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› Islamic Finance Made in Germany – A Case Study on Kuveyt Türk (KT Bank): Germany’s First Islamic Bank

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› Islamic Finance Made in Germany – A Case Study on Kuveyt Türk (KT Bank): Germany's First Islamic Bank

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Abstract

In recent decades, Islamic Finance has seen an interesting growth and spread, not only in the Arab or other Muslim, but also in Western countries. This article focuses on Islamic Finance in Germany, a European country characterized by strong economic growth and an increasing Muslim community, mostly of Turkish origin, which saw the opening of its first Islamic Bank in July 2015.

After a very brief overview on the experience and the current situation of Islamic Finance in Germany, we will focus on the question whether within the German supervisory law, within the rules for corporate governance or within the civil and tax law legal obstacles can be found that hinder the establishment of Islamic Financial Institutions in Germany. As Islamic bank customers choose Sharia compliant products voluntarily out of respect for their faith, we will focus on the role of the Sharia Supervisory Board, which certifies whether a financial product is in accordance with the Islamic Law.

The main part of this article will contain a case study on the KT Bank. We will discuss the current situation of the bank, examine some of their products and ask whether their Sharia Supervisory Board and their internal Sharia Compliance System can be brought in line with the German supervisory and company law. Afterwards we will analyze the position and role of the participatory depositors, especially those who invest their savings under the principle of profit and loss sharing, in the context of Corporate Governance. We will answer the question whether these stakeholders should have a possibility of participation within the bank. Finally, we will discuss Islamic Finance in the context of Corporate Social Responsibility and analyze the position of the KT Bank in this context.

Content

1. Introduction	2
2. Islamic Finance in Germany: An Overview	4
3. The legal framework for Islamic Banks in Germany	7
3.1. Supervisory Law: no special rule for Islamic Financial Institutions?.....	7
3.2. Corporate Governance as a legal obstacle for Islamic Institutions?.....	10
3.3. German Contract Law	15
3.4. Double Tax in the case of a murabaha.....	16
4. The German KT Bank: A case study	17
4.1. Foundation, legal structure and financial background	17
4.2. Products and services offered: what risks associated	19
4.2.1. The self-presentation of the KT Bank.....	19
4.2.2. KT Participation Account	21
4.2.3. KT Real Estate Financing.....	22
4.2.4. KT Instalment Loan, KT Car Financing, KT Business Loan	24
4.3. Internal Organization of KT Bank and Corporate Governance.....	27
4.3.1. A Sharia Supervisory Board called Ethical Council	27
4.3.2. A Sharia Compliance Department named Prinzipien- Umsetzungskomitee (Principles Implementation Committee)	30
4.4. The depositors and investors' position in the context of Corporate Governance	31
4.5. The KT Bank in the light of Corporate Social Responsibility	35
4.5.1 The concept of Corporate Social Responsibility – an overview	35
4.5.2. The KT Bank's CSR view	37
5. Conclusion	39
References	42

1. Introduction

In addition to many scandals, such as the manipulation of exchange rates and the interest rates “EURIBOR”,¹ the global financial crisis of 2007/2008 and its aftermath have awakened the debate on new forms of finance. Unlike conventional finance, these forms tend to be more oriented towards ethical, moral and religious aspects. Although Islamic Finance has an ancient tradition, it can be named in this context. According to several studies, Islamic Finance growth in the recent decades was at an annual rate revolving around 10-20%,² and with a development that has reached various economic sectors.³ This development started in the early 1970s after the end of colonialism of many Arab countries, which had marginalized the Islamic Finance.⁴

Islamic Finance can be defined as follows: It encompasses all kinds of financial services that are conducted without breaching the rules of the *Sharia*, although the contract itself is subject to a secular (national) jurisdiction. There are nearly no known examples where Islamic religious law was chosen as the governing law of a contract or at least there this would be valid.⁵ Islamic Banking is not only interest-free-banking. In fact, in addition to the prohibition of *riba* (commonly translated as interest), there are several underlying principles of Islamic Finance in the Koran such as the prohibition of speculation (*maysi*) and of implementing elements of uncertainty in contracts (*ghara*), also called the prohibition of gambling. Moreover, trade or investment in goods and in any activity prohibited by the Koran (*haram*) is not accepted. As a consequence of these basic principles Islamic financial transactions are characterized by the method of profit and loss sharing (PLS) and the fact that nearly all financial transactions have an underlying real asset.

¹ For more Details see Lehmann (2016), 207, 211 et seq.

² According to the ICD-Thomson Reuters Islamic Finance Report 2016, the global indicator of Islamic Finance development (IFDI) in 2016 was about 9% (8,828%). It is an indicator of the overall health and development of the Islamic financial industry worldwide that includes: Quantitative Development, Knowledge, CSR, Governance and Awareness. For more information see e.g.: <http://www.zawya.com/islamic-finance-development-indicator/>.

³ According to the latest Thomson Reuters report 2015/2016, “*State Of The Global Islamic Economy Report*”, Muslim consumers in 2014 spent about 1.8 trillion dollars in the Islamic economic sector and it is estimated that this amount will reach up to 2.6 trillion dollars in 2020. It is a market with obvious potential development with regard to the core business Halal, strengthened by a predominant presence of young Muslim consumers (1.7 billion worldwide). The purpose of the Global Islamic Economy Indicator (GIEI) is to show the current development of Islamic economy sectors. The GIEI is a composite weighted index comprised of *six sector level indicators* (Halal Food, Islamic Finance, Halal Travel, Modest Fashion, Halal Media and Recreation, and Halal Pharmaceuticals and Cosmetics) across 73 core countries. The Indicator is not a ranking of current size and growth of each market, but evaluates the quality of the overall Islamic economy ecosystem including social considerations. For more information see: <http://www.zawya.com/mena/en/story/ZAWYA20150810103426/>.

⁴ Iqbal and Mirakhor (2011). p. 13 et seq.

⁵ Casper (2014), p. 41, 42; see also Warde (2000), p. 5. In the Beximco case of the Court of Appeal, 28 January 2004, [2004] All ER (D) 280 the court decided that Islamic law cannot be chosen as the governing clause.

The development of Islamic Finance has not only taken place in Arab-Muslim, but also some European countries, in particular in Great Britain, which today is considered a hub of Islamic Finance in Europe with five Islamic Banks operating in the British financial sector. Besides Great Britain, this development has taken place in France, Luxembourg and finally Germany, which has seen the opening of its first Islamic bank in July 2015.

The establishment of Islamic Finance in the European context leads to some difficulties: The religious peculiarities of Islamic Banks make them differ from the conventional banks. Therefore, the integration of Islamic Banks into the different countries' regulatory and tax environment is a significant challenge.

The application of the PLS principle seems to leave some gaps in terms of the managerial powers' equilibrium and the representation of interests in the Islamic bank management bodies. They are directed to ensure transparent management activity and to protect the interests of the stakeholders, especially those who take up the responsibility of investing their savings by sharing the risk of loss, the so-called *participatory depositors*. Notably, they do so without having effective managerial powers over the activities, not even over those supported by their financial contribution.

Therefore, it is important to analyze Islamic bank's corporate governance, its specificities and the approaches that can be taken in order to ensure compliance with the ethical-religious goals as well as with the law and the best practices provided by the mandatory law of the country in which it operates. In particular, we will take the following points into considerations:

1. The Islamic bank in the context of German supervisory and company law;
2. The Islamic bank's corporate governance structure;
3. The bodies responsible for the Sharia supervision, their configuration in the Islamic bank's corporate governance and their integration under the law;
4. The stakeholders' protection, with particular emphasis on the case of the participatory depositors.

Starting with a general overview on the development of Islamic Finance in Germany, we will examine German law regarding corporate governance and the possible integration of the Sharia supervisory function and finally conclude with the study of the case of Kuveyt Turk Bank, the first Islamic Banks operating in Germany.

2. Islamic Finance in Germany: An Overview

In 2010, the former German Federal President Christian Wulf said that Islam belongs to Germany. Although the veracity of this statement is still discussed controversially today,⁶ it cannot be ignored that Germany's Muslim population has risen rapidly ever since Turkish workers immigrated during the late 1960s. By the end of 2015, the federal Statistics Office Germany had registered the highest net immigration rate of foreigners in the history of the Federal Republic of Germany. Many of the 1.1 million counted immigrants were Muslims.⁷ According to the latest statistical data, the number of Muslims present in Germany amounts to 4.7 million (5.9% of the total population)⁸. This number is expected to increase as a result of the refugee crisis and further migration waves. A lot of these people are potential customers of Islamic Banks.

The beginning of Islamic Finance in Europe dates back to the 1980s, when the first branches of foreign Islamic Banks opened in the United Kingdom. In Germany, however, Islamic Finance was not offered for many years. German Muslims had predominantly come from Turkey, where Islamic Banking was not very popular until the 1990s. Until the AKP came to power, Turkey was a practicing secular state⁹ with a slow development of Islamic Banking. Therefore, German Muslims with Turkish background had little experience with Islamic Finance at all. Many of them had been educated in accordance with the philosophy of modern Turkey's founding father, Atatürk, who once said: "I have no religion, and at times I wish all religions at the bottom of the sea."¹⁰ Consequently, Islamic Banks saw no market for Islamic financial products in Germany. This changed in the very late 1990s, when the first Islamic Funds - founded mostly under the law of Luxembourg - were offered in Germany. The absence of Islamic financial products in Germany definitely ended in 2004, when the first Islamic bond (Sukuk) was issued by the federal state Saxony-Anhalt.¹¹ Subsequently, there has been an appreciable openness toward Islamic Finance. The German Federal Financial Supervisory Authority (BaFin) has promoted two international conferences in 2009 and 2012. They outlined the peculiarities of Islamic financial instruments and the potential economic benefits the country might gain from establishing an Islamic Finance industry in Germany.

⁶ See <http://www.zeit.de/2015/09/christian-wulf-angela-merkel-islam-deutschland>.

⁷ See https://www.destatis.de/EN/PressServices/Press/pr/2016/03/PE16_105_12421.html.

⁸ For further information refer to the following link: http://www.bamf.de/SharedDocs/Anlagen/DE/Publikationen/Broschueren/jahresbericht-forschungszentrum-2015.pdf?__blob=publicationFile.

⁹ According to Turkey's current constitution, the country is still secular, but since AKP came to power this is no longer visible in everyday life.

¹⁰ Quoted after Mango (1928).

¹¹ The *Sukuk* was subscribed by Gulf countries investors (Bahrain and United Arab Emirates) 60% and by European investors for the remaining 40% (France and Germany). In 2009 the entire amount of the *Ijarah Sukuk* (equal to 100 million euro) was repaid; see ECB Occasional Paper No. 146. Available at SSRN: <http://ssrn.com/abstract=2251204>.

Despite the absence of Islamic Banks in Germany, various conventional German banks, such as the Deutsche Bank, Unicredit (at that time still known as Hypo-Vereinsbank), or the insurance company Allianz have offered Islamic Banking through branches or subsidiaries in different Arabic countries, mainly located in the Gulf States.¹² Primarily, this so-called “Islamic Window” offered Islamic investment banking, instead of Islamic retail banking, to German customers. Since 2008, the German financial market has experienced a considerable presence of Islamic investment funds like the Meridio Funds, which was founded under the law of Luxembourg.¹³ Another milestone in the development of Islamic Finance was the foundation of the Institute for Islamic Banking and Finance in Frankfurt in 2006, a consulting firm in the field of Islamic Finance.¹⁴ One more reason for the increasing popularity of Islamic Banking was the significant presence of non-Turkish Muslim immigrants and the growing heterogeneity of the Muslim community in Germany.¹⁵ Hypothetically, the so-called re-Islamization of Turkey might have had an influence on some of the German Muslims with Turkish background. However, there is no empirical evidence to support this thesis.

Although Islamic Finance developed significantly within the first decade of the millennium, it took until the summer of 2015 for the first Islamic bank to be established in Germany. In 2004, the Kuveyt Türk Katılım Bankası A.Ş. had established a branch in Mannheim, without a German banking license. In 2010 they got a license limited to the brokering of deposit business with undertakings domiciled in a state outside the European Economic Area (sec. 1 subsec. 1a sentence 1 No. 5 German Banking Act). However, without a full banking license, the range of products was limited. The KT Bank applied for a full license in 2012. But without a blue print, it took the German supervisory authority (Bundesanstalt für Finanzdienstleistungsaufsicht, in the following BaFin) nearly two and half years to make sure that Germany’s first Islamic bank was working in compliance with the German Supervisory Law. The reasons for this extraordinary long process remain unknown to the public. One reason might have

¹² Schönenbach, R. (2011), „An Overview of Islamic Finance in Germany” available at <http://www.citizentimes.eu/2011/03/04/an-overview-of-islamic-finance-in-germany/>.

¹³ Funds, that had been available in Germany, are listed by Farhoush and Mahlknecht in Cattelan, 2013, p. 206, who rightly point out that the level was still low. For details of Islamic Funds under German Law see Casper (2016), p. 129-151 and Casper (2011c) p. 229-246.

¹⁴ For more Details see www.ifibaf.com and https://www.franz-hitze-haus.de/fileadmin/redakteure/download/IFIBAF_Company_2014.pdf.

¹⁵ According to the study "Muslim Life in Germany", published in 2009 by the German Interior Ministry (http://www.bamf.de/SharedDocs/Anlagen/EN/Publikationen/Flyer/flyer-muslimisches-leben-kurzfassung-en.pdf?__blob=publicationFile), the Muslim population in Germany is today highly heterogeneous. The Turkish are still the dominant group, about 63 per cent (in absolute values from about 2.5 to 2.7 million people); but about 14 per cent (between 496,000 and 606,000 people) are from the southeast European countries (Bosnia, Bulgaria and Albania); from the Middle East about 8 per cent with a number between 292,000 to 370,000 migrants; from North Africa around 7 per cent (between 259,000 and 302,000 people), most of whom came from Morocco and, finally, the rest is from Central Asia / CIS, Iran, South/Southeast Asia and other parts of Africa (about 8 per cent in total).

been that there was no rulebook for establishing an Islamic Bank in Germany. Another could be the unprecedented nature of the products of an Islamic Bank.

Now one might argue, that the German law in particular and European law in general has been hindering the development of Islamic Finance in Germany as it is not familiar with contracts or even financial institutions governed by a religious law. But as further discussed under 3., this argument is not convincing at all. First of all, Islamic Finance is not governed by the Sharia in the sense that Islamic law is the applicable law of the contract of Islamic financial products. The contract is governed by the national secular law, and the parties simply try to stipulate it in accordance with Islamic law or its religious principles. Secondly, German law is neutral to the religions or ethical background of the content of a contract as long as the contract complies with mandatory German law.¹⁶ The same is true for German supervisory law. As long as all requirements under German supervisory law are fulfilled, it does not matter whether the bank has an ethical, a religious, agnostic or a capitalistic background. In fact, it is the other way around. As the German society is – like most societies in Europe – an open-minded and liberal society, its law is also open to different religious or ethical business models of financial institutions.

Another important factor that has effectively promoted and continues to support the development of the Islamic Finance and Islamic Banking sector in Europe is the European Union Directive 2004/39/EC on *Markets Financial Instruments* (MiFID)¹⁷. It involves the so-called "*Single European Passport*" wherewith licensed banks operating in a EU country may expand their business to other member countries without having to repeat the authorization process.¹⁸

¹⁶ For more details see Casper (2011a), p. 251-274 and fundamental on this aspect Huster (2017).

¹⁷ Directive 2004/39/EC of the European Parliament and of the Council from of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (http://ec.europa.eu/finance/securities/isd/mifid/index_en.htm).

¹⁸ The EU has just elaborated a new MiFID II. It still has to be incorporated into the national law of the member states with the aim of making financial markets more efficient, resilient and transparent, and to strengthen the protection of investors. For more details see: http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm.

The European *passporting* clause is also valid for Islamic Banks already authorized in one of the EU member states and enables them to expand their activities throughout the European Union. This way, the Islamic financial institutes have an opportunity to also operate in EU countries with less willingness and openness to the development of this religious finance model in their national financial market.

Future developments depend on a wide range of factors. The Turkish KT Bank can be considered a pioneer actor in the Islamic Finance field of Germany. Nonetheless, it would be helpful if other Islamic Banks entered the German banking sector in order to facilitate the development of Islamic Finance in a healthy competitive climate and to avoid a bank classified as Muslim becoming a mere ethnic bank.

3. The legal framework for Islamic Banks in Germany

3.1. Supervisory Law: no special rule for Islamic Financial Institutions?

Similar to other European Countries, Germany has no special rules regarding its supervisory law for Islamic Banks or other kinds of ethical or religious Financial Institutions as it is known in countries like e.g. Bahrain or Malaysia.¹⁹ As mentioned before, the supervisory law in Germany naturally treats all religious or ethical firms equally. Therefore, the German law only asks whether an Islamic Bank meets all requirements for establishing a Bank in general. Before we go into a discussion of what difficulties an Islamic Bank has to be aware of during this process, the question whether the German supervisory law is at all applicable to Islamic Financial Institutions has to be answered.

Different to the approach in many other countries, German supervisory law does not provide a general clause, which defines the nature of a Bank or Financial Institutions. Instead, sec. 1 of the German Banking Act (Kreditwesengesetz) contains an enumerative list of financial contracts. If a company offers one or more of these contracts regularly, it is required to hold a banking license for doing so. As this list was originally written in 1934 it only contains traditional contracts such as a loan with interest, saving or current accounts, leasing contracts, the collection of cheques or cashless payments such as a credit transfer²⁰. Although this list was extended several times since 1934, it does not include a *mudaraba*, a *musharaka* or a *murabaha*. If e.g. a company would only offer financing via *murabaha* contracts on a regular basis, one could argue that a banking license might not be necessary because a *murabaha* is

¹⁹ For Bahrain see an overview in Casper (2010a), p. 457, 462 et seq. with further references. Critical to this aspect Casper (2011b), p 21.

²⁰ If one offers only credit transfers or credit cards he or she needs only a license under the German Supervisory Act for different forms of cashless payments (Zahlungsdienstenaufsichtsgesetz) and not under the German Banking Act (Kreditwesengesetz). But this makes no difference in our context.

not a loan. Among German Scholars it is controversially discussed whether a *mura-baha*, due to a functional approach, can be considered a loan in the course of the German supervisory law because it allows the customer to finance goods without paying interest.²¹

However, there is no doubt that an Islamic Bank which offers the typical variety of financial products such as deposit banking or the issuing of credit cards²² is required to hold a license because this kind of services are clearly named in the list of sec. 1 of the German Banking Supervisory Act. Apart from this a bank should be interested in acquiring a license for its own account and benefit because a reasonable customer is unlikely to trust a financial services provider without a license.

If an Islamic Financial Institutions (IFI) applies for a banking license, it has to meet all the requirements of the German Banking Act. It is not necessary to list and discuss all of these requirements here. But we are going to highlight some of the aspects that could be difficult to fulfill for an Islamic Bank.

One main issue, which came up during the application of the KT Bank for a license, was the ultimate responsibility of the management board for all corporate actions and its independence from the Sharia Supervisory Board (SSB). Although the ultimate responsibility is not explicitly mentioned in the German Banking Act, it is a fundamental principle of Corporate Governance and the Supervisory Law because the Bank shall not be ruled from persons operating in the background.²³ Only registered managers who are monitored by the supervisory authority are allowed to take on responsibility. The German Financial Supervisory Authority already mentioned this aspect in a letter from June 8, 1989 concerning Christian Investment Funds.²⁴ The letter emphasized that the investment policy and the decision which assets may be bought must be made by the funds management and not by an external ethical board. More details on how to ensure the ultimate responsibility will be further discussed in sec. 3.2.; as this is mainly a question of Corporate Governance.

²¹ See for more details Casper (2010b), p. 345, 349 et seq with further references, who is supporting the functional approach and argues that the *agio* (the surplus) with that the Islamic Bank sells the product to its customer is similar to interest and the whole contract fulfill the same function like a loan.

²² See above footnote 20.

²³ See for example *Sorge* (2010), p. 363, 365 et seq with further references.

²⁴ BAKred letter dated 8 June 1989 (Az. V 4/51) titled „Anforderungen an die Umschreibung der Anlagegrundsätze, Funktion von Anlageausschüssen“.

Another concern, regarding in particular Islamic Banks, is the policy of refinancing. As the traditional market for refinance is based on interest, a fully flagged Sharia compliant bank cannot use this source of refinancing. The Islamic Bank must constantly ensure the Financial Supervisory Authority of sufficient liquidity for debt payment. Refinancing of Islamic Banks is one of the black boxes within academic discussion of Islamic Banking. One way to comply with the German Supervisory Law is to show superior equity in comparison to other banks or the possible participation in a Sharia compliant, interest free refinance market based on sukuks and other kinds of Islamic Finance. Alternatively, a potent liquidity sponsor such as a treasury house organized and supported by a state that promotes Islamic Finance meets the requirements of the German Supervisory Law. We are not aware of the details on how this question was solved in the KT case.²⁵ To our knowledge, the KT Bank in Germany works with a high equity rate and deposits of its customers.

Another issue in the context of the supervisory law is the protection of deposits. Under German and European law, a bank has to be part of a deposit guarantee scheme. This scheme, normally a fund, guarantees the deposits up to a certain sum in the case of an insolvency of the bank. In Germany this sum goes up to 100.000 Euro.²⁶ Some Islamic Scholars argue that this kind of an absolute promise to pay back the deposit is not compatible with Islamic Law and should be modified for Islamic Banks, as it is not in accordance with the principle of profit and loss sharing.²⁷ However, investor protection is guaranteed by German law to all investors and is therefore mandatory. The German Act of the protection of the deposits (Einlagensicherungsgesetz) also forbids the depositor to waive this privilege.²⁸ In Germany, the KT Bank accepted this requirement and is ever since a member of the deposit protection scheme of the private banks in Germany.²⁹ However, KT Bank is not a member of the voluntary deposit protection scheme which grants deposit protection beyond the 100.000 Euro threshold of the mandatory deposit guarantee scheme.

²⁵ Therefore, we will not come back to this aspect in our case study under 4.

²⁶ See Einlagensicherungsgesetz dated 28 May 2015 (BGBl. I S. 786) and DIRECTIVE 2014/49/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 April 2014 on deposit guarantee schemes, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0049&from=DE>.

²⁷ Archer and Karim (2007), p. 330 et seq; Hassan and Lewis (2007), p. 344 et seq.

²⁸ A different perspective from British law takes Wilson (2012) p. 116.

²⁹ See <https://einlagensicherungsfonds.de/banks/kt-bank-ag> and https://www.kt-bank.de/wp-content/pdfs/Informationsbogen_fuer_den_Einleger.pdf. Therefore, there is need to come back to this point in details under 4.

3.2. Corporate Governance as a legal obstacle for Islamic Institutions?

When talking about Corporate Governance and Islamic Financial Institutions, two different approaches may occur. One perspective is the traditional western view of Corporate Governance. It asks how an Islamic Financial Institution, given its different structure, can be successfully integrated into this traditional system, which is based on three different theoretical approaches: the agency theory, the stakeholder theory and the stewardship theory.³⁰ The other point of view is advocated by Islamic Scholars who focus on what they can learn from the traditional debate on Corporate Governance in order to develop an autonomous system of Corporate Governance for the IFI, helping to ensure these Institutions work in compliance with the Islamic Law and its Principles.³¹ In the following and once more in 4.3, we will argue from the perspective of a traditional, western point of view on Corporate Governance. Furthermore, we will discuss whether this view – or to be more precise – whether the mandatory German company law can be a legal obstacle to build up an Islamic Bank in Germany. Subsequently in 4.4. and 4.5, we are going to switch the argumentative perspective and address the issue, whether the participatory depositors should be treated as a shareholder from a Corporate Governance for Islamic Financial Institutions point of view.

To the traditional debate on Corporate Governance, a religious supervisory body such as a SSB seems to be a clear alien element. This can evidently be seen in the German Company Law. Sec. 76 subsec. 1 of the German Stock Corporation Act can be translated as the following: “The management board shall have direct responsibility for the management of the company.”³² Among German Scholars it is widely accepted that this direct responsibility has to be interpreted as the above-mentioned ultimate responsibility. This can also be seen in sec. 119 subsec. 2 of the German Stock Corporation Act, which emphasizes that even the shareholders’ meeting may only decide on matters concerning the management of the company if required to do so by the management board. Thus, a strong influence of the SSB on the management has to be avoided. In the following, we are going to discuss how this can be ensured.

From a German point of view, a SSB can be qualified as an advisory council (*Beirat*), which is, however, unfamiliar to the German Stock Corporation Act (AktG). Due to sec. 23 subsec. 5 AktG, the majority of the German literature assumes the prohibition of the establishment of an advisory council as there is no room for another supervi-

³⁰ See the overview by Obid and Naysary, Towards a Comprehensive Theoretical Framework for Sharia Governance in Islamic Financial Institutions, in: Harrison/Ibrahim (2016) p. 10, 12 et seq.

³¹ For this approach see e.g. Obid and Naysary (footnote 30), p. 10, 20 et seq.

³² This translation was taken from Norton Rose (ed), German Stock Corporation Act (Aktengesetz), available under <http://www.nortonrosefulbright.com/knowledge/publications/147034/german-stock-corporation-act-aktengesetz>.

sory body besides the regular Supervisory Board (*Aufsichtsrat*).³³ Nonetheless, from our point of view, the SSB is no subject to this discussion. A SSB can be embedded in the German understanding of Corporate Governance, if there is a clear separation between the responsibilities of both supervisory bodies, and if the management board is still responsible for all decisions regarding the bank. Therefore, there is no reason to qualify an SSB as an advisory council (*Beirat*) competing with the Supervisory Board.

As shown before, the ultimate responsibility of the management board is a key principle of German law on stock corporation companies as well as of supervisory law.³⁴ Hence, the SSB's decisions cannot be binding for the company. Even if its decisions may be factually binding, according to the law the ultimate decision has to be made by the management board of the respective bank, which bears the sole responsibility for a company's business policy. The AAOIFI, Governance Standard for Islamic Financial Institutions No. 1, sec. 2 which demands that the SSB's opinion shall be binding on the Islamic bank, is not in accordance with German and European Law. Also the former British Financial Services Authority (FSA), the predecessor of today's Financial Conduct Authority (FCA), demands proof from IFI that, in case a SSB is installed, it only exercises an advisory function and does not interfere with the management of the institution. In an explanatory paper this is stated as follows: „The key point from the FSA's perspective is that firms can successfully show that the role and responsibilities of their SSB are advisory and that it does not interfere with the management of the firm.”³⁵

An IFI based in Germany needs to take precautionary measures in order to avoid any SSB decisions to become formally or factually binding. One way to do this is to have the internal regulation of the SSB and/or the management board state clear responsibilities and declare the decisions of the SSB as not binding. Another possibility is to have the SSB adopted by the managing and not by the supervisory board or the shareholder meeting, so the management board may release the SSB when it tries to influence the management board. Furthermore, it should be highlighted that after the SSB has objected specific financial products or work processes within the Islamic bank, due to their non-Sharia-compliant nature, it must propose various problem-solving solutions to the management board. The Managing Board may then choose between different alternatives.³⁶

³³ *Mertens*, in: Kölner Kommentar zum AktG Vor § 76 Rn. 28; *Habersack*, in: Münchener Kommentar zum AktG § 95 Rn. 6; *Hoffmann-Becking*, in: Münchener Handbuch zum Gesellschaftsrecht, tome 3: AG, 3rd ed. 2007, § 29 Rn. 19a.

³⁴ See for example *Sorge* (2010): 363, 365 et seq with further references.

³⁵ FSA, Islamic Finance in the UK: Regulation and Challenges, November 2007, www.fsa.gov.uk/pubs/other/islamic_finance.pdf, p. 13.

³⁶ For more Details see *Sorge* (2010): 363, 367 et seq.

On the other hand the independence of the SSB from the management board is also an important aspect of the Corporate Governance of Islamic Financials institutions (IFSB Guiding Principles on Sharia Governance Systems for Institutions offering Islamic Financial Services, December 2009, No. 3.1. margin number 40 et seq.; AAOIFI Governance Standard for Islamic Financial Institutions No. 1 sec. 2, No. 5, sec. 2-7).³⁷ As long as the act of protection against unfair competition is not triggered, the neutral, secular German or European law neither bothers whether this aspect is ensured by the Islamic Bank, nor whether the SSB works well or whether the financial product offered by an Islamic bank is eventually Sharia compliant or not. The same applies for the qualification of SSB members.³⁸

When seats in different SSBs are held by one and the same person, conflicts of interest must be avoided. According to a survey by funds@work, *Nizam Yaqubi*, one of the most popular scholars, is a member in 85 SSB at once.³⁹ Although the German and European law contains several provisions regarding the avoidance of conflicts of interest, there is no rule for the SSB in particular. This has to be changed, not only from the perspective of the debate on Corporate Governance for IFI, but also from the traditional western viewpoint on Corporate Governance. From the German perspective, one could refer to the rules for the Supervisory Board (sec. 100 subsec. 2 German Stock Corporation Code). Due to this rule a person is not allowed to hold more than 10 mandates in different Supervisory Boards. Many German Scholars suggest reducing this number to six.⁴⁰ We agree that the discussion regarding sec. 100 German Stock Corporation Code does not hold the same weight with regard to the SSB. The workload of members of an SSB is not as extensive as the one of a regular Supervisory Board member. However, holding 85 mandates is undoubtedly an excessive workload; even for hardworking and efficient people. More importantly, a clear rule regarding the prevention of conflicts of interest must be added to German Supervisory Law. If a scholar within the SSB is only concerned with the certification of Islamic financial products or the business process of an IFI, there is no need to ban him from holding a membership in the board of a competing Islamic financial institution. However, if the advisory function of the SSB plays an important role, rules of incompatibility in regard to a membership in SSBs of competing institutes need to be established. The advisory function should primarily be fulfilled by the internal Sharia Compliance Department or Officer and not, or at least not primarily, by the external SSB.

³⁷ For more details see Casper (2014), p. 41, 53 et seq.

³⁸ For more details on this aspect, that an is an important point from the view of Corporate Governance for IFI, see Casper (2014), p. 41, 51 et seq.

³⁹ See report by funds@work, *The Small World of Islamic Finance - Sharia Scholars and Governance*, 19 January 2011, http://www.funds-at-work.com/uploads/media/Sharia-Network_by_Funds_at_Work_AG.pdf_03.pdf.

⁴⁰ See e.g. Deutscher Juristentag (ed.), *Beschlüsse der wirtschaftsrechtlichen Abteilung des 69. DJT No. 18*, available under www.djt.de.

Another point in the debate on Corporate Governance for IFI is the role of the internal Sharia Compliance or Review. According to the AAOIFI Standards “the internal Sharia review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of an IFI. It shall be established within an IFI to examine and evaluate the extent of compliance with Islamic Sharia rules and principles, fatwas, guidelines, and instructions issued by the IFI’s Sharia supervisory board” (No 3. sub 2 part 1).” From the German or European Perspective there is no such obligation. But every IFI located in the EU has the obligation to establish a regular Compliance Department as governed by Art. 13 MiFID, sec. 25c para 1 KWG German Banking Act or section 33 German Securities Exchange Act (WpHG). As regular Compliance and an internal Sharia Compliance are not the same, the crucial question is whether the Sharia compliance function can be embedded in an existing regular Compliance Department. To answer this question one has to be aware of three basic requirements for a regular Compliance Department stipulated in section 33(1) cl. 2 no. 1 of the WpHG. This section calls the Compliance Department a “compliance function” without drawing a distinction. Thereafter, the Compliance Department of investment services companies must meet three criteria: independence, effectiveness and permanence.⁴¹ Today it is widely accepted that independence does not mean independence from the management board, but only from other persons within the company as Compliance is a task of the management.⁴² The management board is responsible for the whole enterprise including compliance to all legal duties and therefore to the Compliance Department as well. Consequently, the question about the role of an internal Sharia Compliance Department and its influence on the management board must be brought up. If the SSB’s decision has no binding effect and no direct influence on the Sharia Compliance Department and if this is subordinated to the management board, there is no reason why the internal Sharia Compliance Department cannot be embedded into the regular Compliance Department. Yet this question can only be answered with respect to the specific circumstances and guidelines of the Islamic Financial Institution (IFI).

Therefore, another rule within the AAOIFI Governance Standards could be problematic: “The primary objective of the internal Sharia review is to ensure that the management of an IFI discharges their responsibilities in relation to the implementation of the Sharia rules and principles as determined by the IFI’s SSB.” (No. 3 sub 2 part 2). “They shall have direct and regular communications with all levels of management, SSB and external auditors, which shall enhance the organizational status of the internal Sharia reviewers.” (No. 3 sub 7). This statement could potentially conflict with the independence of the management board from the SSB. On the other hand, the principles of the AAOIFI clarify: “The head of the internal Shari’a review shall be re-

⁴¹ With regard to the general debate on Corporate Compliance and Corporate Governance see Casper (2017), p. 477 et seq.

⁴² Casper (2017), p. 477, 481 et seq.

sponsible to the board of directors.” (No. 3 sub 7). And further it is pointed out that “[t]he head of the internal Shari’a review shall discuss conclusions and recommendations with appropriate levels of management before issuing a final written report.” (No. 3 sub 20). This report has to be written four times a year and is addressed to the SSB as well. To our understanding, these last two statements of the AAOIFIF confirm that, even according to the principles of the AAOIFI, the internal Sharia Compliance Department falls under the responsibility of the Board of Directors or the two boards in the two-tier system. As long as the Sharia Compliance Department does not function as the SSB’s extended arm and as long as it does not automatically report potential breaches of Islamic law directly to the SSB before having informed the management board, both kinds of Compliance Departments may be merged together. However, clear guidelines for the Compliance Department ought to be written down as a precautionary measure. They shall set out the differences between actions triggered by a breach of public and religious law as well as the reporting structure and the relationship between internal Sharia Compliance Department and the SSB.

This section’s subject matter was whether German Corporate Governance might be a legal obstacle for Islamic Banks in Germany. As long as the aspects mentioned above are taken into account, a SSB as well as an internal Sharia Compliance Department may be brought in line with the German requirements for good Corporate Governance. Therefore German Company Law is no legal obstacle for IFI.

3.3. German Contract Law

As mentioned before, financial contracts between an IFI and their customers are not governed by Islamic Law. From the perspective of German International Private Law, this would not be possible either. At least the wide majority of German Scholars argues that only the parties may choose the state made law of another state, but not religious law.⁴³ Therefore, the IFI have mutually agreed upon German Contract Law as the jurisdiction to govern the interpretation and enforcement of the terms of their contracts.

German Contract Law is neutral to the beliefs and the religious or ethical background of the contracting parties. But due to German Civil Law's principle of freedom of contracts the parties are free to implement this background into the contract, in particular if they use contract templates issued by the AAOIFI or the IFSB, as long as these provisions are in accordance with the mandatory civil law.⁴⁴ Since there is no uniform interpretation of the Sharia a product might be tested on its Sharia-conformity (so called Sharia Risk). This question has also been widely discussed under the catchphrase "Sharia Trap". There is no need for this article to go into more details. We leave it at summarizing the results of studies of Co-Author Casper. The religious background of a contract is not necessarily the basis of the transaction in terms of sec. 313 German Civil Code.⁴⁵ The interpretation of the contract must take the religious background of the parties into account. Oftentimes, this shows which party bears the risk of the contract's potential nonconformity with Islamic Law. In this context, it is generally not appropriate for only one party to bear this risk on its own. In case of financial products, e.g. a sukuk, prospectus liability can be triggered. If a customer blames his Islamic Bank for the financial product's lacking alignment with Islamic law following the signing of the contract, prospectus liability should be confined to extreme cases of obvious breaches of the Sharia principles. An indemnification clause or alternatively a disclaimer may be acceptable if the classification by the SSB is a legitimate interpretation within the commonly accepted boundaries of Islamic law. Prospectus liability does not apply when the assessment of a product's Sharia compliance changes during the duration of the contract. In this case the IFI is only liable for a breach of contract if the change was predictable and if the investor suffers a financial loss from this exact change.⁴⁶

To put it in a nutshell, German contract law poses no legal obstacle for Islamic Finance in Germany.

⁴³ From the German Perspective Bälz (2005), p. 44, 45 with further references; from the international Perspective Junius (2007), p. 537, 546 et seq.

⁴⁴ For more Details see Casper (2011a), p. 251, 256 et seq.

⁴⁵ For more Details see Casper (2011a), p. 251, 260 et seq.

⁴⁶ For more Details see Casper (2014), p. 41, 55 et seq.

3.4. Double Tax in the case of a murabaha

German Tax law is equally neutral to the religious or ethical background of a contract. But due to the structure of a murabaha, which can be described as a double purchase transaction⁴⁷, taxes may pose a reason to hinder a murabaha or make it at least much more expensive. To some extent, this problem can be solved in the context of the value added tax (VAT). If the net price of the financed good the bank has to pay for on first purchase is e.g. 1.000; the bank has to pay a VAT of 19% to the seller (190). By selling the same good to its customer with a surplus of – let's say – 200 to the net price, the customer has to pay VAT on 1.200, which means 228. The bank may deduct the VAT it had to pay to the seller from this sum, the so-called value added tax on input (*Vorsteuer*). Therefore additional VAT due the structure has only to be paid on the surplus. In our example the additional VAT is 38. Therefore the VAT presents no serious obstacle to financing goods with a murabaha instead of the conventional loan with interest, although the debtor does not have to pay VAT on the interest of a loan.

However, this system does not work in the context of the stamp duty land tax for real estate (*Grunderwerbsteuer*). The German Act on land transfer tax knows no deductible input tax. In our example above the bank would have to pay the full stamp duty land tax on the 1.000 and the customer then again on the 1.200.⁴⁸ This problem does not only accrue in Germany. The British legislator has solved this problem in 2003. Ever since, the stamp duty land tax in a murabaha transaction has to be paid only once by the customer of the bank.⁴⁹ The German Legislator has not recognized this problem yet or at least has seen no reason to act and exempt the murabaha from the double stamp duty land tax. But as we will show in the further course of our case study, this double taxation can be legally avoided by using a diminishing musharaka in form of a partnership under German civil law.

⁴⁷ Ayub (2007), p. 217 et seq; El-Gamal (2006), p. 65 et seq; Thurner in: Ebert/Thiessen (2010), p. 146 et seq; Casper (2010b), p. 345, 354 et seq.

⁴⁸ The rate of the stamp duty land tax in Germany varies in the different federal states between 3,5% and 6,5%.

⁴⁹ For details see Nethercott and Eisenberg (2012), recital 4.157; Ercanbrack, *Regulation financial institution in the UK*, in: Cattelan (2013), p. 157, 165.

4. The German KT Bank: A case study⁵⁰

2015 was a crucial year for the development of the Islamic Finance industry in Germany. It was marked by the debut of the first Islamic bank, the Kuveyt Turk Bank AG (in the following KT Bank). Authorized by the BaFin as a credit institution subject to the German supervisory law, the KT Bank aims to offer complete financial products and services compatible with the principles of the Islamic Law (the Sharia) and the principles of good management.

As the KT Bank is pointing out on its website, it aims to be one of the Eurozone's leading banks by offering services to everyone, regardless of religious faith. The KT Bank presents itself as a bank for the Muslim community and for all those who wish to invest in a sustainable and socially responsible manner.⁵¹ In a long run, the KT Bank wants to offer "Islamic Finance made in Germany".

4.1. Foundation, legal structure and financial background

The "KT Bank AG" was founded as a stock corporation under German Law (Aktiengesellschaft, AG) in November 2014. It is a 100% subsidiary of Kuveyt Türk Katılım Bankası A.Ş. located in Istanbul, which has been operating for nearly 30 years. The majority of the parent company's shares are owned by the Islamic Bank Kuwait Finance House (KFH), which was founded as the first Islamic Bank in Kuwait in 1977. As mentioned before (see above 2.) the Kuveyt Türk Katılım Bankası A.Ş. had already opened a representative office in Mannheim in 2004, offering ethnic services related to the transfer of money from the Germany Turkish community to their families in Turkey and was eventually granted a limited license for non-EEA deposit broking in 2010.

The incorporation of the KT Bank as a fully flagged Sharia compliant bank took place after overcoming several difficulties, mainly related to the corporate governance specificity characterizing the Islamic Banking model (in particular the presence of the Sharia Supervisory Board) and their subsequent integration in the German regulatory framework. Regulatory difficulties and specificities of the Governance structure will be discussed in the section about the KT Bank's corporate governance structure (4.4.). Moreover, the different product categories on the assets and liabilities side have been subject to scrutiny by the regulator.

⁵⁰ Our case study is based on questionnaires and an interview administered to the KT Bank AG Frankfurt's Branch and on information can be found on the bank's website. The authors are very thankful to Mr. Ibrahim Bilgin, Head of AML & Compliance at KT Bank AG for answering the questionnaire and additional questions.

⁵¹ See <https://www.kt-bank.de/ueber-uns/kt-bank/>.

The request for obtaining the license to operate as a credit institution was submitted to the BaFin in October 2012 and granted in March 2015 after two and a half years of continued commitment from the promoters of this banking project. KT Bank started its business on July 1, 2015. In the German media this opening has been widely discussed and was a starting point for academic study on Islamic Finance promoted by the BaFin with two conferences a couple of years ago.

Currently, the KT Bank is defined as the first Islamic Bank authorized to operate in Germany. It is based in Frankfurt am Main, with three other branches located in Berlin, Mannheim and Cologne and the prospect of opening new branches in Munich and Hamburg. The longterm goal would be to offer products and Islamic Banking services in continental Europe.

We have no valid data about the structure and the number of customers besides the information given by the KT Bank itself, saying that 90% of them are Muslims, of which about 70% have a Turkish origin.

This information highlights the specificity of the social context in which the KT Bank AG has to operate. It focuses primarily on the fulfillment of the economic religious requirements related specifically to the Turkish community. Notwithstanding the predominant presence of the Turkish community, the KT Bank should target customers of different origins to extend their reach.

Due to the recent opening of the KT Bank AG there is no consolidated data about its financial structure and economic dimension. However, some economic and financial data relating to the KT Bank's activities is available in its disclosed balances sheets for 2015 and 2016.⁵² However, the balance sheet of 2015 is not very informative either, because KT just started its business activities in July 2015 with the first six months being the starting period. By the end of 2016 the total asset has been about 108.3 Mio. Euro (54.4 Mio. Euro in 2015), the equity was 37.5 Mio. Euro (22.5 Mio. Euro in 2015) with an annual deficit of 11.4 Mio. Euro (9.5 Mio. Euro in 2015). The volume of the KT Bank customers' liabilities amounted to 38.1 Mio. Euro, realizing an increase of 29.9 Mio. Euro compared to the end of 2015 period (respectively 8.2 Mio. Euro) and were divided over the debts due on a daily basis (22.5 Mio. Euro) and other liabilities (15.6 Mio. Euro). The latter refers to participation accounts with terms between three months and three years, conferred by participatory depositors, a special category of stakeholders that will be analyzed in the following parts of this paper. Finally, the KT Bank announced on its website that the assets have been doubled in

⁵² It can be found under www.bundesanzeiger.de (https://www.bundesanzeiger.de/ebanzwww/wexsservlet?session.sessionid=72bfd2c967742bead5a5584ec74dd891&page.navid=detailsearchdetailtodetailsearchdetailprint&fts_search_list.destHistoryId=57773&fts_search_list.selected=2e3e22f8dedd6233 and <https://www.bundesanzeiger.de/ebanzwww/wexsservlet>).

2016 compared with 2015. But even with a balance sheet of 108.3Mio. Euro by the end of 2016 achieved as announced, the KT Bank is still a small Bank comparable to a smaller or mediums sized Volks- and Raiffeisenbank.⁵³

4.2. Products and services offered: what risks associated

4.2.1. The self-presentation of the KT Bank

From the analysis of the KT Bank website, one can observe an appreciable attention to the marketing. In addition to the classic business presentation (about us, mission, corporate governance, etc.), the website contains a detailed section dedicated to the theoretical definition of an “Islamic Bank”, its fundamental principles (*prohibition of riba, maysir, gharar, PLS* etc.), and their technical explanation.

This shows how much the bank willingness to demonstrate its religious authenticity and explain to its customers the ethical and religious values characterize its range of financial products and services. Specifically, the KT Bank defines itself as an Islamic Bank that operates:

- *in a responsible manner;*
- *with maximum transparency;*
- *no interest on loans;*
- *not highly speculative operations;*
- *halal Investments.*

⁵³ These banks that are organized as a cooperative have an average balance sheet of 875 Mio. Euros. The smallest VR Bank has a balance Sheet of 20 Mio Euro; the biggest of 38 Billion Euro, for details see [https://www.bvr.de/p.nsf/o/D3E488DF22571CECC1257DoAoo5439B7/\\$file/ListeAllerBanken_2016_.pdf](https://www.bvr.de/p.nsf/o/D3E488DF22571CECC1257DoAoo5439B7/$file/ListeAllerBanken_2016_.pdf).

In addition to the written presentation, the homepage lists a number of slogans⁵⁴ and short videos that explain the functioning of the bank, products and services offered in a simplified and comprehensive way.⁵⁵

The website, originally drafted in German and Turkish language, is currently available in English as well. The bank emphasizes the religious and ethical aspects of its business by advertising the products not only through words, but also through images and symbols characterizing the Muslim culture (e.g. importance of the family, Muslim women wearing a veil).

The KT Bank's marketing strategy is primarily concerned with illustrating its ethical-religious nature. This may reasonably be explained by the fact that its main target group is the Muslim community which, despite its consistent presence, remains a minority in comparison to the total German population that has benefitted from years of traditional banking services.

Desirable would be the implementation of other languages, namely Arabic, in view of the considerable presence of Arab-Muslims that might be interested in becoming KT Bank' customers.

Regarding the typologies of products offered, the website contains two sections, one dedicated to private customers and the other for business customers.

The area reserved to the *retail clients* includes the following products: a) opening of bank account compatible with Sharia (the absence of the application of interest); b) credit cards; c) participation account; d) real estate financing; e) instalment loans; and f) money transfers to Turkey.

A set of products with which the KT Bank seeks to satisfy the daily financial needs of its private and business clients, based on shared values and religious compatibility:

"Now there is an account that fits in my life. And my conviction"

"With our business account, we offer a solution for the management of your daily banking activities".

⁵⁴ The following are some examples of slogans:

"An Islamic bank? There is now also in Germany"

"Now there is a bank with which you has much in common. With which you share the same values"

"Now there is a bank that does not deal with everything. but with all the responsibility"

"Now there is a bank, which does not speculate, but make reasonable investments".

⁵⁵ Please refer to the following link for displaying an example of commercials video: <https://www.youtube.com/channel/UCOrNQnAJU1Dxeiu44NyqMOW>.

Interviews conducted with the KT Bank show that its customers aim to satisfy, in order of priority, the following financial requirements:

1. *Finance / Business investment;*
2. *Islamic Real Estate Financing;*
3. *Opening of banking account providing payment services without the riba (interest);*
4. *Consumer loans (esp. car financing);*
5. *Investment in the Stock market.*

On the retail clients side, there are more requests for the products “*Real Estate Financing*” and “*Car Financing Product*”. In contrast, on the corporate client’s side, there is a higher demand for the *Murabaha* based product, namely the “*Kt Business Loan*”. In the following, we will describe some of the various Islamic financial products offered by the KT Bank, which were subject to Sharia supervision, carried out by its Ethics Council, in order to ensure their compliance with the Sharia.⁵⁶ The Sharia compliance certificates issued by the KT Bank’s Ethics Council are given in different languages (German, Turkish, English and Arabic) and published on the Bank’s website. Our information is mainly based on our interview and online sources. We did not have access to sample contracts for these products.

4.2.2. KT Participation Account

The participatory account contract involves the deposit of the customer’s money at the KT Bank. Clients may invest their savings in projects compatible with the Sharia principles and according to the principle of sharing profits and losses on the basis of a percentage of allocation previously agreed upon by the parties.

It is a substitute to the traditional savings account which is based on interest. The participation account is no regular current account for deposit and cashless payments. Current accounts are offered by the KT Bank as well, but they are very similar to the current accounts of conventional banks. The main difference is that there is no possibility to overdraw the current account with the KT Bank.

The participation account contract considered one of the pillars of Islamic Finance. In particular, the KT Bank offers a well-defined plan for this *participatory deposit*, in which it specifies the extent of profits shared between the bank and the customer (in terms of percentage) based on the duration of the deposit (3 to 36 months) and the

⁵⁶ The Sharia compliance certificates issued by the Ethics Council of KT Bank are available in the following link: <https://www.kt-bank.de/en/service/certificates/>.

investment size (minimum amount is 1,000 €).⁵⁷ If the customer invests e.g. more than 50,000 Euro for 24 months he or she receives 93% of the profit while the bank keeps 7% to itself. The account is based on the traditional mudaraba concept.⁵⁸ Therefore, the amount of the profit is not guaranteed.⁵⁹ Due to the concept of the mudaraba, this also applies for the invested capital. The investor has to bear the risk of capital loss. Surprisingly, the website does not explicitly mention this risk in the description of the participation account.⁶⁰ But the general terms and conditions of the participation account⁶¹ clearly state in sec. 5.3: “Losses of the invested capital have to be borne by the customer, but the loss is limited to the amount of the invested capital. However, the bank will endeavor to minimize possible losses of the customers.” Contrary to a regular mudaraba, only a part of the profit is shared between the bank (mudarib) and the customer. Instead, the bank has the right to transfer a reasonable part of the profit into a special fund called “Gewinnstabilisierungsreserve” (see sec. 5.1, 5.2 general terms and conditions), that can be freely translated as a cushion-fund with the purpose of stabilizing the profit over the years. This fund can not only be used to upgrade the profit, (disbursement in years with a low profit) but also to avoid or minimize a participation in the losses (see sec. 5.3 sent. 3 of the general terms and conditions).

4.2.3. KT Real Estate Financing

The formula of the Real Estate Financing contract is another good example for the engagement Islamic Banks employ in order to determine financial techniques compatible with the religious principles and the secular legal framework in Germany.⁶²

⁵⁷ The illustrative tables relating to the entity (in percentage) of the profits posted by KT Bank are present in the following link: <https://www.kt-bank.de/en/retailclients/participationaccount/>.

⁵⁸ See e.g. Johansen and Hanif in: Nethercott and Eisenberg (2012), p. 174, 184 et. seq.

⁵⁹ KT Bank stated the average outcome between 0.43% with a duration of three months and 0.62% with a duration of 12 months; the average annual percentage of paid returns in May 2017 were 0.68% with three months, 58% with 6 months and 70% with 12 months terms.

⁶⁰ See: <https://www.kt-bank.de/en/retailclients/participationaccount/>, there is only mentioned: “This lucrative option is based on the principle of profit and loss participation.”

⁶¹ https://www.kt-bank.de/wp-content/pdfs/Sonderbedingungen_fuer_Beteiligungskonten.pdf, they are only available in German.

⁶² The development of these legal solutions was made possible thanks to the support of some legal companies interested in the topic of Islamic Finance; in this case from the company Norton Rose Fulbright.

In order to avoid the double taxation on the property transfer (see above 3.4.) and to be financed according to the PLS principle, the KT Bank has adopted a procedure in which the bank and the client constitute a civil law partnership (GbR), following the preliminary valuation of the client, the solvency, and the property's condition. In the beginning, the customer receives share equivalent to his co-payment and the bank subscribes the rest of the shares.

Next, they proceed with the purchase of the real estate in the name of the GbR. At this point, the stamp duty land tax has to be paid by the customer and is normally financed as well.

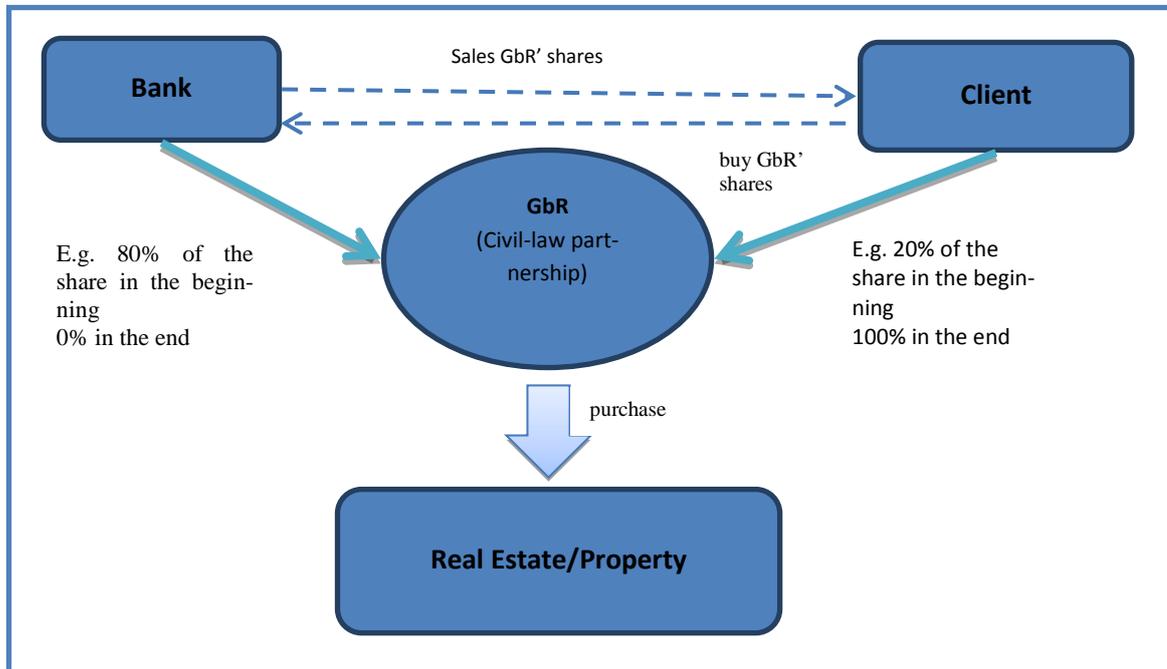
Finally, the client buys the bank's shares in the GbR, probably for an amount corresponding to the total cost of the property plus a mark-up (Agio), which is used to pay the service and the financing cost of the bank, which must be paid monthly in fixed rates for a maximum period of ten years, thus becoming the sole owner of all shares.⁶³ There is no formal liquidation of the partnership needed, because in the moment one partner has all the shares she or he consequently gets the property purchased in the name of the GbR. This method, apparently complex, has been certified by the Ethic Council as a diminishing *Musharaka* (also called *Musharaka Mutanaqisa*) transaction compatible from the Sharia view (Table 1.1.).⁶⁴ In accordance with German tax law, the duty stamp land tax has not to be paid twice if the established company lasts at least five years and the client holds at least 5.1% of the shares during this time. Thus, it is possible to avoid paying the stamp duty twice.

In accordance with German Law, every partner of a civil law partnership is liable for all debts of the partnership. If the customer asked a craftsman in the name of partnership to repair the house that was financed, the bank would be liable as well. The KT Bank pointed out that the customer is not allowed to sign contracts in the name of the partnership, but only in his or her own name. Both parties also agree that in the internal relationship the customer alone is liable and bears the risk of defects of the house. Therefore, he has the right to claim remedies against the seller of the house in his own name. The Ethical Board of the KT Bank has approved this practice.

⁶³ For more details of house financing with a diminishing musharaka Johansen and Hanif in Nethercott and Eisenberg (2012), recital 6.16 et seq.; Ayub (2007), p. 300 et seq.; in particular from the German point of view: Wurst (2011).

⁶⁴ For further information please refer to the following link: <https://www.kt-bank.de/en/retailclients/realestatefinancing/>.

Table 1.1. KT Real Estate Financing (Source: own elaboration)



4.2.4. KT Instalment Loan, KT Car Financing, KT Business Loan

This category of contracts offers a service, requested by both retail and business's banks clients, for the purchase of goods by the financing rates method. A financing model, that in the conventional banking service is mainly based on the application of the interests, as direct compensation for the amount anticipated from the bank for the purchase of the assets. The KT Bank offers this service by using the Islamic financial instrument of *Murabaha lil imiri bi-Shira* (*Murabaha* with purchase order), namely a financing contract free from interests and therefore Sharia compliant.⁶⁵

The structure of the contract is based on an agency mandate, in which the KT Bank assigns to its client the task of purchasing a specific good (selected by the clients) from a third party in a religiously lawful manner on behalf of KT Bank. Successively, the KT Bank sells the purchased good to the client, at a price corresponding to the initial acquisition cost plus a reasonable surplus (*Agio*) previously agreed upon, according to an instalment payment plan (Table 1.2). This contract structure of *Murabaha lil imiri bi-Shira* is used by the KT Bank for several certified products (KT Car

⁶⁵ https://www.kt-bank.de/wp-content/uploads/2017/01/Verbraucherkredit_englisch.pdf.
https://www.kt-bank.de/wp-content/uploads/2017/01/KFZ-Finanzierung_englisch.pdf.
https://www.kt-bank.de/wp-content/uploads/2017/01/Geschäftskredit_englisch.pdf.

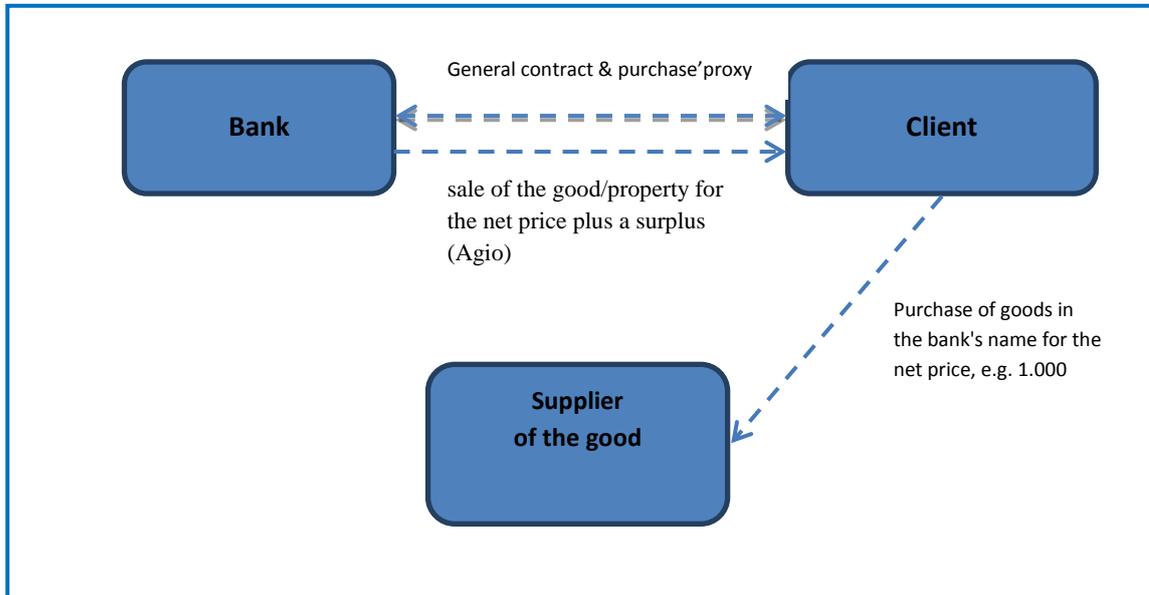
Financing and KT Business Loan).⁶⁶ From a Western perspective this surplus is nothing else than a discounted form of interest like it is known in a loan with a disagio.⁶⁷ Nevertheless, all law schools of the Sunni Islam unanimously consider this kind of murabaha legitimate, although at first glance the bank „only“ bears the purchaser’s risk of bankruptcy just like a usual bank does in an installment loan with interest. A breach of the riba-prohibition is not supposed to be considered as long as the bank bears at least the risk of accidental losses in the interim’s time and the risk of non-payment. This would be possible if the financed good was first delivered to the bank so that the risk of accidental losses was borne there, or if the bank, and not the seller, was responsible for a defect of the car. The takeover of such a quasi-entrepreneurial risk, however, is doubtful if the bank never acquires the ownership of the item or only acquires it for a logical second. Furthermore, if it disbars any warranty claims for defects as to quality and refers the purchaser to claims against the seller (the so-called cessions-remedy), which appears to happen quite often in practice as seen in leasing contracts. In our interview KT Bank pointed out, that the customer can claim warranty from the bank if he is a consumer in the scene of sec. 13 German Civil Code. Only in contracts with commercial customers, the warranty rights of bank against the seller are ceded to the customer and the warranty in the relation between the bank and its customer is excluded. Notably, in the interview the KT Bank also pointed out that the customer directly acquires the car. In a first step the bank and the customer agree on a basic contract. With this contract the customer is empowered to begin negotiations about buying the car in the name of the bank. Yet the customer is not authorized to sign the contract in the name of the bank. This is done by the bank herself. After the KT Bank has signed the first contract and paid the purchase price to the dealer, the customer is entitled to receive the car directly from the seller. To ensure that the KT Bank does not sell something it does not own yet, which would be unlawful under Islamic law, the second sales contract between the bank and the customer is only signed after the bank has paid the dealer and the car has been delivered to the customer.⁶⁸ In theory, the KT Bank and their customer would now sign the second sales contract. But in practice, the customer already unilaterally signs this contract before the bank makes the payment to the dealer. However, the KT Bank signs this second contract after the payment and the delivery of the car. After signing this second contract, it sends a copy to the customer, who is granted a right to withdraw the contract within two weeks from the time of access (sec. 312d, 355 German Civil Code).

⁶⁶ <https://www.kt-bank.de/en/service/certificates/>.

⁶⁷ In a loan with a disagio, the borrower has not to pay interest on a regular basis. Instead of this, the borrower receives only e.g. 95% of the loan, but has to pay back 100% of it. From an economic perspective, it is agreed that the disagio of 5% can be qualified as the interest that is paid in advance.

⁶⁸ For a better understanding of this construction one has to know that the German separation between the sales contracts an obligation and the assignment of the property as different contract is not known to the Islamic law.

Table 1.2. KT Bank' *Murabaha lil imiri bi-shira* (Source: own elaboration)



This structure of the Murabaha lil imiri bi-Shira, used by KT Bank, is characterized by an evident absence of direct contact between the bank and the supplier of the sale asset. It is entrusted directly to the client and at least the commercial customer bears this risk of the effect and has to claim the remedy, which is ceded to him by the bank. It is not our aim to discuss the Sharia-compliance of this structure, which was successfully approved by KT Banks's Ethical Council in accordance with the predominate opinion within the Sunni Islam.

4.3. Internal Organization of KT Bank and Corporate Governance

As mentioned before under 2. and 3.2., Corporate Governance in general and the role of the Sharia Supervisory Board (SSB) of the KT Bank have been an issue during the licensing process. Therefore, we are going to analyze the SSB of the KT Bank in more detail (4.3.1.). Afterwards, we are going to precisely describe and evaluate the internal process of the Sharia Compliance structure (4.3.2.).

4.3.1. A Sharia Supervisory Board called Ethical Council

As a starting point, we want to recall that the KT Bank is organized as a stock corporation under German Law (Aktiengesellschaft). Hence, it has three mandatory organs: The shareholders' meeting, a supervisory board and a managing board. As the KT Bank is a 100% subsidiary of Kuveyt Türk Katılım Bankası A.Ş. located in Istanbul, there is only one single shareholder. Therefore, the German Corporate Law applies, but we do not have to go into any details, because this is not a specific question of Islamic Banking. The supervisory board is elected and adopted by the shareholders' meeting. Because the KT Bank has less than 500 employees, no codetermination is applicable.⁶⁹ Momentarily, the KT Bank has a supervisory board of three members and all of them are serving as managers at the parent company as well. The duties and responsibilities of the supervisory board are stipulated in sec. 96 et seq. German Stock Corporation Code. Thus the management board is limited to two persons; one of them is a former manager with experience in Islamic Finance who has served in different positions in the parent company and the other one is a former bank manager with experience in conventional banking in Germany.

In addition to these three traditional and mandatory organs, the KT Bank has adopted an external Ethical Council. Due to the "Rules of procedure of the external Ethical Council", which are not released at the moment,⁷⁰ and according to the description on the website,⁷¹ it fulfills all three function of a SSB: First, the function to certificate all products offered by the KT Bank as Sharia compliant. This certification function is explicitly mentioned in the "Rules of procedure of the external Ethical Council" (in the following REC) and it can also be found in the description of the Ethical Council on the website. In addition to the description of the products, a link to the legal opinion (fatwa) of the Ethical Council is offered to the customers. Besides this main function of a SSB, the Ethical Council has to supervise the accordance of the business

⁶⁹ If the KT Bank had more than 500 Employees, 1/3 of the seats in the supervisory board would have to be elected by the employees, in case of more than 2.000 employees, 1/2.

⁷⁰ As the REC is not public, KT Bank asked us not to quote directly. We respect this. Therefore we tried to repeat the main content as it is important for our survey in our own words.

⁷¹ See <https://www.kt-bank.de/en/aboutus/ethicscouncil/>.

policy with the Sharia. Moreover, the Ethical Council also has to take up an advisory function that may be criticized from the point of Corporate Governance (see above 3.2.). In our view, this function of the SSB seems to be important to the KT Bank, because it is explicitly mentioned in the REC. The Ethical Council shall provide advice to all bodies of the bank in all relevant aspects of religion and ethics aligned with business policies and issues. According to the website this advisory function also includes the training of the employees.

As the Ethical Council meets all three functions typical for a SSB, one may wonder why the Council is named “Ethical Council” and not SSB. In the interview, the KT Bank pointed out that the expression “Sharia” has a negative connotation in Germany. To our interpretation: Ethical Board sounds smarter. For marketing reasons this decision might be reasonable, but there is no doubt that the Ethical Council serves as a SSB.

Through the interview we learned that the role of the SSB/Ethical Council was an obstacle during the licensing process. The first draft of the KT Bank’s charter ruled that the SSB was appointed by the supervisory board, and not – as advised by the AAOIFI – by the shareholders’ meeting. But the BaFin feared that this kind of adoption might still give the SSB an overly strong influence on the management board. Therefore, the SSB is now appointed by the management board itself. To our understanding, this was not necessary on the basis of the German Supervisory Law. The basic principle of the management’s ultimate responsibility could have also been assured by clear rules of competences, so that the SSB has no possibility to influence the management and to prevent a binding effect of the SSB’s decisions on the management board. Rules like this can be found in the REC as well, which explicitly emphasizes that the Ethical Council shall act as an advisory body. Moreover, it points out that the Ethical Council is not allowed to give binding instructions to any other body of the bank, in particular not to the management. But the Ethical Council has the right to advise the bank’s statutory bodies on products and processes in line with the principles of Islamic Banking. It was interesting for us to read that the REC explicitly highlight that the Ethical Council is bound by the law and the articles of the charter. This self-evident statement and the emphasized ban of any binding instructions by the SSB to the management board and any other body of the bank is clarification that the decisions of the SSB have no legally binding effect. In our understanding all this is a result of the discussion with the BaFin during the process to get a license.

Due to the REC, the results of its consultation will be summarized by the Ethical Council into an opinion describing the process or product conformity in line with the principles of Sharia compliant banking. This opinion has to be submitted to the Managing Board. Afterwards it’s the duty of the Ethical Council to start a consultative

process with the Managing Board and the departments of the bank, in order to harmonize the economic and religious targets of the business process or product with legal requirements. The results of this consultation process are summarized in a decision paper that will be transformed into an opinion on the conformity of a process or product with the principles of Islamic Banking prepared by the Ethical Council. It is also remarkable that the REC explicitly highlights that after this consultation process the Managing Board has to make a decision at its own discretion. But nevertheless, one can see that there is a factual binding effect, as the bank has set up a special internal “Principles Implementation Committee”⁷² responsible for the implementation of the decisions by the Ethical Council. But this is not unlawful as long as it is highlighted that in a case of conflict the management can make decisions at its own discretion.

To put it in a nutshell: The Ethical Council to the KT Bank serves as a SSB, but its structure is compatible with the German Supervisory Law.

The REC also contains different rules in the sense of Corporate Governance for IFI concerning the qualification of the members of the Ethical Council. The REC points out that each member of the Ethical Council must have the necessary knowledge, skills and professional experience in Islamic Banking. Each member of the Ethical Council must hold a university degree in Islamic Studies. This statement guarantees at least a sufficient knowledge in the field of the Islamic Law. Due to the reference to Islamic Banking instead of Islamic Law it is also ensured that each member of the Ethical Council needs a sound understanding of finance in general.

The Ethical Council currently consists of three members.⁷³ The chairman is a well-respected Islamic scholar from Kuwait, who also serves as the chairman of the parent company’s SSB.⁷⁴ The second member is located in Bahrain and the third one, a PhD-Candidate⁷⁵ in Islamic Law, is based in Istanbul. Therefore, we would guess that all the meetings are held in Turkish or Arabic. But as long as there is a sound translation of all German contracts and business proposals this is acceptable. The KT confirmed in the interview that all documents are translated into German and the German version of the REC is decisive in the case of doubts of its content. The REC clarifies that the Ethical Council meets regularly every two months and, if required, at request of the Chairman of the Ethical Council or Managing Board. This helps to professionalize the work of the SSB and ensures that the members of the Ethical Council are not

⁷² In German “Prinzipien-Umsetzungskomitee”, for details see below 4.3.2.

⁷³ See <https://www.kt-bank.de/en/aboutus/ethicscouncil>.

⁷⁴ Although Dr. Anwar Shuaib Abdulsalam is also the member of other SSB, he is not listed in the survey mentioned above (footnote 39) that lists an accumulation of mandates, which is, from of Corporate Governance point of view, problematical.

⁷⁵ At least according to the German version of the homepage: <https://www.kt-bank.de/ueberuns/ethikrat>, not mentioned in the English version.

members of too many SSBs at the same time. But there is no limit of the membership in mandates in different SSBs of competing banks. However, it is to be welcomed that the principles for the Ethical Council contain a clear rule to avoid conflicts of interest. Conflicts of interest shall be disclosed to the Supervisory Board and the other members of the Ethical Council without delay. With this, the KT Bank sets an example which could be a role model for other Islamic financial institutions.

Unclear to our understanding is why the REC only addresses “interest-free” and not Sharia compliant banking. Yet due to the structure of the KT Bank as a full-fledged Sharia compliant bank, this limitation makes no difference. The REC gives the SSB the right to examine whether the products and the business are in accordance with all the principles of Islamic Banking as named above (1.).

4.3.2. A Sharia Compliance Department named Prinzipien-Umsetzungskomitee (Principles Implementation Committee)

Like every modern Islamic bank, the KT Bank has an internal Sharia compliance function. On a first glance, the structure seems a bit complicated or at least complex. First of all, the KT Bank has an Islamic Compliance Officer (ICO). Further we learned from our interview that the regular compliance department focuses on the Sharia compliance as well, at least by minimizing the risks that might appear from Islamic Banking such as a low liquidity rate or difficulties in refinancing. On top of this, the KT Bank implemented a Principle Implementation Committee (abbreviated as PUK after the German term “Prinzipien-Umsetzung-Komitee”⁷⁶). According to its procedure rules, this Committee is responsible for the implementation of the principles and decisions of the Ethical Council. One of its main functions is to create a transformation conduit between the SSB and the bank in general, and the management board in particular. The members of the PUK have the right to attend the meetings of the Ethical Councils. Therefore, the PUK meets at least before and after every single meeting of the Ethical Council to prepare and revise the meeting. Members of the Committee are the ICO, the (regular) CCO, the head of the law department and other heads of the various concerned departments and persons, who were appointed by the Management Board.

In the context of Corporate Governance one may be critical of the fact that the PUK is – due to the procedure rules – furthermore responsible to audit the implementation

⁷⁶ Just by the way: the German phrase “Prinzipien-Umsetzung-Komitee – PUK” sounds like the result of a lesson in the class “how to train your bureaucratic-lawyers language skills”; also critical towards too many substantives in the language of German lawyers see e.g. *Wolfgang Gast* “In Anbetracht der Tatsache, daß... - Über die Verehrer des Substantivs”, *Die Zeit* 1988 No. 36 dated 8 September 1988, <http://www.zeit.de/1988/36/in-anbetracht-der-tatsache-dass>.

of and adherence to the decisions of the Ethical Council in the branches and departments. This could be interpreted in way that the PUK, and not the management board, is entitled to pass on binding orders by the SSB to employees of the bank. But since the rules clarify that the PUK is a board for consulting and exchange, and is not authorized to issue instructions to the management board, these concerns can be set aside. Furthermore, the REC indicates that the ICO reports directly to the managing board and serves as a link between it and the Ethical Council. The German version the REC expresses this much more clearly and should – to our understanding – be translated as: “the ICO is directly subordinate to the managing board”. Taking this clarification into account, one may argue that the ICO is an employee of the bank that helps the management to build up banking services in compliance with the Islamic principles and therefore promotes the success of the company.

We summarize: in our point of view the KT Bank has developed a well elaborated internal compliance function based on three pillars: first and foremost on the ICO, secondly on the PUK and thirdly on the regular compliance department. The structure is in accordance with the German understanding of compliance in the context of Corporate Governance, as the management board bears the ultimate responsibility for the Sharia compliance within the KT Bank.

4.4. The depositors and investors’ position in the context of Corporate Governance

In this paper we would also like to lay a focus on the participatory depositor, whose relationship with the bank is based on the principle of the PLS. As mentioned in the context of KT Bank participatory account (4.2.2.), the participatory depositor is an important aspect within the debate on Corporate Governance for IFI.

The traditional debate on Corporate Governance, with a focus on the shareholder value concept, would not address the participatory depositor as he or she is only a creditor. However, they take a different starting point: the stakeholder approach.⁷⁷ Stakeholders can be employees, creditors, customers and suppliers or people in general who have a special interest in the company. It is not our aim to discuss this concept generally. However, from our understanding the *participatory depositors* should have a more active role within the IFIs. The debate on Corporate Governance for IFIs should pay more attention to the participatory depositor with a specific regard to the management and monitoring of the projects selected by the Bank and partly financed through their savings.⁷⁸ The stakeholder approach is especially known and accepted in Germany in the context of co-determination. In companies with more than 500 resp. 2.000 employees, one third resp. the half of the seats in the supervisory board are reserved for representatives of the employees.⁷⁹ This kind of representation is relatively similar to our suggestion of the participation' principle in an IFI, because both groups represent the company. On top of this, the participatory depositors characterize Islamic Finance.

This constitutes a hybrid figure of participatory depositors characterized by a mix between the typical depositor-saver attributes and those of the shareholder-investor, somehow similar with a participation right (*Genussrecht*) under German Law. However, the difference is that they cannot benefit from all the powers granted to the classic shareholder; even if oftentimes the deposited amount is greater than the amount of shares held by shareholders, these stakeholders do not have the right to vote in shareholders meeting.⁸⁰

From an equitable Islamic bank corporate governance perspective, this combination of the saver and investor role is essential to allow a possible involvement of the participatory depositor in the selection of investments, the management and monitoring of the projects, because the participatory depositor share possible losses of this asset.

The possible integration of these stakeholders in the structure of the Islamic Bank's corporate governance could strengthen the relationships of trust between the parties and simultaneously help achieving the objectives of transparency. Hence, the need to implement mechanisms and procedures aimed to encourage stakeholder participation in the management through a possible representation in the governance bod-

⁷⁷ Freeman, *Stakeholder Theory of the Modern Corporation*, in: Beauchamp, Bowie and Freeman (1984); Freeman (1994), pp. 409-422.

⁷⁸ For more details see A. Ait Allali (2016), p. 2-5.

⁷⁹ See Drittelbeteiligungsgesetz (2001) in succession of BetrVG (1952) resp. Mitbestimmungsgesetz (1976), for the historical development of co-determination in Germany and the impact of the Catholic Social Teaching on this development see Casper (2017b)

⁸⁰ Chapra and Habib (2002), p. 43.

ies. One of the possible ways to include representatives of the participatory depositors is to compose a “Governance Committee”⁸¹ in order to ensure greater involvement in project management and monitoring. This participation contributes to the establishment of a collaborative environment and a longterm relationship between the Islamic Bank and the savers investors. The “Governance Committee” is a governance committee recommended by the IFSB (Guidelines on Corporate Governance of 2006), intended mainly to protect the various stakeholders, who do not have same rights like the shareholders. This governance committee is responsible to monitor and ensure that the administrative and accounting procedures, the internal controls system and disclosure policies are conducted in a way based on respecting the interests not represented in these bodies, with particular attention to the deposits participation holders. This committee, as specified by the IFSB, should be composed of at least one member of the Board with executive powers, a Sharia specialist, possibly a member of the Sharia Board, a member of the Audit Committee and an independent director.

Concerning IFI located in Germany one might look for a role model in the already existing debate on regular Corporate and co-determination with the participation for employees. Employee participation through representation in the supervisory board and the protection of their interests is imbedded in a law that tightly regulates the procedures for the election depending on the enterprise type and the total size of workers to be represented. Contrary to participatory depositors, employees have a stronger position in the company because they “invest” much more of their time and depend on it to a certain extent. Therefore – from a legal policy perspective – participatory depositors should, in contrast to employees, not be represented in the supervisory board. But they could be represented by a special committee, such as the governance committee as provided for in the IFSB guidelines. From our view, this should be the role model for IFIs in Germany as well. As long as an IFI in Germany has no codetermination under German Law (like momentarily the KT Bank because they have less than 500 employees) and the employees are nonetheless represented in a Governance Committee, the same is true for IFIs in countries without codetermination.

⁸¹ More information is available at the following link: <http://www.ifsb.org/standard/ifs3.pdf>.

Another aspect to consider in this perspective of the participatory depositors involvement in the bank's corporate governance is whether they should have influence on the whole business of the bank or only on the investment policy concerning the funds financed through their money. Relating to the first point, the influence on the whole business is plausible and would be relevant when the funds raised, according to the PLS principle, are used not only to refinance loans granted to the bank customers, but also for purposes strictly related to ownership i.e. treasury, liquidity management or proprietary trading activities. With regard to this issue, we are open to both solutions because the influence on the different projects as well as on the whole business and the associated involvement in the corporate governance will contribute to the bank's development and success.

This hypothesis has been exposed to the attention of the KT Bank in order to detect its point of view and the possible applicability of this proposal in its corporate context. In particular, we asked the Bank what role the participatory depositors could play in managing and monitoring projects whose contracts are based on the principle PLS. The participatory depositor, according to the KT Bank, plays a passive role in the company's corporate governance. This is due to the type of financial products offered, which are mostly based on *mudaraba* (direct funding), where the bank (as *rabb al-mal*) finances the investment projects. We want to stress the point that although the Islamic bank acts as a financier, in essence, the funding source is the collection of savings from the public. Therefore, the aspect of what is ought to be an active stakeholder role remains an important issue to consider in its business strategy. This may further be adopted to the participations accounts, also based on the *mudaraba* contract, where there is no direct economic risk for the participatory depositor. The same considerations are also applicable to the "real estate financing" based on *musharaka mutanaqisa*⁸² (diminishing in English), the housing and car financing method granted to its customers without the use of interest.

These two products, due to their nature, do not involve any direct client interest that is linked to the corporate strategic decisions and to its possible managerial involvement. Finally, the KT Bank believes that an eventual realization of this perspective representation of participatory depositors may be achieved with the use of an Audit Committee that deals with the general managerial control, unlike the Governance Committee as it is required by the IFSB.

⁸² It defines *Musharaka Mutanaqisa* as: "A type of *Musharaka* contract where the *Musharaka* may be entered into by two or more parties on a particular asset or venture which allows one of the partners to gradually acquire the shareholding of the other partner through an agreed redemption method during the tenure of the contract. Also known as diminishing partnership or *Musharaka Muntahiya Bittamlik*". Bank Negara Malaysia, Concept Paper - Sharia Requirements, Optional Practices and Operational Requirements of *Musharakah*, 2013, page 71-72, see http://www.bnm.gov.my/guidelines/05_shariah/CP_Musharakah.pdf.

This question of representation and protection on the Islamic Bank institutional level will almost certainly be answered with an increase of the savers-investors category, and, especially in the European context, with a strong focus on the consumer protection, the stakeholder concept and the social and environmental responsibility.

4.5. The KT Bank in the light of Corporate Social Responsibility

Among the goals the Islamic Bank should pursue is the protection of the interests of the society in which it operates and the effort to contribute to the realization of social justice through its activity. In other words: try to be a socially responsible enterprise. Concepts that are connected to the Corporate Social Responsibility (CSR) will be dealt with a specific regard to the Islamic Bank (4.5.1) and the KT Bank's CSR viewpoint (4.5.2).

4.5.1 The concept of Corporate Social Responsibility – an overview

Among the fundamental elements characterizing Islamic Finance is the concept of corporate social responsibility. The issue has been debated frequently in recent years at the level of the different European countries as well as at the level of the European Union.⁸³ The concept of social responsibility revolves around three main elements that must characterize the enterprise activity: in addition to the profit creation, the company must consider the protection of the stakeholders (primarily its employees, customers and suppliers, etc.) that are directly or indirectly influenced by its work and environment.

Particularly, in 2010, the AAOIFI developed a set of governance standards for Islamic Banks including the standard No. 7 named “Corporate Social Responsibility Conduct and disclosure for Islamic Financial Institutions”, which defines CSR as:

“All activities carried out by an IFI to fulfil its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions”.

⁸³ According to EU documents CSR is defined as: “the integration, on a voluntary basis by enterprises, of social and environmental issues in their activities and the interaction with stakeholders” (European Communities Commission, 2001; 2002; 2006).

In terms of the literature review on the Islamic Bank CSR, have been several studies on the subject that had like object of analysis the principles, the objectives, the determinants and disclosure, which will be summarized in the following lines.⁸⁴ Ekawati (2004) examined the concept of Zakat, CSR and Community arguing and reached the conclusion that both, Zakat and CSR, share the same ultimate goal, namely the creation of social welfare and justice. Mohammed (2007) has studied the Islamic philosophy in relation to corporate social responsibility and concluded that Islam CSR is built on the basis of four principles: unity, justice, free will and responsibility. Irwani and Dusuki (2007) recognize the effects of maqasid Sharia (the objectives of Islamic law) and of the *maslahah* (public interest) in relation to CSR. According to this approach, the CSR practices are divided into three categories: essential (*dharuriyyah*), necessary (*hajiyah*) and luxury (*tahsiniiyyah*); based on these three categories the authors have prepared guidelines the company or the management can follow to avoid conflicts of interest with the stakeholders. Dusuki (2008) analyzes the concept of CSR based on the concepts of *Khalifah* (vice vicar in the earth) and *Taqwa* (devotion) emphasizing the responsibility that men and women have to respect the Islamic law and avoid activities that may cause damage to the society (attract attention to environmental best practice, safety, social benefits). Zinkin and William (2010), contrary to what was stated by Mohammed (2007) and Dusuki (2008), concluded that there is a fundamental difference between the Islamic CSR concept and the UN Global Compact's CSR concept. In relation to Zinkin and William's conclusions, some concurring authors point out that the latter's research did not consider important Islamic peculiarities, specifically the spiritual nature of the Islamic economic. Spiritual values are realized through the clear expression of *halal* (lawful activities to be pursued) and the *haram* (forbidden activities not to be followed).

From these studies it can be deduced that the Islamic enterprises' CSR can be divided into three relational responsibilities dimensions: 1) the relationship of responsibility to Allah (God); 2) the relationship of responsibility towards human beings; 3) the relationship of responsibility towards the environment.⁸⁵

To our understanding, the Islamic Banks' CSR is reached through the Islamic social contracts (*Qard El-Hasan, Salam and Zakat*), the objectives and underlying values, in their essence; they converge in those pursued by the conventional enterprises' CSR. The difference between the latter is their source: from a Muslim perspective. The source of corporate social responsibility is the Koran and the Sunna.⁸⁶

⁸⁴ Yusuf and Bahari (2015), p. 76-78.

⁸⁵ Yusuf and Bahari (2015), p. 77.

⁸⁶ Yusuf and Bahari (2015), p. 78.

4.5.2. The KT Bank's CSR view

Regarding our case study, given the recent opening, until now there is no social projects, with which the KT Bank could fulfill its social role, launched in the German community yet. As a result, there is a notable absence of social communication documents (Sustainability Reports and annual reports). However, in our interviews the KT Bank expressed an intention to launch these social initiatives in the future by proposing similar projects in addition to those already experienced by the majority shareholder of the parent company (The Kuwait Finance House), taking into account the specificities and needs of the local context in which they are administered.⁸⁷

We had prepared a set of multiple choice questions on the CSR subject to the KT Bank summarized in the following.

According to the KT Bank, the Islamic Bank CSR' concept is:

“Contributing to more social justice (Participation), Encouraging entrepreneurship”.

An answer confirming the consideration of Islamic Finance values by the KT Bank and its desire to achieve social justice through investments focused on collaborations between those who own capital and those who employ the workforce, and therefore serving the social context and environment that lays the ground for all this.

Among the reasons encouraging the adoption of social practices by enterprises, our case study has identified the following preferences:

- 1) religious inspiration of the firm
- 2) ethical entrepreneur's motivations or director's motivation
- 3) promotion of the firm image
- 4) existence of guidelines and standards that define detailed rules for behavior and communication with the stakeholders (AAOIFI, IFSB, ...)

The excluded choices, instead, are the following:

⁸⁷ In the following link contains the activities carried out by KFH on CSR and Corporate Sustainability:
http://www.kfh.com/pdf/Sustainability_Report_2015.pdf;
https://www.kfh.bh/media/document/KFHB_Annual_Report_2015.pdf.

- 1) search for benefits in the relationship of the banks and the financial market
- 2) external pressures (such as institutions, labor unions, suppliers, consumer associations, environmental groups)
- 3) Fiscal Incentive

The selected preferences show the interest of the Bank to apply the social responsibility practices on the basis of a religious belief, as it reported on its mission,⁸⁸ and dissociate themselves from the idea that CSR practices are the result of regulations impositions, trade unions and consumer associations.

The so far collected data shows they have found an application in the following CSR practices:

1. respect for workers' rights and promoting equal opportunities
2. guarantee of products and services' qualities
3. partnerships with the local community (sponsoring cultural events, sports, etc.)
4. integrated communication (economic, social, environmental, competitive)

The following CSR practices, instead, are not integrated:

1. respect for the environment
2. ethics selection of suppliers
3. adoption of corporate governance best practices and enrichment of the relations with shareholders and the financial community
4. dialogue with all types of enterprise contacts
5. social responsible investments
6. charities acts

Given the communication tools and the social responsibility report, the KT Bank intends to adopt the two following main instruments, as done by the KFH, the major shareholder of its mother company the KT Bank in Istanbul:

1. *The Sustainability Report* (hopefully within next year)
2. The *ethical code* of conduct or behavior

The following options have been discarded:

⁸⁸ "Our mission is to become the leading socially responsible and first choice house bank for the Muslim community as well as for all customers who are interested in ethical investments", see <https://www.kt-bank.de/en/aboutus/kt-bank/>.

1. The Social Report
2. The Environmental Report
1. *Various national and international certifications* (SA 8000, EMAS, ISO 14001, OHSAS 18001, ISO 9001, ISO 26000)

In terms of the other Islamic financial instruments the KT Bank intends to use in order to achieve its social responsibility objectives, considering their religious significance of social justice realization as required by Sharia, there is most importantly the *Qard El Hasan* instrument - a social loan that does not include any remuneration for the bank.

The other two Islamic financial instruments were discarded: Zakat and Waqf.⁸⁹ Regarding Zakat, the bank does not intervene because it is a religious obligation for the customers to be paid personally and directly as well as to choose the people to which they assign this part of their profits (estimated by 2.5% of its annual income discharged from any debts).

Finally, the KT Bank aims to offer its customers the Islamic insurance contracts (*Takaful*) for 2018, perhaps in partnership with some insurance companies that have a profound working experience in this field in Islamic countries like Malaysia (Allianz, Münchener Rückversicherung etc.).

5. Conclusion

This work's main objective has been to study the case of the first German Islamic bank, the KT Bank. Our starting point was an analysis of the German context in which it operates. We asked whether German law could be a legal obstacle for the foundation of an Islamic bank.

Thanks to the secularity and neutrality of the European and German law toward religious or ethical aspects that are integrated in a financial contract by parties there is openness to Islamic Finance and the establishment of Islamic Banks in different European countries, in particular in Germany. But some legal rules like the ultimate responsibility of the management board of a bank need to be taken into account, so that the Islamic bank acts in accordance with the national law.

The main difficulties that have characterized the KT Bank's debut are:

1. the presence of the Sharia Supervisory Board (called Ethical Council) and its prerogatives in relation to the management board;
2. the double taxation as a result of the application of the Islamic financial instruments based on the principle of Profit and Loss Sharing.

⁸⁹ For more details on the Waqf Institute please refer to the following paper: Zuki (2012), p. 173-178.

The first issue was resolved by changing the Ethical Council's nomination procedure. The appointment of this board is made by the management board and not by the supervisory board as it had been proposed to the BaFin in the initial application. In particular, the BaFin raised the dual management responsibility issue performed by two different bodies: according to German law, the enterprise's management responsibility is an exclusive activity of the management board. Therefore, the Ethical Council is qualified to work as an advisory body on Sharia compliance relating to the products offered by the bank, with no obligatory authority over the decisions taken by the management. But besides that, the Ethical Council has no supervisory function in general management and operating tasks. This is still the duty of the supervisory board. Reviewing the internal structure of KT Bank's SSB and internal Sharia Compliance we concluded that the structure is in line with the German Supervisory and Company Law.

The second issue – the double taxation – was resolved by establishing a civil law partnership (GbR) between the KT Bank and their participatory clients in order to purchase jointly the real assets in the GbR's name. This method is practicable in the Real Estate Financing product, certified by the Ethical Board as an appropriate compatible Sharia participation (the so-called *Musharaka Mutanaqisa*).

In our interview and questionnaires we also focused on Corporate Governance for Islamic financial institutions. Our focus was the institutional participation of participatory depositors, e.g. through the representatives' provision in a Governance Committee (a body established by the IFSB 2006 guidelines to protect the different stakeholders by shareholders). As we learned this participation is only at a very early stage for different reasons concerning the structure and variety of products offered by the KT Bank in the moment and due to legal and technical difficulties linked to the German legal framework, e.g. the need to identify an equitable representatives election mechanism (for example, the definition of the elective basis dimension and the communication methods between these players). In our opinion it remains essential to find solutions that enable the protection of these stakeholders surely destined to grow in number with the future development of this banking sector. Protection methods must be based on the transparency principle, which ought to characterize the enterprise's good corporate governance. Eventually, this can really compensate the supported economic risk.

The aspect of CSR is one of the goals pursued by the KT Bank. The preferences expressed in the questionnaire show the bank's interest to assimilate the social responsibility practices based on religious and ethical values and the dissociation from the idea that the CSR practices are the result of legal provisions or pressure from the trade unions and consumer groups.

The KT Bank is at the moment still a small bank with the size of smaller German Volks- and Raifeisenbanks. In conclusion of this study, the KT Bank was asked to express its opinion on the possible success this business model might have in the European context and the economic growth opportunities in Germany. According to the KT Bank, this will depend on its ability to generate a reasonable profit for its clients. As far as possible this profit must be greater than the profit arising from interests of the traditional financial system. Specifically, among the factors that may contribute to the Sharia compliant product development in Germany, in order of priority, marked by the KT Bank, are:

1. Interesting and competitive profit rates;
2. Marketing policies directed to make known the Sharia compliant products;
3. Human resources with appropriate training on Islamic Finance;
4. The use of the country's official language by the Islamic bank subsidiary operating in Germany;
5. The use of the mother language of the Muslim community (mostly Turkish and Arabic).

The KT Bank seeks to be a European Islamic bank creating profit in accordance with secular laws, the Islamic and ethical principles and simultaneously striving to find solutions that might facilitate the integration of its specificity in the corporate governance systems and adopt socially responsible performance.

In our title we expressed the hypothesis that the KT Bank offers Islamic financial products "made in Germany". To be more precise: KT Bank offers some of the Sharia compliant products that have been developed in many countries in the last 40 years and has successfully embedded these products in the German legal framework.

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