators should be trying to work with the industry to find solutions to issues like this one, rather than imposing measures designed for conventional banks. Consequently, if the regulator feels the need to protect depositors beyond just increased transparency and disclosure measures, the existence of *takaful* is proof that strategies can be developed to do this in a more concrete, yet still Shariah-compliant way.

Focusing the regulatory gaze on measures like transparency enhancement and using *takaful* to protect capital is a fairer approach which is better commercially for Islamic banks. An approach which focuses on enhancing

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<sup>85</sup> Aldohni (n 4) 172.

<sup>86</sup> Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2007) 421.

<sup>87</sup> Abdulrahman K Tolefat and Mehmet Asutay, *Takaful Investment Portfolios: A Study of the Composition of Takaful Funds in the GCC and Malaysia* (Wiley 2013) 27.

transparency is fairer because it takes into account the specific gap which exists in the operation of Islamic banking that need to be filled by regulation. This is referring to the increased need for information which arises since the depositor is meant to bear the risk of losses under the PLS-based mode of intermediation used in Islamic banking. Regarding the use of *takaful* for capital protection, this is clearly a fairer option because it makes use of a mechanism designed with the restrictions set by the Shariah in mind. In contrast, the blanket imposition of guaranteed deposits is the less fair option, as it does not consider the fact that such a measure is in conflict with Shariah principles.

With regards to how this shift in the regulatory gaze can lead to market expansion, increased transparency measures can help build confidence and dispel uncertainty by making potential depositors more aware of exactly the kinds of risks they are taking by investing in an Islamic bank. As Hassan and Chowdhury state, ‘transparency in risk management and the bank’s underlying soundness, particularly to investment account holders, plays a central role in bolstering participant confidence’.<sup>88</sup> Bolstering confidence in the system would attract those customers who initially doubted the Shariah-authenticity of Islamic banking, thus increasing the prospects of market growth.

Turning to the use of *takaful*, this article argues that a capital protection scheme based on *takaful* can further foster the growth of the market, since such a system would be based on a financial mechanism created according to Shariah principles. This argument goes back to the point that potential depositors seeking Shariah-compliant modes of intermediation are concerned that Islamic banks, under the current regulatory framework, are not Shariah-authentic. By using *takaful* to offer depositors capital protection, the regulatory framework would therefore help build confidence in the Shariah-authenticity of Islamic banks, thus attracting more customers and helping the industry grow further. Having established which areas the regulation of Islamic banking in the UK should be focused on, the article now considers the unavoidable question of how the regulator should approach the culturally-sensitive religious element involved in Islamic banking.

## 2) The Religious Aspect of Islamic Banking

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<sup>88</sup> Hassan and Chowdhury (n 36) 96.

Another pertinent issue which must be addressed is how the regulator should approach the regulation of Islamic banking in a way which engages more with the nature of this type of banking, yet which does not make it cross the threshold of being a religious regulator. Thus far, the UK regulators have achieved this by not involving themselves with the regulation of the Shariah compliance of Islamic financial products. This is because, as the UK government has expressed, this would not be an appropriate action for a secular regulator like itself.<sup>89</sup> This article agrees that the regulator should not regulate the Shariah compliance of the products offered by Islamic banks as it is not suited to take on this role. Yet, there are ways for the regulator to approach the regulation of this industry in a way which is considerate of the uniquely religious elements of this industry, without encroaching upon the sensitive issue of regulating religion. One way to do this is to make use of the Shariah standards created by global bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for the regulation of Islamic finance.

The AAOIFI Shariah Standards ‘represent a successful attempt by the contemporary Muslim scholars at harmonization and standardization of *Shari’ah* views on Islamic banking’.<sup>90</sup> These standards are renowned in the international Islamic finance industry and ‘are deemed the most outstanding Shari’ah reference for this industry and its various stakeholders’.<sup>91</sup> Importantly, the AAOIFI Shariah Standards are considered to be a harmonisation effort because Islamic law is not monolithic; rather, various schools of jurisprudence exist. The differences of opinions which emerge from these different schools of thought give rise to juristic disagreement (*ikhtilaf*), which is accepted in Islamic law so

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<sup>89</sup> Her Majesty’s Treasury, *The Development of Islamic Finance in the UK: The Government’s Perspective* (Her Majesty’s Treasury 2008) 19.

<sup>90</sup> Muhammad Tahir Mansoori, ‘Is “Islamic Banking” Islamic? Analysis of Current Debate on Shari’ah Legitimacy of Islamic Banking and Finance’ (2011) 50(3/4) *Islamic Studies* 383, 400.

<sup>91</sup> Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), ‘Shari’ah Standards: Full Text of Shari’ah Standards for Islamic Financial Institutions As at Safar 1439 A.H.’ (2017) 6 <<https://aaoifi.com/shariaa-standards/?lang=en>> accessed May 21 2021.

long as jurists are clear about the methodology used to reach their different conclusions.<sup>92</sup>

As part of the harmonisation effort, the AAOIFI has to pick and choose certain juristic opinions so they can create standards which are easy to use by regulators. This act of picking and choosing is facilitated in Islamic law through the use of *talfiq*. *Talfiq* is a jurisprudential tool which allows scholars to legitimately use the opinions of different schools of thought in order to arrive at a particular legal opinion. The use of this tool, as well as the laborious process consisting of over ten stages used by AAOIFI to create their Shariah standards, have allowed these standards to garner legitimacy not only in Muslim majority countries, but in all countries where Islamic finance is prevalent.<sup>93</sup> As John Dewar and Munib Hussain of Milbank LLP state, though AAOIFI standards are not formally adopted into the regulatory framework, ‘these standards are certainly useful in identifying best practice for IFIs and examples of the application of regulatory rules to IFIs’.<sup>94</sup> The AAOIFI Shariah Standards therefore represent a set of regulatory rules whose creators have gone to great lengths to ensure their compliance with the Shariah. Thus, drawing from these standards can be a useful way for the secular UK regulators to regulate the Islamic banking industry in a manner which engages with the principles of Islamic banking, but without having to risk crossing the threshold of becoming religious regulators. This is because the religious aspects which the UK regulators are hesitant to engage with have already been considered by AAOIFI as a renowned Islamic standard-setting body. Implementing these standards, therefore, would enhance the legitimacy of the UK’s regulatory framework without the need to undertake the socially sensitive issue of engaging with different Islamic jurists’ opinions.

Here, it would be useful to discuss how certain AAOIFI Shariah Standards address some of the issues under the current regulatory framework that have been examined throughout this article. Firstly, we can begin by exploring how

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<sup>92</sup> Mashood Baderin, ‘Understanding Islamic Law in Theory and Practice’ (2009) 9 *Legal Information Management* 186, 190.

<sup>93</sup> AAOIFI (n 91) 6.

<sup>94</sup> John Dewar and Munib Hussain, ‘Q&A: Islamic Finance Regulation and Supervision in United Kingdom’ (*Milbank LLP*, 20 October 2020) <<https://www.lexology.com/library/detail.aspx?g=72c6f2ca-a391-4b35-864f-d32375f8c6c9>> accessed 30 June 2021.

the Standards deal with the issue of capital protection for depositors. Shariah Standard No (5) confirms what was discussed in Chapter 2 of this article regarding the Shariah validity of guarantees in the context of *mudaraba* contracts. Specifically, it states that ‘it is not permitted to require from a manager in the Mudarabah... contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit’.<sup>95</sup> Then, looking at Shariah Standard No (45), the AAOIFI emphasises the fact that capital protection is wider than merely providing guarantees and includes ‘using available methods to prevent loss, decrease or destruction’.<sup>96</sup> The Standard then offers a number of permissible methods to protect an investor’s capital. One such method includes the use of *takaful* (as described above) which ‘may be obtained either by the investors themselves or through the investment manager on their behalf’.<sup>97</sup> Thus, the AAOIFI Shariah Standards, being based on Islamic legal thinking, provide a better way for the UK regulators to regulate capital protection in Islamic banking compared to the current problematic imposition of guaranteed deposits.

Next, we can look at how the Shariah Standards encapsulate the need for enhanced transparency measures in the regulation of Islamic banking, as discussed earlier in the chapter. Shariah Standard No (47) very clearly stresses the fact that Islamic banks should make their methods of profit calculation transparent to customers and allow them to inquire about these methods. This reflects the fact that more transparency is needed in the operation of Islamic banking since the PLS-based mode of intermediation requires profits to be distributed according to a predetermined ratio rather than using simpler and more familiar interest payments. Furthermore, this Standard requires that Islamic banks make their methods transparent even before clients engage with the bank. This is because the Standard imposes on the bank the obligation to make its methods clear even in ‘its advertising campaigns and product marketing brochures’.<sup>98</sup> This further emphasises the fact that these Standards aim to eliminate any risk of deception or uncertainty in order to be, as far as possible, in line with the Shariah spirit of trust and mutual cooperation in financing arrangements. So, drawing from the AAOIFI Shariah Standards provides a way

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<sup>95</sup> AAOIFI (n 91) 125.

<sup>96</sup> *ibid* 1102.

<sup>97</sup> *ibid* 1104.

<sup>98</sup> AAOIFI (n 91) 1140.

to address the increased need for transparency in Islamic banking without the risk of turning the UK regulators into religious regulators.

Circling back to the central thesis of this article, it is submitted that use of AAOIFI Shariah Standards would be fairer approach to regulating Islamic banks which would also improve the prospects of the industry growing even more. Drawing from these standards is fairer because the Muslim scholars who laboured to create them obviously took the unique features of Islamic finance into account. As mentioned, the creation of a Shariah Standard is a long, multi-stage process which ensures that the standards produced are in line with Islamic legal thinking. Therefore, using these thought-out standards is more favourable in terms of fairness than subjecting Islamic banks to regulatory rules made with only their conventional counterparts and the products they offer in mind.

On the topic of improving the commerciality of Islamic banks, the central point here is, again, the need to foster confidence in the Islamic banking system by striving towards Shariah-authenticity. Subjecting Islamic banks to regulations which draw from AAOIFI Shariah Standards would help in this regard. This is because the renown of these standards in the world (and particularly among Muslims) means that Islamic banking industry in the UK will earn more legitimacy, and doubts over its Shariah-authenticity will be more easily dispelled. This is especially so in light of the present state of the Islamic banking industry under the current regulatory framework which forces it to, at several points, compromise on its Shariah-authenticity. Thus, it stands to reason that using the AAOIFI Shariah Standards can help the market expand by fostering confidence in the system and attracting more customers. Importantly, if the UK regulators adopted these standards in their regulation of Islamic banking, this would improve upon the current approach in terms of fairness and market growth while allowing them to remain secular as they would not have to engage with the religious aspects of these standards since this has already been taken care of by AAOIFI; all they would have to do is implement them.

## CONCLUSIONS

Regulation has an undeniably significant impact on the growth of any market. This is why the overall aim of this article was to show that, given how different Islamic finance is from conventional finance, a new regulatory approach which sufficiently acknowledges this fact would not only be more desirable for the commerciality of Islamic financial institutions, it would be fairer as well. To that end, the article began by outlining the operation of Islamic

banking and highlighting the particular risks the PLS-based mode of intermediation entails. This was done with a view to emphasise how the current regulatory framework fails to adequately account for the idiosyncrasies of this type of banking and how this is holding the industry back commercially. Subsequently, Chapter 2 analysed how some of the principal tools used to regulate banking in the UK clash with the features and restrictions inherent in the two-tier *mudaraba* structure used in Islamic banking. Those analyses were used to argue that a regulatory approach which integrates the tools used in Shariah-compliant banking would be fairer and more commercially sensible for Islamic banks, as opposed to the current blanket imposition of regulations made with only conventional banking in mind. Finally, Chapter 3 discussed some pertinent issues the UK regulators might face due to such a change in its approach to regulating Islamic banking. Specifically, it discussed where the regulator should shift its gaze as well as the issues raised by the culturally sensitive religious element of this type of banking. Throughout the discussion, various starting points for a fairer and more commercially sensible approach to regulating Islamic banking in the UK were presented.

At the start of the article, it was mentioned that the basis of the UK's current approach to regulating Islamic finance is 'no obstacles, no special favours'. The goal of this approach is to create a level playing field between all financial market participants in the UK. The findings of this article indicate that, when it comes to Islamic finance specifically, this approach has failed to level the playing field and has instead held Islamic banking back from realising a mode of intermediation that is more in line with the principles of Shariah. As shown at various points in this article, the Islamic banking industry in the UK has had to compromise in order to conform to a system of regulation that caters to conventional banking structures. If the UK regulators truly wish to level the playing field, it needs to engage with Islamic banks in a more meaningful way as this would allow the industry to stand on its own two feet rather than letting it live in the shadows of its conventional counterpart. Doing so would reflect the fact that, for the UK Islamic banking industry to thrive 'in a competitive market alongside CFIs [conventional financial institutions], it needs to differentiate itself'.<sup>99</sup> While such an approach may initially garner criticism for appearing to give Islamic banks special treatment, this article has made it apparent this is not

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<sup>99</sup> Hassan and Chowdhury (n 36) 76.

so given that the current framework favours conventional banking to the detriment of Islamic banking.

Following the findings of this article, the next steps for research in this area should focus on developing specific ways in which UK regulation can better integrate Shariah-compliant tools into its framework. Though the sole focus of this article has been on one area of Islamic banking, this research should explore other areas of the Islamic finance industry as well. Working towards a regulatory framework which engages with the specific features of Islamic finance will certainly be more challenging than merely imposing existing regulatory rules across the board; yet, it is imperative in order to achieve a truly level playing field among all participants in the financial markets. Fortunately, as pointed out in the final chapter of this article, there are various points from which the necessary research can begin so that the UK can work towards developing a fairer regulatory framework which would allow the UK Islamic finance industry to flourish and reach even greater heights than it has thus far.