



Banking regulation in Bosnia and Herzegovina and  
Challenges of Financing in Accordance with Islamic Principles

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# Introduction

## **Background and Importance of Islamic finance**

- Governed by Shariah law, prohibits interest (riba), excessive uncertainty (gharar), and investing in haram (forbidden) activities.
- Emphasizes profit-sharing, risk-sharing, asset-backed financing, and ethical investments.

## **Key contracts:**

- Mudarabah (profit-sharing), Musharakah (joint venture), Ijarah (leasing), and Murabaha (cost-plus financing).
- Aims to promote justice, transparency, and shared prosperity.
- Significant Muslim population in B&H with demand for Shariah-compliant financial products.
- Driven by personal and business needs aligning with religious beliefs.
- Increasing awareness and understanding highlight the need for a robust Islamic financial infrastructure.



# Introduction

## **Objective of the Article:**

To investigate the challenges faced in implementing Islamic banking contracts in Bosnia and Herzegovina

- Regulatory, legal, and operational barriers hinder implementation.
- Challenges include restrictive legal frameworks, inability to use profit-sharing and trade-based models, and difficulties in mobilizing funds according to Shariah law.

## **Additional objectives:**

- To discuss potential solutions and future prospects
- Explore legal reforms, regulatory adjustments, and educational initiatives.
- Discuss potential growth of Islamic finance considering global trends and increasing interest in ethical and Shariah-compliant products.



# Overview of Islamic Finance Principles

## Prohibition of interest (Riba)

- Prohibits earning income from lending money at interest.
- Promotes profit and risk sharing
- Ensures fair and equitable financial transactions.

## Risk-sharing and profit-sharing (Mudarabah and Musharakah)

- **Mudarabah:** Profit-sharing partnership where one party provides capital (rab-ul-mal) and the other provides expertise and management (mudarib).
- **Musharakah:** Joint venture where all partners contribute capital and share profits/losses in proportion to investments.

## Asset-backed financing (Murabaha, Ijara)

- Requires transactions to be backed by tangible assets or services.
- **Murabaha:** Cost-plus financing where the bank buys an asset and sells it to the client at a markup, with deferred payment. Ensures transparency.
- **Ijara:** Leasing agreement where the bank buys and leases an asset to the client. Client pays rent, and may have the option to purchase the asset at the end of the lease term.



# Differences between Islamic and conventional banking systems

## Interest vs. Profit-sharing

- **Conventional Banks:** Earn income through interest on loans.
- **Islamic Banks:** Generate profits through profit-sharing, leasing, and asset-backed sales, ensuring risk-sharing instead of risk-transfer.

## Ethical investments

- **Islamic Banks:** Prohibited from investing in businesses involved in haram activities (e.g., gambling, alcohol, pork production).
- **Conventional Banks:** No such restrictions, allowing investment in a wider range of industries.

## Asset-backed transactions

- **Islamic Banks:** Require all financial transactions to be backed by tangible assets or services, linking finance to the real economy.
- **Conventional Banks:** Allow for more speculative and unsecured financial activities.

## Transparency and fairness

- **Islamic Banks:** Emphasize transparency, fairness, and ethical conduct in transactions. Contracts must be clear, with all parties aware of their rights and obligations.
- **Conventional Banks:** Do not have the same stringent requirements for transparency and ethical considerations.



# Current Legal and Regulatory Framework

## Overview of current banking laws in Bosnia and Herzegovina

- **The banking sector is governed by a comprehensive legal framework ensuring financial stability, transparency, and consumer protection.**
- **Key Legislation: Law on Banks, covering establishment, operation, and supervision of banks.**
- **Mandates: Capital adequacy, risk management, and corporate governance standards.**
- **Regulatory Body: Banking Agency of the Federation of Bosnia and Herzegovina oversees implementation and enforcement.**

## Specific regulations affecting Islamic finance

- **Current Laws: Do not explicitly accommodate Shariah-compliant financial products.**
- **Challenges: Difficulties in implementing profit-sharing contracts and trade-based models.**
- **Disclosure Requirements: Need for clear disclosure of interest rates on loans and returns on deposits complicates offering Shariah-compliant products.**



# Regulatory Challenges

## Restrictions on profit-sharing contracts

- **Mudarabah and Musharakah:** Central to Islamic finance, requiring profit and loss sharing without predetermined interest rates.
- **Current Regulations:** Mandate clients must know exact charges or returns in advance, conflicting with variable nature of profit-sharing agreements.

## Limitations on trade-based financing models

- **Murabaha and Ijara:** Essential to Islamic finance but face regulatory hurdles.
- **Challenges:** Legal requirements for transparency and prohibition of disguised interest complicate implementation within conventional banking frameworks.
- **Impact:** Banks struggle to structure these transactions to comply with both Shariah principles and local regulations.

## Requirements for clear disclosure of charges and returns

- **Conventional Banking Regulations:** Require precise information on interest rates and expected returns.
- **Conflict:** Islamic finance emphasizes risk-sharing, where returns are based on actual business performance and cannot be guaranteed.
- **Result:** Islamic financial institutions face difficulties complying with disclosure requirements while maintaining Shariah compliance.

# Practical Challenges in Implementation



## Difficulties in applying Islamic contracts

**Challenge:** Legal requirements for transparency, pre-determined charges, and interest disclosures.

**Impact:** Incompatible with variable and profit-sharing nature of Islamic finance (Mudarabah, Musharakah).

**Result:** Difficult to fully implement Shariah-compliant financing models.



## Inadequate knowledge and expertise among bank employees

**Challenge:** Lack of adequate knowledge and expertise in Islamic finance.

**Impact:** Most banking professionals trained in conventional practices.

**Result:** Knowledge gap hinders effective implementation and promotion of Islamic financial products.

# Practical Challenges in Implementation

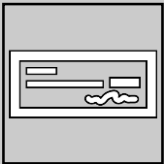


## Lack of awareness and understanding of Islamic finance

**Challenge:** Many clients lack awareness and understanding of Islamic finance principles and products.

**Impact:** Misconceptions and reluctance to use Islamic financial services.

**Solution:** Educate clients about the benefits and operations of Islamic finance to increase acceptance and demand.

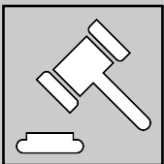


## Misalignment of client expectations with Islamic finance principles

**Challenge:** Clients have expectations based on conventional banking practices (fixed interest rates, guaranteed returns).

**Impact:** Misalignment with risk-sharing and variable return principles of Islamic finance.

**Solution:** Educate clients to align their expectations with the unique aspects of Islamic financial products.



## Legal and Regulatory Challenges from the Banking Law

**Challenge:** Law on Banks mandates clear disclosure of interest rates and pre-determined charges.

**Impact:** Conflicts with Islamic finance principles (profit-sharing, asset-backed transactions).

**Result:** Regulatory environment not conducive to growth of Islamic finance. The law does not explicitly accommodate Shariah-compliant financial products.



# Potential Solutions and Recommendations

## 1. Regulatory Reforms

- **Suggestions for amending laws and regulations**
  - **Amend Existing Laws:** Modify transparency and disclosure requirements to accommodate Shariah-compliant financial products.
  - **Allow Profit-sharing Contracts:** Enable use of Mudarabah and Musharakah contracts.
  - **Introduce Specific Legislation:** Establish a clear regulatory framework for Islamic banking.

## 2. Capacity Building

- **Training and development for bank employees**
  - **Comprehensive Training:** Implement programs on Islamic finance principles, products, and procedures.
  - **Enhance Expertise:** Equip bank staff to manage and promote Shariah-compliant financial services effectively.
- **Awareness campaigns for potential clients**
  - **Targeted Campaigns:** Raise awareness through educational seminars and informative materials.
  - **Client Education:** Explain benefits and operations of Islamic financial products to align client expectations and foster trust.



# Potential Solutions and Recommendations

## 3. Innovative Financial Products

- **Development of new Islamic financial instruments**
  - **Innovative Products:** Create new profit-sharing schemes, investment products, and financing solutions compliant with Shariah principles.
  - **Adapting existing products to comply with Islamic principles**
  - **Restructure Existing Products:** Transform conventional loans into Murabaha agreements and adjust leasing products to fit Ijara models.
  - **Ensure Compliance:** Eliminate interest and back transactions with tangible assets to offer a wider range of Shariah-compliant financial services.



## Future Prospects and Opportunities

- **Market potential for Islamic finance in Bosnia and Herzegovina**
  - **Significant Potential:** Large Muslim population and increasing demand for Shariah-compliant financial products.
  - **Rising Awareness:** Growing understanding of Islamic finance principles among individuals and businesses.
  - **Untapped Market:** Substantial opportunities for growth and development within the financial sector.



# Future Prospects and Opportunities

## Regulatory Support:

- Introduce and implement laws to support the development and operation of Islamic financial institutions.
- Create a clear regulatory framework for Shariah-compliant products.

## Educational Programs:

- Develop and implement programs for bank employees and potential clients.
- Enhance understanding and acceptance of Islamic finance principles.

## Product Innovation:

- Encourage the development of innovative Islamic financial products tailored to local market needs.
- Ensure competitiveness with conventional banking products.

## Public Awareness Campaigns:

- Launch campaigns to raise awareness about the benefits and operations of Islamic finance.
- Build trust and confidence among potential clients.

## Collaboration and Partnerships:

- Foster collaboration between Islamic financial institutions, conventional banks, and regulatory bodies.
- Share knowledge, expertise, and best practices.



# Conclusion

## Challenges:

- Restrictive legal frameworks
- Lack of expertise among bank employees
- Limited client awareness

## Proposed Solutions:

- Regulatory reforms to accommodate Shariah-compliant financial products.
- Capacity building through training and awareness campaigns.
- Development of innovative financial products tailored to Islamic principles.



# Conclusion

## The importance of addressing these challenges for the growth of Islamic finance

- **Crucial for Growth:** Addressing these challenges is vital for the growth and development of Islamic finance in Bosnia and Herzegovina.
- **Supportive Environment:** Creating a supportive regulatory environment, enhancing banking professionals' knowledge and skills, and educating clients can unlock the full potential of Islamic finance.

## Call to action for stakeholders

- **Collaboration Needed:** Regulatory bodies, financial institutions, and community leaders must collaborate to implement these solutions.
- **Inclusive Financial Sector:** Working together can promote a more inclusive and diversified financial sector.
- **Economic Growth and Social Well-being:** This collective effort will contribute to economic growth and social well-being in Bosnia and Herzegovina.



# THANK YOU

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