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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Banking contracts and Sharia rules within the European Union framework

by **Gabriella Gimigliano**

Abstract: *The paper deals with the application of Sharia rules within the European legal framework for banking contracts. It attempts to ascertain whether Sharia rules can be legally enforceable in contracts made between a Muslim client and a bank. The paper comprises five sections, all of which refer to the European legal framework. In section 1, the paper provides for the three catchwords of the analysis, "integration", "Sharia" and "contract"; in section 2, the paper focuses on the scope of the non-discrimination principle on the grounds of religion; section 3 aims to clarify who the parties of the contracts at issue are with a view to ascertaining whether a European credit institution is per se entitled to provide Sharia-complaint products; section 4 points to the principle of incorporation and how it might make Sharia rules operate as applicable law or contracting terms. Finally, section 5 draws some conclusions.*

1. The paper deals with the application of *Sharia* rules within the European legal framework for banking contracts. It attempts to ascertain whether *Sharia* rules can be legally enforceable in contracts made between a Muslim client and a bank.

The analysis is based upon three catchwords: "integration", "*Sharia*", and "contract" and argues that *Sharia* may be regarded as a factor in the European integration process, which is based on the values of democracy and pluralism; the main point is that the application of *Sharia* rules within the EU-based framework for banking contracts may be frustrated on the grounds of legal uncertainty.

The first catchword at issue is "integration". The EU is a legal order based upon a process of approximation of Member States' legal systems to pursue its own objectives, as laid down in the Treaties and clarified by the jurisprudence of the Court of Justice. Therefore, any attempt to accommodate *Sharia* rules within the European framework must be based upon articles 2 and 3 of the

Treaty on European Union (hereafter, TEU). Art. 2 establishes that «The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail».

Among the Union's objectives, art. 3, §3 TEU provides for combatting discrimination and social exclusion, as well as establishing an internal market, defined as «an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties»[1].

The term *Sharia* may be translated as *Divine Law*; the word literally means «the road leading to water» or the «way to the source of life»: for Muslims, the Way was revealed by God through His most important Prophet, Muhammad. God's revelations were collected in the *Quran* (the Holy Book), while the *Sunna* contain the Prophet Muhammad's examples, which have been relayed as an authenticated report of His lifetime. They encompass all aspects of human life[2] and establish broad principles as well as specific models for the family, commercial activities, banking, and financial operations[3].

Generally speaking, *Sharia* may be characterised according to its approach to money and property. Indeed, money is considered as potential capital, because it needs human effort to make it productive, or as a «monetized claim of its owner to property rights created by assets» obtained either by combining individuals' creative labour and natural resources or by making exchanges[4]. In turn, property is driven by a "sharing" logic: it is argued «Being God the only Creator and Owner of everything in the universe, His order (*hukm*) guarantees per se the justice of any property right (*haqq*), which is not the "right" of a person against the "right" of another person (as in the Western tradition), but the "right" of a person with the corresponding "obligation" of another person, linked together in a constant unity (*tawhid*)»[5].

From this approach to money and property follow two basic *Sharia* principles: the prohibition of *riba* and *gharar*. Generally speaking, *riba* means "increase" and covers any excess in the principal that is not "justified" by the risk associated with the use of money, both in exchanges and investments. However, this risk is not the same as credit or liquidity risk. Rather, it is the risk that being a partner in an economic activity may end up resulting in lower profits than excepted or none at all; in addition, it is the risk that something bought is destroyed or damaged before taking title of it, while the price is being paid in instalments[6]. *Gharar* means risk and it covers the sale of risk itself and the transaction involving excessive uncertainty. Traditionally, scholars teach that «while it is not allowed to sell the fetus of a camel in the womb, it is allowed to sell a pregnant camel and for more money than a similar but non-pregnant camel»[7].

Lastly, the third catchword is "contract": according to the 2002 Principle of European Contract Law (or PECL), this is a multilateral or bilateral juridical act, namely an «agreement which is intended to give rise to a binding legal relationship or to have some other legal effects»[8].

The PECL code is a set of general principles of law drawn up by European academics and applied by the contracting parties on a voluntary basis, namely when the parties incorporate them into the contract, when the parties have agreed that their contract is to be governed by the "general principles of law", the "*lex mercatoria*", or the like, and, ultimately, when the parties have not chosen or agreed on any system of law to regulate their contract[9].

In addition, the institutional legislative process has laid down some binding law rules. By no means exhaustively, one may refer to the directives on e-money, the directive on distance marketing in the provision of financial services, those on payment services in the internal market, and so forth. Although they enjoy a different scope and level of harmonisation, they established a higher level of protection for consumer clients, laying down a set of compulsory rules[10].

However, this paper does is not concerned with contracts in general. It deals with the process of accommodation of *Sharia* rules in banking contracts, i.e., contracts drawn up between a credit institution and a client, either a consumer or an entrepreneur. It must be borne in mind that, within the European Union framework, credit institutions are licensed entities, and they may be authorised to provide not only the core banking business and those banking activities listed in the 2013 banking directive annex[11] but also investment services[12].

The MiFID 2 directive has laid down a series of contract terms and business conduct rules on the provision of financial services[13]. Indeed, MiFID 2, building on the MiFID 1 directive[14], maintained all its main principles, including the duty of credit institutions and investment firms to act fairly and in the best interests of their clients, their obligation to provide clients with information; the assessment of suitability and appropriateness of investment services and financial instruments for investors, the obligation to execute orders in the terms most favourable to their clients and in compliance with specific client order handling rules. In addition, amending MiFID1, MiFID 2 has laid down *a)* a harmonised regime for the access of investment firms and market operators of third countries (countries other than the European Union Member States) that seek to provide services to eligible EU counterparts, «specific rules on the product governance (creation and distribution of financial products), new duties of information on costs and charges in the service provider-customer relationship»[15], giving less or no leeway to contracting parties in the process of negotiation and drafting contract terms. This is the reason why this paper prefers to focus on *Sharia*-compliant contracts drawn up between a credit institution and a client with the banking business as their object.

The paper comprises four further sections, all of which refer to the European legal framework. In section 2, the paper will focus on the scope of the non-discrimination principle on the grounds of religion; section 3 aims to clarify who the parties of the contracts at issue are with a view to ascertaining whether a European credit institution is *per se* entitled to provide *Sharia*-complaint products; section 4 points to the principle of incorporation and how it might make *Sharia* rules operate as applicable law or contracting terms. Finally, section 5 draws some conclusions.

2. Good operation of the internal market and the construction of a European Union as a pluralistic and inclusive society depend also on the correct application of the principle of non-discrimination on grounds of religion or beliefs, as laid down in articles 10 and 19 TFEU, framing the *Sharia* accommodation process in the EU-based framework for banking contracts.

The EU-based framework contains no general definition of “discrimination”; by contrast, any directives aiming to combat forms of discrimination provide their own definition peculiar to the rules of the directive to be applied. Nor has European jurisprudence filled this regulatory gap. However, it has been suggested – and I agree with this solution – to borrow a workable definition from the Canadian Supreme Court case law, according to which discrimination is «a distinction, whether intentional or not but based on grounds relating to personal characteristics of the individual or group, which has the effect of imposing burdens, obligations, or disadvantages on such individual or group not imposed upon

others, or which withholds or limits access to opportunities, benefits, and advantages available to other members of society. Distinctions based on personal characteristics attributed to an individual solely on the basis of association with a group will rarely escape the charge of discrimination, while those based on an individual's merits and capacities will rarely be so classified» [16].

Art. 10 TFEU provides that «In defining and implementing its policies and activities, the Union shall aim to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation», while, according to art. 19 TFEU, «Without prejudice to the other provisions of the Treaties and within the limits of the powers conferred by them upon the Union, the Council, acting unanimously in accordance with a special legislative procedure and after obtaining the consent of the European Parliament, may take appropriate action to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation».

Considering articles 10 and 19 TFEU as the leading primary rules, there are at least three questions to deal with regarding the process of accommodating *Sharia* rules.

Firstly, one wonders to what extent such Treaty rules compel the EU institutions or the Member States to remove any legal obstacles that may make *Sharia*-compliant transactions more difficult or less convenient rather than conventional ones. In other words, does the Treaty prescribe a "duty of action"? One such issue might be the case of double stamp duty. Whenever a Sharia-compliant sale-based business operation is performed within a conventional legal system, an issue of double-stamp duty may arise.

Sharia forbids Muslims to pay (or receive) an increase on a sum of money lent; it is a form of *riba*. The Sharia legal tradition therefore provides for alternative legal instruments to achieve the same economic result, for example entering sale-based transactions, such as *murabaha*, literally, a mark-up sale with a commission to purchase. According to the *murabaha* model, a customer entrusts a bank with purchasing the goods and reselling them to him; the bank assumes ownership of the assets before transferring title to the assets to its customer, calculating the sale price as "an agreed mark-up over its own costs". This means that that there are two transferrals of assets, one from the supplier to the bank and the second from the bank to the customer[17]. This double step implies a double stamp duty making *murabaha*-based transactions more expensive than conventional ones[18].

There is another point worth mentioning: in the event of political inertia, can European citizens enjoy the effects of articles 10 and 19 TFEU directly? According to the principle of direct effect of European law rules, any individual is entitled to invoke a European provision before a national or European court with a view to ensuring the application and effectiveness of EU law throughout the Member States. Although it is a fundamental principle of European law, its application is subject to several conditions.

Closely connected to the direct effect principle is the vertical and horizontal application of articles 10 and 19 TFEU. These concern the relations between individuals and the Member States and the relations between individuals respectively. Thus, one wonders whether the principle of non-discrimination on the grounds of religion or beliefs enables the Union (or the Member States) to intervene in Sharia-compliant contract terms given that, according to art. 1.102 PECL, paragraph 1, «Parties are free to enter into a contract and to determine its contents, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles».

The first observation to be made is that the Treaty in force renumbered art. 13 of the Treaty of European Communities (TEC) as art. 19 TFEU, while art. 10 represents something new. Both of them lack a definition of "religion"[19], both outline the principle of non-discrimination as a cross-sectoral

principle[20], and both cover the negative and positive harmonisation processes in the internal market[21].
Under art. 13 TEC, there was no duty of regulatory action either on the national policymakers or on the European Community. This aspect illustrates the difference with regard to the non-discrimination principle on the grounds of nationality or sex[22]. The conclusions seem unchanged within the framework of art. 10 and 19 TFEU[23]. Interestingly, it has been noted that the legislative institutions enjoy a «broad power of appreciation» over appropriate action, which is considered as a political issue[24].
Concerning the direct effect (both vertical and horizontal the Court of Justice has stated the direct effect of non-discrimination as a general principle of (EU) law, both in vertical and horizontal terms, as far as primary or secondary rules are concerned. However, this approach has raised some doubts: a number of scholars have argued that the general principles of law are principles of interpretation and therefore do not confer rights on individuals. In addition, also those scholars who agreed with the Court of Justice on the direct effect above apply it only to the relationship between the individual and the State[25].
However, in *Egenberger*, the Court of Justice established that it is the Charter of Fundamental Rights (the Charter), rather than a secondary source of law, that justifies a horizontal application of the principle of non-discrimination on the grounds of religion or belief. This implies that «The prohibition of all discrimination on grounds of religion or belief is mandatory as a general principle of EU law. That prohibition, which is laid down in Article 21(1) of the Charter, is sufficient in itself to confer on individuals a right which they may rely on as such in disputes between them in a field covered by EU law». As the direct horizontal application has been stated, one wonders when the Charter is in fact applicable[26].

3. The banking contracts in question are those between a Muslim customer and a *Sharia*-compliant bank.
A customer is a consumer or a professional adhering to *Sharia* precepts[27]. In the European legal framework, there is a general definition of consumer and entrepreneur, but the 2011 Consumer directive provides that a “consumer” is a «natural person who, in contracts covered by this Directive, is acting for purposes which are outside his trade, business, craft or profession», while a “trader” is «any natural person or any legal person, irrespective of whether privately or publicly owned, who is acting, including through any other person acting in his name or on his behalf, for purposes relating to his trade, business, craft or profession in relation to contracts covered by this Directive» [28].
On the opposite side of the contract there is a bank. According to the European legal framework for credit institutions, these are legal entities with their head office and central administration in the same Member State, authorised to operate a banking business[29]. The status of legal person might raise some doubts according to classical Islamic law, which only provides for partnerships rather than limited liability companies. However, considering that it would be extremely cumbersome to organise a bank (or an investment fund) as a partnership, Sharia legal scholars have reached the conclusion that banks, investment firms, or investment funds, may be formed as corporations or stock companies, accepting the idea that they only adhere to the basic principles of Islamic partnership law, «not to all rules in details»[30].

It worth noting that if a conventional bank is authorised to provide, among other things, *Sharia*-compliant products and services, it is supposed to set up an Islamic window, namely, a business line financially separate from the rest[31].

However, it might also be an Islamic credit institution based within the Union, either a branch of a third-country Sharia-compliant bank or an EU-based Islamic bank. In the latter case, it is a legal entity authorised to carry on banking business in accordance with the European banking framework, with its head office and central administration in a Member State.

In economic terms, both *Sharia*-compliant and conventional credit institutions perform a maturity transformation function: indeed, they are legal entities collecting repayable funds from the public and extending credit. However, analysing the asset and liability sides, there is a creditor/debtor relationship between the customer and the bank in conventional banking business, while traditionally *Sharia*-compliant business activity is based upon a partnership model.

Within the EU framework, a credit institution is defined as an «undertaking whose business is to receive deposits and other repayable funds from the public and to grant credits for its own accounts»[32], where the link between the two prongs is of paramount importance[33]. The asset and liability operations have in common the transfer of ownership of the monies "borrowed" and "deposited". The borrower acquires title to the funds, and agrees to pay back to the bank the sum of money plus an interest rate on the expiry date; the interest rate is fixed in advance, whatever the degree of profitability the funds are used for. In turn, the bank assumes title to the funds deposited by the client and is entitled to use them to extend credit, acquire shares in undertakings, and make investments within the limits established by the 2013 Banking Directive and Regulation as well as by supervisory authorities' regulations. However, the bank itself will be ready to pay the deposited monies back on the client's demand or whenever the client issues a payment order.

On the asset side, the prototype operation lies in the deposit contract: the term comprises «any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution»[34]. Indeed, there exists a broad concept of demand deposit. It also covers bonds and other repayable funds: not only the «financial instruments which possess the intrinsic characteristic of repayability, but also those which, although not possessing that characteristic, are the subject of a contractual agreement to repay the funds paid»[35].

On the liability side, European banking legislation contains no definition of lending activity. However, the Consumer Credit directive sets out the definition of "consumer credit agreement" as an «agreement whereby a creditor grants or promises to grant to a consumer credit in the form of a deferred payment, loan or other similar financial accommodation, except for agreements for the provision on a continuing basis of services or for the supply of goods of the same kind, where the consumer pays for such services or goods for the duration of their provision by means of installments»[36]. Likewise, the previous version of the Consumer Credit Directive defined the "credit agreement" as «an agreement whereby a creditor grants or promises to grant to a consumer a credit in the form of a deferred payment, a loan or other similar financial accommodation»[37]. The creditor-debtor contract relationship is not consistent with *Sharia* rules in more than one aspect.

Firstly, the paying out of interest on the sum of money borrowed or deposited[38]. This commercial practice does not comply with *riba* prohibitions. An ancient *hadith* states that any exchanges between

fungible goods belonging to the same class (for example, money for money, food for food, goods sold by volume and so forth) is forbidden unless the contracting parties perform their obligations immediately. Therefore, every exchange of debt for debt is deemed a gratuitous contract[39].

Secondly, *Sharia* provides for a partnership relationship between the client and the bank both in the extension of credit and in the collection of repayable funds. There are two leading models: *mudaraba*– and *musharaka*-type operations.

The former approach requires a capital provider ("silent partner") and an entrepreneur ("active partner") contributing either their own capital or their time and work to the venture. Therefore, both of them are entitled to a pro-rata basis return; conversely, all losses fall solely on the capital provider, while in the case of returns lower than expected or no returns at all, the entrepreneur has already lost his time and efforts[40]. The latter partnership model has the appearance of a partnership in ventures where the bank and other partners contribute capital or work to the venture together with their client: all of them participate in the business management as well as in the profits and losses according to a predetermined ratio proportionate to their stakes[41].

Both profit-and-loss sharing models may be applied to the asset and liability sides of the banking business. Taking, for example, the *mudaraba*-based approach, on the liability side, the client acts as the "silent partner" and the bank as the "active partner": however, in conventional terms, this contract relationship is more comparable to portfolio management on an individual basis rather than conventional sight deposits, where the depositor is a riskless creditor[42]. In turn, on the asset side, the client is the "active partner", while the bank is the "silent partner": however, the conventional borrower is a debtor and, most of the time, he/she has to reimburse the capital according to a predetermined interest rate either in instalments or on the spot, whatever the actual returns may be.

From the above observations, it would seem that the client-bank relationship in conventional banking business is not comparable to the *Sharia*-compliant one: the former is based upon a creditor-debtor relationship, while the latter is rooted in a partnership model. However, the legal analysis is far from being black and white.

Initially, legal analysis of the accommodation process may be relaxed by the enforcement of the teleological approach, typical of the European legal frameworks. As a general rule, the European Courts have provided the so-called *effet utile* doctrine, which reads as: «a corollary to the teleological method of interpretation adopted by the ECJ judges in order to apprehend the meaning of Community law in light of its purpose. Accordingly, once the purpose or end of a legal provision is clearly identified, the detailed terms shall be interpreted in order to produce the desired effect». This means that any comparison between activities and services provided by Sharia rules and conventional rules is a long way from being made on a formal basis[43].

Moreover, on the liability side, the conventional and Islamic models of banking business provide for comparable sight or demand (or call) accounts. *Sharia*-compliant sight deposits are demand deposits, repayable at par on demand, but the bank – as active partner – may use these funds to make PLS investments; the bank is enabled to use the deposit funds, but "guarantees the repayment of the entire amount of money at any given moment"; in turn, the depositor is entitled to place and withdraw funds on demand, as well as to execute and receive payment transactions[44].

This means that a Muslim customer entering a contract with a EU-based Sharia-compliant bank may enjoy the advantages of the monetary function of banking exactly like a non-Muslim customer entering a payment account or a deposit account contract with a conventional credit institution based in Europe.

On the asset side, Islamic banks can also provide non-PLS funding. Indeed, the provision of funding on a mark-up basis establishes a creditor-debtor relationship between the bank and the "borrower". One of the most common non-PLS financing modes is *murabaha*. In *murabaha*-based transactions, banks and customers enter into sale-based transactions. The bank finances the purchase of an asset by buying the item on behalf of the client and then resells it to the client adding a mark-up. It is a cost-plus profit contract: the mark-up is the service price. Moreover, the bank provides funds entering into an *Ijara* financing: this resembles either an operating lease or a financing lease. In the *ijara*-operating lease, the bank-lessor transfers the usufruct of the item to the customer, while the lessee is entitled to use it on payment of specified rentals over a certain period; otherwise, in the *ijara*-financing lease, the bank-lessor buys the asset and leases it to the borrower-lessor. If the latter opts to buy it, the monthly payments will cover both the rentals for their use and the instalments towards the purchase price. In the teleological approach, mentioned above, some non-PLS transactions – the *ijara* especially – show some functional-based similarities in relation to passported activities, i.e. financial activities other than banking business subject to the principle of mutual recognition and listed under article 1, para. 2, letter *f*[45].
In the end, being a *Sharia*-compliant credit institution in the EU may be more expensive, but this does not impede operating in the EU as such or entering a contract with a consumer or a trader.

4. The terms of banking contracts may be implied by statute: within the European legal framework they are governed by directives and regulations. This is the case of the 2007 and 2015 Payment Service Directives, which provide for preliminary information duties on charges, fees, and normative conditions; this information will form the backbone of the payment services contract. In addition, the 2009 e-money directives defines e-money as an electronic currency and regulates the main contents of an e-money issuance contract between an issuer (for example, a credit institution) and a holder (be it a consumer or a trader) from the points of view of the e-money issuance process the e-money issuer is in charge of performing, the paying-out of interest, and other benefits on e-money balance, or the main contents and costs of the right to redeem conferred upon the e-money holder[46].
With a view to using the same technique to incorporate Sharia rules within banking contracts, a supporting argument is that the parties' freedom to choose the law applicable is one of the cornerstones of the system of conflict-of-law rules in the field of contractual obligations. However, Sharia rules are generally not State-based rules, and neither the 1980 Rome I Convention[47] nor the 2008 European Regulation on the law applicable to contractual obligations support this construction[48]. While the 1980 Rome I Convention, that sets out the parties' freedom of choice, established that «The rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries»[49], the 2008 European Regulation confirms the choice of the law as the law of a country, but, provides that «This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention»[50]. Which are the «non-State bodies of law»? What does this concept cover? According to the Commission proposal for 2008 regulation, the rationale behind the preamble (13) was to boost the impact of the parties' will and «would authorise the choice of the UNIDROIT principles, the Principles of European Contract Law or a possible future optional Community instrument, while excluding the *lex mercatoria*, which is not precise enough, or private codifications not adequately recognised by the international community»[51].

However, *Sharia* rules turn out to be more comparable to *lex mercatoria* than to Unidroit principles or PECL rules. Since the medieval age, the *lex mercatoria* has always mirrored the needs of the merchant community, developed through a bottom-up process, promoted by the mercantile corporations and the special jurisdiction of the mercantile courts with a view to supporting the freedom of contract and a fair-and-just (*ex aequo et bono*) decision-making process. In the modern age, the *lex mercatoria* is still recognised as a driving force in the creation of a uniform, «customary, spontaneous and thus non-statutory» legal order, while its development has been fostered by non-governmental institutions like the International Chamber of Commerce (ICC)[52]. Sharia rules: *i)* characterise the Muslim community, covering both religious and commercial activities, apart from the nation-State the community members belong to; *ii)* express the idea of «a theory of property rights centred on an "equal sharing" of economic resources» and postulating a primacy of real economy over finance, (b) a theory of obligations where money is more than a commodity, and works as a means of exchange and investment in real activities, and (c) where labour and investment are the only legitimate instruments for acquiring property»; *iii)* are the outcome of a bottom-up normative process, because the leading sources of law are the Quran and Sunna, the holy book and the Prophet's example respectively, together with Islamic jurisprudence, which has arisen through the interpretation of legal experts, the so-called *Sharia* scholars; *iv)* are based on the interpretative activity (*fiqh*): while the divine law is always perfect, the «human comprehension of that law» is merely a supposition of what God's law truly is; it explains that there are several schools of (*Sharia*) law, but they are not organised hierarchically; v) in the end, AAOIFI is performing a valuable task in the process of developing and disseminating accounting, governance auditing concerning the activities of Islamic financial institutions and its application, and harmonising the accounting policies and procedures adopted by Islamic financial institutions[53].

The second legal technique available is so-called incorporation by reproduction. It means that the contracting terms are drafted in such a way as to cover every aspect of the contracting relationship. This mechanism is consistent with the standard and one-sided nature of banking contracts. Furthermore, incorporation by reproduction seems to meet the information requirements provided by the European lawmaker for the need for legal certainty and the predictability of contracting rules. Indeed, once all relevant *Sharia* rules have been inserted in the contract since the beginning, no "*Sharia* risk" should arise from the contracting relationship: the "Sharia risk" is interestingly defined as «the chance that an Islamic financing transaction is challenged on grounds that it does not comply with Islamic law»[54].

Incorporation by reproduction seems to be a workable solution as long as the scope is quite narrow, like the framework contract for the provision of payment services, for example. By contrast, if the banking contract is of a broader scope, covering the provision of payment services, or deposit and credit transactions, it would not seem sensible to lay down any *Sharia* rules to be applied from the beginning, not least because it is difficult to foresee the nature of the banking operations that will be performed in either the near or more distant future.

As a third option, one might turn to so-called incorporation by reference. It entails inserting into the contract one or more clauses that refer to a set of non-State rules in order to lay down the rules on the contracting parties' obligations. The statement often reads as follows: «Subject to the principles of Glorious Sharia, this agreement shall be governed by and construed in accordance with the laws of ... (a Country)». Incorporation by reference may provide great advantages in terms of flexibility. Since it refers to either all the *Sharia* rules or only the relevant *Sharia* rules according to the main purpose of

the contract, a clause like this can cover all possible operations that may be performed throughout the duration of long-term contracts or framework contracts such as banking contracts. However, the flexibility of this clause may challenge the principle of legal certainty enshrined under the European Principles of contract law and the freedom of contract. Indeed, notwithstanding the doubts raised on the boundaries of the law of contractual lien, the ground rules of contracts must be highly foreseeable by the parties and clearly identified when such rules are to be enforced in national jurisdictions.

There is no case on this issue in the Court of Justice's jurisprudence, but there are interesting examples in English case law. In *Shamil Bank of Baharain v. Beximco Pharmaceuticals Ltd. and others*[55], *Musawi v RE International (UK) Ltd and others*[56], *Halpern and others v. Halpern and others*[57] the above-mentioned incorporating clause had been inserted by the contracting parties with regard either to *Sharia* rules or to *Jewish* rules, but referred to English law as the applicable law of the contract in all of them. Thus, the English courts were requested to ascertain the intention of the parties to be bound to a commercial contract containing the said clause.

It is interesting that although the English contract law legal tradition has largely refrained from burdening the contracting parties, in the above-mentioned proceedings the English courts ruled against *Sharia* as legally enforceable rules because it ran counter to the essential need for legal certainty and the predictability of contracting terms.

From the courts' reasoning one might infer that,

- the contracting terms should sufficiently identify "black letter"[58] provisions, i.e. the basic rules of the non-State law to be incorporated by reference, provided that the courts are not entitled to make the contract for the parties (*sub* a). Indeed, in Beximco case law, once it has been ascertained that the reference to the principles of *Sharia* was a reference to the whole body of *Sharia* law, the court of appeal held that «Thus, reference to the principles of Sharia stands unqualified as a reference to the body of Sharia law in general. As such they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless»[59];
- the doctrine of incorporation by reference is properly applied when the contract may be construed and applied by the court pursuant to the contract's governing law. This means that the court should call for expert advice only at the end of the interpretation process carried out according to, for instance, English law. Otherwise, as Mr Justice Clarke in Halpern *vs* Halpern stated, «(...) Those laws [i.e.: *the applicable laws*] would only be a shell in which to incorporate a different non-national law»[60];
- non-State rules are considered "apt" to be incorporated by reference when they are consistent with the secular role of English courts. With regard to *Sharia* rules, one might agree that there was a broad consensus on the general principles as they were expressed in the Holy Books but should also admit that their enforcement through specific rules would involve secular courts in controversial religious disputes[61].

The criticisms from the English courts raise, once again, the issue of the legality of *Sharia* rules. Following the third approach (incorporation by reference), which allows the contracting parties to enjoy some degree of flexibility, one may point to three possibilities:

- *Sharia* rules as trade usage[62]. Indeed, it does not appear persuasive that *Sharia* rules were treated as customs implied in the contracts. Customs, like *Sharia* rules, come from a bottom-up regulatory process because they are not the result of concerted agreements or bargains.

However, the European lawmaker addressed the legal certainty of contracting terms and their uniform application among its founding principles in the 2002 Principle of European Contract Law (or PECL)[63]. PECL principles cover trade usage and establish that «The parties are bound by any usages to which they have agreed and by any practice which they have established between themselves. Unless agreed otherwise, they are considered to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned»[64]. However, trade usage is applied (when enforceable) only in transactions between businesses. This means that addressing Sharia rules as trade usage does not allow us to cope with contracts drawn up between a bank and a Muslim consumer or a micro-enterprise[65].

- *Sharia* as a legal system (or an «emergent legal system»). *Sharia* rules are legal precepts according to a pluralistic approach, as Santi Romano, a leading Italian jurist, puts it. In his construction, a legal system (or institution or legal order) is made up not only of rules of conduct, but first and foremost, of rules of organisation[66]. At the heart of Santi Romano's theory is the idea of community, regarded as an organisation embodying a social order. It means that where there is a group of persons with or without legal personality, displaying a more or less complex organisation, there is a legal system and, as a consequence, an institution. This means that the concept of legal system departs from any religious, ethical, political purposes pursued and becomes a matter of form: it needs organisational rules, namely rules addressing the authority entrusted with legislative power, the procedures to lay down and enforce the rules of conduct, and, in the end, the conditions of membership of the social organisation. At the same time, Romano's approach argues that any organised social force may be considered a legal order: «[T]here can be multiple legal orders, each corresponding to a different social force (variously embodied in, and represented by, an ideal, a common purpose or an aspiration)»[67]. However, EU law and the European jurisprudence tend to address the "legal system" as a State legal system due to the demand for legal certainty. This might explain why a contemporary legal scholar has cautiously addressed *Sharia* as an emergent legal system: «Looked at from a Western, positivist perspective, that legal system appears rather strange, for there are no signs of the usual Western sources of law, i.e. legislation and case-law. However, it does have norm-creating mechanisms. The institutional creation of "standards", the collecting of fatwas, the organic forces mentioned above, including such processes as the consensus of scholars, standard documentation, and the search for guiding principle: all are creating certainty and uniformity in legal rules»[68].
- *Sharia* rules as general clauses. They are all juridical prescriptions to be applied through reference either to other legal precepts or to notions falling outside the general legal framework, such as cultural, technical, or social rules. This is the case for the precautionary principle, good faith, fair trading, or the concept of artistic value. Thus, EU law and the European Court of Justice are familiar with this type of concept as seen in the directive on misleading advertising, the trademark directive, and the unfair terms directive, such as "good faith", or general terms such as "likelihood of confusion" and "significant imbalance". It is argued that there is no reason to conclude that those legal terms do not fall within the jurisdiction of the Court of Justice, or, in

other words, that the national courts are entrusted with providing the final interpretation of such terms of contract by reference to national private laws[69].

4. The Union aims to build up an inclusive and pluralistic community firmly based on the non-discrimination principle. At issue is the principle of non-discrimination on the ground of religion and beliefs, which suffers from legal uncertainties on the level of application, but is it only a question of vertical application? It goes without saying that full application of the non-discrimination principle is an essential pre-condition for making the "internal market" work properly.

The main objective of this analysis was to investigate the process of accommodation of *Sharia* rules in banking contracts when a contract is made between a Muslim customer and a bank providing Sharia-compliant products and services or being a fully *Sharia*-compliant bank.

Firstly, this process is challenged by the lack of a comprehensive European framework for banking contracts and, in general, the lack of a European contract law. This means having to deal with a puzzling framework: there are cases, such as the provision of e-money and payment services, that enjoy a framework harmonised under several (though not all) aspects, but there are some others where the national lawmakers have much leeway in regulating banking contracts, for example, deposits and other bank transactions associated with reimbursable funds.

Secondly, this process of accommodation is challenged by difficulty in establishing the nature of Sharia rules within a conventional legal context given that they do not officially represent the law of a specific country. In contract law, there is a widespread demand for legal certainty. This is the main argument presented by the English court in the *Beximco* judgment.

Among the accommodation options set out in this analysis, preference is goes to a process of incorporation by reference, where *Sharia* rules are considered to be like general contract clauses or terms. Indeed, although my personal preference is for the construction of *Sharia* rules as a legal system or, at least, an "emergent legal system", the EU rules and regulations are more familiar with general clauses, for example, the "good faith" clause in the unfair commercial practices directive. One might suggest a different legal construction if the same problem were to be analysed at the national level.

References

[1] Art. 26 of the Consolidated Version of the Treaty on the Functioning of the European Union (TFEU).

[2] See, G. Bilal, *Islamic finance: alternatives to the Western model*, in *Fletcher F. Aff., 1999 (23), 143 ff.* wrote that «Islam, according to believers, is a social system imparted by Allah (God) to mankind»; while according to M.K. Lewis–L.M. Algaons, *Islamic Banking*, Edward Elgar Cheltenham, 2001, 25, «In any case, the *shari'a* is essentially a complex of rules to which individual adherents must adhere if they are to meet the requirements of their faith, irrespective of whether the observance of these is enforced by temporal authorities».

[3] The legal literature on Islamic finance is too vast to be listed exhaustively. See, in addition to the references mentioned in the previous footnote, M. Fahim Khan – M. Porzio (eds), *Islamic banking and finance in the European Union. A challenge*, Cheltenham: Edward Elgar, 2010; M. Kabir Hassan – M. L. Lewis (eds.), *Handbook of Islamic banking*, Cheltenham: Edward Elgar, 2007; B.L. Seniawski, *Riba today: Social equity, the Economy and Doing business under Islamic Law*, *Colum. J. Transnati'l L.* 2001 (39), 701; C. Mallat, *Commercial law in the Middle East: between classical transactions and*

modern business, Am. J. Comp. L., 2000 (48), 81; A.L.M. Abdul Gafoor, *Islamic banking and finance. Another approach*, The Netherlands: Apptec Publications, 2000; J.F. Jeznec, *Ethic, Islamic Banking and the global financial market*, *Fletcher World Aff.*, 1999 (23), 161; F. Vogel – S. L. Hayes III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague and Boston: Kluwer Law International, 1998*;* S. Chinoy, *Interest-free banking: the legal aspects of Islamic financial transactions*, in *Journal of International Law*, 1995, 10(2), 517-524.

[4] Z. Iqbal – A. Mirakhor, *Islamic banking*, IMF: Washington D.C., March, 1987, 1 – 8.

[5] V. Cattelan, *Introduction. Babel, Islamic finance and Europe: preliminary notes on property rights pluralism*, in V. Cattelan (ed), *Islamic finance in Europe*, Cheltenham, UK, 2013, 1-12.

[6] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan – M. Porzio (eds), *Islamic banking and finance in the European Union*, 40 – 60.

[7] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 49.

[8] *Amplius*, Study Group on a European Civil Code and Research Group on EC Private Law (2009), *Principles, definitions and model rules of European private law*. Draft Common Frame of Reference (DCFR), Sellier, European Law Publishers.

[9] Art. 1, PECL.

[10] Dir. 2000/46/EC of 18 September 2000, published in OJEU L 275/39, of 27.10.2000 on the taking-up, pursuit of and prudential supervision of the business of electronic money institutions; dir. 2009/110/EC of 16 September 2009, published in OJEU L267/7, of 10.10.2009 on the taking-up, pursuit and prudential supervision of electronic money institutions; dir. 2005/29/CE, of 11 May 2005, published on O.J.E.U. of 11 June 2005, L 149/22; dir. 2006/123/EC of 12 December 2006, published on O.J.E.U. of 27 December 2006, L 376/36; dir. 2007/64/EC of 13 November 2007, published in OJEU 319/1, of 5.12.2007 on payment services in the internal market.

[11] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[12] According to Annex 1, section a, MIFID 2, the investment services and activities are: (1) Reception and transmission of orders in relation to one or more financial instruments; (2) Execution of orders on behalf of clients; (3) Dealing on own account; (4) Portfolio management; (5) Investment advice; (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis; (7) Placing of financial instruments without a firm commitment basis; (8) Operation of an MTF; (9) Operation of an OTF.

[13] Markets in Financial Instruments Directive 2014/65/EU (MIFID 2).

[14] Markets in Financial Instrument Directive 2004/39/EU (MIFID 1).

[15] More details: Yeoh, MiFID II opportunities and regulatory challenges, Business Law Review 2018 (39), 126 – 135. The so-called "passporting regime" allows the investment firms and the credit institutions based in a Member State to provide those activities listed as financial services throughout the European Union, either establishing a branch or providing services from abroad, and a further license is needed in the host country.

[16] Case law: *Law Society of British Columbia* v. *Andrews*, [1989] 1 SCR 143; DLR. (4th) 1. More details in: L. Flynn, *The implications of article 13 EC. After Amsterdam, will some forms of discrimination be more equal than others?*, in *Common Market Law Review* (36), 1999, 1127 – 1152.

[17] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (Eds), *Islamic Banking and Finance in the European Union: A Challenge*, 52 f.

[18] The United Kingdom, for example, has removed double stamp duty. *Amplius*, FSA, *Islamic finance in the UK: regulation and changes*, November 2007.

[19] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 1130 ff.

[20] Commenting on the *incipit* of art. 13 TEC («without prejudice to the other provisions of this Treaty...»), Flynn (L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than other?*, 1133) argues that «One reading of Article 13 is, therefore, that as a result of this phrase all other Treaty provisions take precedence over it. However, the formula used in Article 13 EC may be intended to allow non-discrimination clauses to be inserted in legal instruments adopted on the basis of other Treaty provisions whose subject-matter, while relevant in the pursuit of equality, does not have this goal as their objective». Therefore, the Union or the Member States are entitled to take regulatory initiative according to the area concerned: it might be an area of exclusive competence of the Union, an area of Member State competence or, in the end, an area of shared competence. See: art. 2- 6 TFEU.

[21] The negative harmonisation process aims to remove any legal obstacles raised at the European or at State level which may impede the full application of treaty principles; the positive harmonisation process is based upon soft laws and compulsory secondary acts, such as directives, regulations and decisions. While the former is performed by the Court of Justice of the European Union, the latter implies the institutional legislative process, as amended thanks to the Lamfalussy approach. Concerning the positive harmonisation process, the principle of non-discrimination may, due to its cross-sectoral nature, allocate legislative competence to the Member States, the Union, or both of them, as it depends on the sector actually concerned.

[22] See: L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than other?*, 1133 ff..

[23] G. Zaccaroni, *Non-discrimination on the ground of religion: a fundamental element of the EU constitutional legal order?*, University of Milan-Bicocca School of Law, Research Paper Series, 2018, n. 18-01.

[24] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 1136 f.

[25] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 1136 f.

[26] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 9. In addition, the principle of non-discrimination on the grounds of religion is established also in the European Convention of Human Rights (art. 9): see, Human Rights Handbook, n.9, https://www.equalityhumanrights.com/en/human-rights-act/article-9-freedom-thought-belief-and-religion

[27] There is nothing to say that the client may be a Muslim; s/he may also be a non-Muslim opting for rules of this kind.

[28] Art. 2, n. 1-2, 2011 Consumer Directive.

[29] There is also a further possibility: the Sharia-compliant credit institution may be a branch of a third-country bank.

[30] See: F. Vogel – S. L. Hayes III, *Islamic Law and Finance. Religion, Risk and Return*, 133 ff.
[31] On the experience of "Islamic windows" in the UK, see: FSA, Islamic finance in the UK: regulations and challenges, 7.
[32] Art. 4, reg. 2013/575/EU, of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, published on *OJ L 176, 27.6.2013, p. 338–436.*
[33] Cfm., Opinion of the European Central Bank of 5 December 2008 on the proposal for a Directive on the taking up, the pursuit and prudential supervision of the business electronic money institutions, published in OJEU C 30/1, 6.2.2009, § 1.3.
[34] Article 1, directive 1994/19 EC. *Supra* note 14.
[35] Case C-366/97. *See:* Opinion of ECB of 26 April 2006 on a proposal for a directive on payment services in the internal market, OJ C 109/10.
[36] Directive 2008/48 EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers repealing Council Directive 87/102/EEC.
[37] It is beyond any doubt that the concept of "granting credit (for its own account)" is not limited to the consumer credit agreement's object, and this paper is not the feasible place to make a comprehensive list of all lending activities. However, the Consumer Credit Directive helps us to figure out the type of relationship between the bank-lender and the client-borrower (creditor-debtor relationship).
[38] This was the *Caixa Bank* case (Case 442/02) where the European Court ruled out a French law preventing banks from paying an interest rate out on sight accounts because it forbade the rationale of the common market. The Court held that the freedom of establishment forbade national lawmakers (i.e.: French regulator) to lay down rules preventing domestic as well as subsidiaries of the credit institutions set up in Member States other than France from remunerating the sight accounts in euro with residents in France to lower the cost of banking services to the consumers. However, even though this regulatory choice was purported to protect consumers' interest, it went beyond what was necessary. In giving its reasons, the Court maintained that, despite the fact that French law made no discrimination between domestic and foreign banks, it ended up scaling down the range of banking products available to the customers by decreasing the range of remunerated and non-remunerated sight accounts they may make their choice upon (See § 22 Caixa-Bank France case). Some critical remarks in: G. Rotondo, *The remuneration of sight accounts and the feasible competition between Islamic and Western systems*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 158 – 163.
[39] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 42. A *hadith* is a written report on the Prophet's life, contained in Sunna; Sunna, in turn, is one of the main Sharia sources of law (see, above paragraph 1). More details on the sources of law: F. Vogel – S. L. Hayes III, *Islamic Law and Finance. Religion, Risk and Return*, 23 ff.
[40] G.M. Piccinelli, *The provision and management of savings: the client-partner model*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 23-39.
[41] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 51 ff.

[42] P. Abbadessa, *Islamic banking: impression of an Italian jurist*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 207 – 211. However, the provision of portfolio management on individual basis is deemed to be a financial service, therefore, a EU-based credit institution is entitled to operate this type of activity as far as it is provided with ad-hoc authorisation. As emphasised in section 1, the financial services are subject to a set of tailor-made EU-based rules and regulations as laid down in MiFID regulatory packages, which fall behind the scope of this paper.

[43] L. Charpentier, *The European Court of Justice and the rhetoric of affirmative action*, European University Institute, Working Paper RSC, 98/30.

[44] G.M. Piccinelli, *The provision and management of savings: the client-partner model*, in M. Fahim Khan, M. Porzio, (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 27 f.

[45] The statutory list of passported activities includes: • taking-up activities: deposit-taking and other forms of borrowing; • lending activities such as consumer credit, mortgage lending factors, invoice discounting and trade finance, factoring, forfaiting, financial leasing, guarantees and commitments; • the provision of payment services; • the issue and administration of means of payment; • money transmission services; and • trading on one's own account or the account of the customers in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments or securities.

[46] For example, the 2009 directive provides that electronic money issuers have to issue electronic money at par value on the receipt of funds and no interest or any other benefit related to the "length of time during which an electronic money holder holds the electronic money"[46].

[47] Dir. 80/934/EEC, OJEC of 9.10.1980 No L 266/1.

[48] In June 2009, Regulation n. 593/2008 of the European Parliament and of the Council replaced Rome I Convention for Member States. An interesting report in Z. Tang (2008), *Law applicable in the absence of choice – The new article 4 of the Rome I Regulation*, in *The Modern Law Review* 71 (5), 785-800.

[49] Art. 3, 1980 Rome Convention.

[50] Preamble (13), EU Regulation Rome I.

[51] COM (2005) 260 final, Brussels, 15.12.2005.

[52] More details in: G. Baron, *Do the Unidroit principles of international commercial contracts form a new lex mercatoria?*, in *Arbitration International*, 1999, vol. 15 (2), 115 – 130.

[53] AAOIFI is a not-for-profit organisation, based in Bahrain and established in 1991. It is responsible for the development and issuance of standards for the global Islamic finance industry. More details on: http://aaoifi.com/?lang=en

[54] K. Bälz, *Sharia risk? How Islamic finance has transformed Islamic contract law*, Occasional Publication (9), September 2008, Islamic Legal Studies Program, Harvard Law School.

[55] *Shamil Bank of Baharain v. Beximco Pharmaceuticals Ltd. And others* [2003] EWHC 2118 (Comm.), All ER (Comm) 849 and Court of Appeal [2004] EWCA Civ 19. See, N. Saleh (2004), *A landmark judgement of 23 January 2004 by the England and Wales Court of Appeal*, in *Arab Law Quarterly* 19, 1-2.

[56] [2007] EWHC 2981 (Ch), [2008] 1 Lloyd's Rep 326, [2008] 1 All ER (Comm) 607.

[57] [2006] EWHC 603 (Comm) and [2007] EWCA Civ 291.

[58] See, Court of Appeal [2004] EWCA Civ 19, at § 51.
[59] See, Court of Appeal [2004] EWCA Civ 19, at § 52.
[60] See, [2006] EWHC 603 (Comm), at § 74.
[61] See, [2003] EWHC 2118 (Comm.), All ER (Comm) 849, at § 36.
[62] «A trade usage may be defined as a general or at least widespread regular observance of a particular line of conduct amongst those engaged in a particular branch of international trade over at least a short period of time». See: https://www.trans-lex.org/903000/highlight_usage/trade-usages/#references
[63] PECL: Article I.2.2. Here it is also established that «The usage is qualified in three ways:1) it must be a usage which the parties knew or ought to have known; 2) it must be widely known and regularly observed in international trade (thereby excluding domestic or local usages) by parties to contracts of the type involved and 3) the usage must emanate from the particular branch of trade in which the parties are operating. If the parties conclude the contract in full knowledge of the usage, it may be regarded as deriving its quasi-normative force, which overrides other non-mandatory rules of the Lex Mercatoria, from the contract itself. If the parties ought to have known the usage, it is endowed with a type of de facto normativity».
[64] PECL: article 1:105.
[65] Within EU law, microenterprises may be legally treated as consumers.
[66] Santi Romano began by contending that a legal system amounted to a sum of norms and, consequently, objectivity and enforceability through sanctions were to be considered as the distinguishing features of the legal system as a whole.
[67] S. Romano, *L'ordinamento giuridico*, Sansoni, Florence, 1962. An interesting analysis in: F. Fontanelli, *Santi Romano and L'Ordinamento Giuridico: the relevance of a forgotten masterpiece for contemporary international*, in *Transnational Legal Theory*, 2015, 67 – 117.
[68] N. Foster, *Islamic finance law as an emergent legal system*, in *Arab Law Quarterly*, 2007, vol. 21, 170 – 188.
[69] I. Klauer, *General clauses in European private law and "stricter" national standards: the unfair terms directive*, in *European Review of Private Law*, 2000 (1), 187 – 210.

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