



The Muslim Council of Britain

LONDON AND ISLAMIC FINANCE

Briefing Paper for the Mayor of London

February 2009

The Muslim Council of Britain
PO Box 57330
London E1 2WJ
Tel - 0845 26 26 786
Fax - 0207 247 7079
Email - business@mcb.org.uk

Executive Summary

- Islamic finance is finance that is consistent with the principles of Shariah.
- The Government has been supportive of Islamic finance because of its benefits to the UK economy and enabling of financial inclusion for the UK's Muslim population.
- Islamic finance may also appeal to non-Muslims because of its ethical principles.
- The FSA has adopted a no special favours, no special obstacles policy.
- Supporting Islamic finance does not require changes to the English legal system.
- Changes in tax legislation do not favour Islamic finance but remove the tax penalties on Islamic finance so as to level the playing field with conventional finance.
- The cessation of the Government's plans to issue a sovereign sukuk (Islamic capital market instrument akin to a bond) was received with considerable disappointment by the Islamic finance industry.
- The Mayor should support Islamic finance for the same reasons why the present Government has supported Islamic finance.
- Maintaining London's status as a leading centre for Islamic finance would attract capital from Muslim countries/corporations inclined towards Islamic financing and create further opportunities to export British expertise and experience in this field.
- Without the active contribution of the MCB, and the expertise it supplies, the role of London in Islamic finance would not have developed so quickly or so successfully.

Contents

1	ABOUT THIS PAPER	4
2	WHAT IS ISLAMIC FINANCE?.....	4
3	WHY HAS THE GOVERNMENT BEEN SO SUPPORTIVE?	4
4	WHAT APPROACH HAS THE GOVERNMENT TAKEN?	6
5	DOES THIS MEAN THE INTRODUCTION OF SHARIAH INTO THE UK TAX SYSTEM?.....	7
6	THE GOVERNMENT SUKUK.....	8
7	SHOULD THE MAYOR SUPPORT ISLAMIC FINANCE?	9
8	WHAT HAS THE MCB DONE TO DEVELOP ISLAMIC FINANCE IN LONDON?.....	9
9	APPENDIX: SOME STRUCTURES USED IN ISLAMIC FINANCE	11

1 About this paper

- 1.1 This paper has been prepared further to point (1) of Dr Muhammad Abdul Bari's letter of 9 December 2008 to the Mayor.
- 1.2 It has been written for the MCB by some members of the Business and Economics Committee of the MCB who specialise in Islamic finance.

2 What is Islamic finance?

- 2.1 The original sources of authority in Islam are the Quran (the word of God as conveyed by the Archangel Gabriel to the Prophet Mohammed, peace be upon him) and the Hadith (collections of accounts of the actions and sayings of the Prophet.) The guidance in these original sources was further developed by religious scholars and jurists of the Muslim world.
- 2.2 These principles and precepts of religious guidance are collectively known as the Shariah, a phrase that can meaningfully be translated as Islamic law, since Muslim countries historically did not have a separate system of secular law. In the context of financial transactions, Shariah prohibits Muslims from:
 - receiving or paying *riba*, an Arabic word generally understood to be equivalent to interest;
 - contracts that contain an excessive level of *gharar*, generally understood to mean excessive uncertainty of terms or outcomes;
 - *maysir*, generally translated as speculation or gambling; and
 - investing in activities or assets that are contrary to the ethical norms of Shariah such as armaments, alcohol, pork, pornography and conventional financial institutions etc.
- 2.3 Very briefly, Islamic finance is finance which is consistent with the Shariah.
- 2.4 The Appendix gives more details of some of the contractual structures that are used in modern Islamic finance.

3 Why has the Government been so supportive?

There are two distinct reasons:

- 3.1 Benefit to the UK economy

London aspires to be the world's leading financial centre and dominates many areas of international financial activity. It is clearly beneficial to the UK economy for international Islamic financial transactions to be conducted through London, benefiting London based banks, law firms, accounting firms, financial printers and the entire range of support services for the city of London.

Although Shariah compliant financial assets globally presently constitute less than 1% of total financial assets, Muslims are between 20% and 25% of the world's population. As economic growth continues in the Muslim world, and as a growing proportion of Muslims seek to have their financial activities become Shariah compliant, the percentage of global financial assets that are Shariah compliant is expected to continue increasing strongly. Where such Islamic finance is conducted internationally, the Government would like it to pass through London.

In London, we now have:

- Four investment banks, which listed in order of FSA registration, are European Islamic Investment Bank plc, The Bank of London and the Middle East plc, European Finance House and Gatehouse Bank plc. London also has branches of the Islamic Bank of Britain plc, which is headquartered in Birmingham.
- One takaful (Islamic insurance) company, Principle Insurance Holdings Ltd which currently sells motor insurance policies under the brand of Salaam Halal Insurance.
- A number of companies that engage in principal investing and fund management. They cannot all be itemised, but some of them are Gulf Finance House, Kuwait Finance House, Dar Capital (UK), Fajr Capital, and Al-Salam Europe.
- Most of the large London based conventional retail and investment banks such as HSBC, Barclays and Deutsche Bank now offer Islamic financial services to their customers, typically with staff who regard such dealings as their main specialism.

Other organisations are in the process of seeking registration with the Financial Services Authority, but are not named for confidentiality reasons.

These companies are not working solely on UK based transactions; the banks and investment companies operate internationally, but rely upon London as a base and as a centre of financial expertise.

So far, the absolute size of the benefit to the London economy is relatively small compared to the financial sector as a whole, but still meaningful. Taking into account jobs at service providers such as accounting and law firms, as well as employment directly in the Islamic financial organisations themselves, over 1,000 jobs in London will be directly dependent upon the Islamic finance sector. More importantly, this economic benefit is expected to grow significantly.

Additionally, liquidity management for the global Islamic finance industry relies on London for benchmarking returns, transacting capital flows and trading underlying commodities.

Furthermore, the development of the Islamic finance sector has reinforced the UK's global reputation as an innovative pioneer in financial services, which probably benefits the role of London as a whole.

3.2 Financial inclusion

The UK has a significant Muslim population. Some Muslim citizens have been excluded from the financial system because of their religious objections to conventional (i.e. non-Islamic) finance. For example, the religious prohibition against paying interest meant that while only conventional mortgages were available some otherwise creditworthy Muslims were unable to finance the purchase of their homes.

Islamic finance is, however, not just an industry for Muslims. As principles-based finance, it also appeals to individuals and religious groups that are attracted by the ethical nature of the products. There have been reports in the press that, in the face of an increasing number of difficulties with conventional banks, savers are moving their money to Islamic financial institutions that are unexposed to toxic assets¹.

Although a full appraisal of the mechanics of Islamic financial products is beyond the scope of this briefing, Islamic finance is sometimes very different to conventional finance. Whilst the economic characteristics of conventional debt products can be replicated with Islamic finance instruments, differences do arise in other areas such as risk allocation, default mechanics and early settlement. Some of these differences are in fact comparatively debtor-friendly and potentially attractive to debtors in the current economic climate.

4 What approach has the Government taken?

Government ministers have spoken on many occasions of the government's supportive attitude to Islamic finance. This has encouraged investors, primarily from overseas, to set up the organisations mentioned above in London.

Apart from welcoming words, the Government's support has been important in two areas:

4.1 Regulation

The UK's principles based regulatory structure is designed to accommodate a range of financial structures to suit a multitude of clients. This is, after all, a key feature which distinguishes the City of London from some of our less flexible competitors. Following this approach, the Financial Services Authority (FSA) has been willing to discuss with Islamic banks how the products and services they wish to offer can fit within the UK regulatory framework.

Overall, the FSA's approach has been to grant Islamic banks no special favours but also to put no special obstacles in their way. Instead it applies exactly the same licensing regime for Islamic institutions as it does for conventional institutions.

¹ Christopher Landau, *Finance with a moral foundation* (BBC News, 17 October 2008)
< http://news.bbc.co.uk/2/hi/uk_news/7677181.stm >

4.2 Taxation

The UK tax system had developed over 150 years in an environment of conventional finance. Accordingly, it imposed additional tax costs where transactions were designed to be Shariah compliant.

For example, where an individual purchases a property with the aid of a conventional mortgage, the individual suffers stamp duty land tax (SDLT) only once, on the original purchase of the property. There is no further SDLT when the mortgage is repaid. Conversely, with most Islamic mortgage structures, SDLT would be payable on multiple occasions (such as when the bank purchased the property from the vendor, and when the customer purchases the property – whether in stages or at the end of the financing - from the bank).

Similarly, when Islamic financing transactions were conducted in forms economically equivalent to debt (such as murabaha, tawarruq or diminishing musharaka) there were severe doubts as to whether the "borrower" would get tax relief for its financing cost.

Accordingly, starting with the elimination of double SDLT on Islamic mortgages for individuals in Finance Act 2003, the Government has been legislating changes to the tax system with the long term goal of a level tax playing field between conventional finance and Islamic finance.

5 Does this mean the introduction of Shariah into the UK tax system?

The categorical answer is no.

Tax law must, and does, apply equally to all taxpayers. Indeed strictly speaking, the UK has not enacted any Islamic finance legislation. A search of FA 2005 will fail to find the words "Islamic", "Shariah", murabaha or any other term used specifically in Islamic finance.

The reason is that the tax treatment of a transaction cannot be allowed to depend upon whether or not it is Shariah compliant. As well as introducing significant uncertainty into the UK tax system, introducing Shariah considerations would create a situation where all taxpayers were not receiving identical tax treatment.

Instead, the UK identified certain types of transaction widely used in Islamic finance, and ensured that those types of transaction received appropriate tax treatment. This is illustrated by FA 2005 section 47 "Alternative finance arrangements", reproduced here in full as originally legislated:

- (1) *Subject to subsection (3) and section 52, arrangements fall within this section if they are arrangements entered into between two persons under which—*
 - (a) *a person ("X") purchases an asset and sells it, either immediately or in circumstances in which the conditions in subsection (2) are met, to the other person ("Y"),*
 - (b) *the amount payable by Y in respect of the sale ("the sale price") is greater than the amount paid by X in respect of the purchase ("the purchase price"),*
 - (c) *all or part of the sale price is not required to be paid until a date later than that of the sale, and*

- (d) *the difference between the sale price and the purchase price equates, in substance, to the return on an investment of money at interest.*
- (2) *The conditions referred to in subsection (1)(a) are—*
 - (a) *that X is a financial institution, and*
 - (b) *that the asset referred to in that provision was purchased by X for the purpose of entering into arrangements falling within this section.*
- (3) *Arrangements do not fall within this section unless at least one of the parties is a financial institution.*
- (4) *For the purposes of this section “the effective return” is so much of the sale price as exceeds the purchase price.*
- (5) *In this Chapter references to “alternative finance return” are to be read in accordance with subsections (6) and (7).*
- (6) *If under arrangements falling within this section the whole of the sale price is paid on one day, that sale price is to be taken to include alternative finance return equal to the effective return.*
- (7) *If under arrangements falling within this section the sale price is paid by instalments, each instalment is to be taken to include alternative finance return equal to the appropriate amount.*
- (8) *The appropriate amount, in relation to any instalment, is an amount equal to the interest that would have been included in the instalment if—*
 - (a) *the effective return were the total interest payable on a loan by X to Y of an amount equal to the purchase price,*
 - (b) *the instalment were a part repayment of the principal with interest, and*
 - (c) *the loan were made on arm’s length terms and accounted for under generally accepted accounting practice.*

As soon as one reads section 47, it is clear that it was designed to facilitate murabaha and tawarruq transactions. However it nowhere uses those terms and nothing in section 47 limits its application to Islamic finance. If a transaction falls within section 47, the tax treatment follows automatically, regardless of whether the transaction is (or was intended to be) Shariah compliant.

This paper cannot cover all of the tax changes in detail. However, a key principle throughout has been that the tax treatment of a transaction cannot be allowed to depend upon its Shariah status.

In passing, the contracts used in Islamic finance conducted by UK banks with UK customers are of course written under English law. Where a UK bank (whether Islamic or conventional) is dealing with a foreign counterparty, the bank and the counterparty need to agree whether to use the law of the UK, of the counterparty’s country of residence, or of some third country.

6 The Government sukuk

6.1 From April 2007 until the Pre-Budget Report (PBR) in November 2008, the Debt Management Office (DMO) conducted a study on whether the Government should become an issuer of Shariah compliant wholesale financial instruments. These are referred to as sukuk; more details are given in the Appendix on page 16.

6.2 The main reasons why issuance was urged on the Government by the Islamic finance industry were:

- It would provide a demonstration of the Government's support for Islamic finance which would reverberate around the world. So far no OECD government has issued such instruments, so for the UK to be first would help consolidate its leading position amongst Western countries in Islamic finance.
- Islamic banks and Islamic insurance companies lack liquid, risk-free, short term financial assets to hold their short term liquidity.

6.3 The Government stated in the recent Pre-Budget Report "The Government has looked carefully at the case for issuing sovereign sukuk and concluded that it would not offer value for money at the present time but it will keep the situation under review."

6.4 This announcement was received with considerable disappointment by the Islamic finance industry in the UK. Even more importantly, it is regarded by many overseas companies as indicative of a lowering of interest in Islamic finance by this government as ministers have been reshuffled. Meanwhile, the French government has repeatedly reaffirmed its intention of competing with London to attract Islamic finance business to Paris.

7 Should the Mayor support Islamic finance?

Yes.

The reasons why the present Government has supported Islamic finance are fully applicable to the Mayor's responsibilities. He should support Islamic finance because doing so is good for the City of London. Maintaining London's status as a leading centre for Islamic finance would attract capital from Muslim countries/corporations inclined towards Islamic financing and create further opportunities to export British expertise and experience in this field.

Other innovative uses of Islamic finance are being looked at. One area explored at the Islamic Finance and Trade Conference last October was to attract funding for part of the 2012 Olympics by issuing sukuk (Islamic bonds.) There is also potential to use Islamic finance structures for regeneration and housing in deprived areas where there are high numbers of Muslim residents. This will help to advance financial inclusion.

Finally, quite apart from the economic benefits to London, it is simply the right thing to do to enable devout Muslims to play a full financial part in our society.

8 What has the MCB done to develop Islamic finance in London?

8.1 The first adaptation of the UK tax system for Islamic finance was in 2003 when the stamp duty rules applicable to residential mortgages were amended to eliminate the double stamp duty charge that applied until then. This change came about as a result of a working party chaired by Sir Eddie George on which the MCB was fully represented.

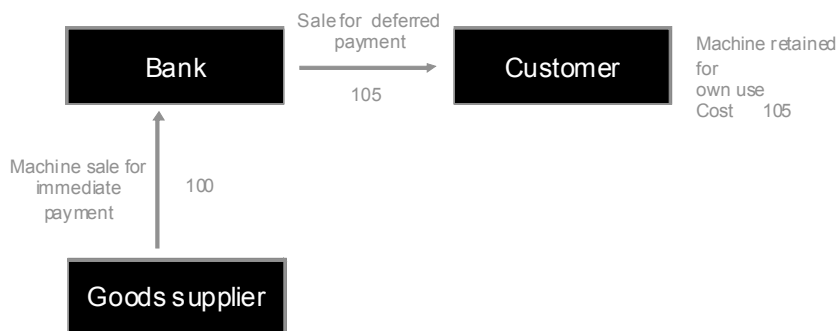
- 8.2 Since then the MCB has responded to every Government consultation on Islamic finance. In 2006 it held the seminal Islamic Finance and Trade Conference at which Gordon Brown, then Chancellor of the Exchequer, stated his goal of making London the gateway to Islamic finance. When the Treasury constituted the Islamic Finance Experts Group in April 2007, it specifically requested the chairman of the MCB's Business and Economics Committee to be a member. In 2008, the MCB held a follow-on Islamic Finance and Trade Conference. Most recently the MCB has issued a public consultation document regarding the transparency standards that should apply to providers of retail Islamic financial products.
- 8.3 The MCB has representatives on the major Islamic Finance working groups in the UK including the UK Trade and Investments Financial Services Sector Advisory Board Islamic Finance Working Group.
- 8.4 Internationally, the MCB sends an official delegation each year to the World Islamic Economic Forum which is the Islamic equivalent of "Davos"; the delegates make a point of emphasising the attractions of London as a leading centre for Islamic finance.
- 8.5 Without the active contribution of the MCB, and the expertise it supplies, the role of London in Islamic finance would not have developed so quickly or so successfully.

9 Appendix: Some structures used in Islamic finance

This appendix illustrates some of the structures that are used in Islamic finance.

9.1 Murabaha

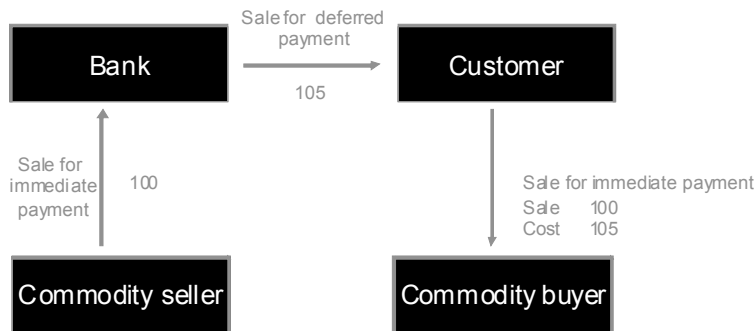
Murabaha



9.2 The above diagram illustrates a straightforward murabaha transaction. The customer wishes to have use of a machine but cannot afford the purchase price. Instead, a bank will buy that machine for, say, £100 and sell it to the customer for a price of £105, payable in say 12 months time. The customer obtains immediate use of a machine worth £100, and has an obligation to pay £105 in one year's time. The extra £5 that the customer pays is clearly, in economic terms, the cost of the finance. However, the legal form of the transaction is that the customer is paying £105 to the bank to purchase the machine.

9.3 Tawarruq

Tawarruq



In this case, the customer has a desire for cash which the bank wishes to provide without creating an interest bearing loan.

The bank will buy something that can be sold very easily afterwards, with little difference between the bid/offer (buy/sell) prices. A typical example would be a quantity of copper bought on a commodity market. The bank buys the copper, immediately paying £100 for it, and transfers ownership to the customer at a price of £105 payable in, say, one year's time.

The customer can then immediately sell the copper for a price of £100. This gives him cash equal to what the bank has laid out, £100, and an obligation to pay the bank £105 in one year's time. The extra £5 is in economic terms the cost of the finance, equivalent in economic terms to paying interest at 5%.

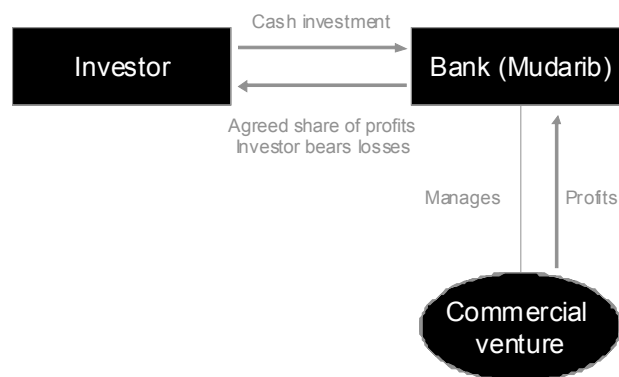
As the tawarruq structure has the economic effect of replicating a conventional interest bearing debt through the form of the commodity purchase and sale, it is disliked by most Shariah scholars. However, it is included in this paper as it is currently widely used by Islamic banks.

9.4 Mudaraba profit sharing investment account

Islamic banks typically offer two distinct forms of accounts: current accounts, which are repayable in full but which give the investor no economic return, and profit sharing investment accounts, which at least conceptually are exposed to the risk of loss but where the customer participates in the profits made by the bank from the use of the customer's money.

One such form of savings account is a mudaraba contract. This is illustrated in the following diagram.

Mudaraba



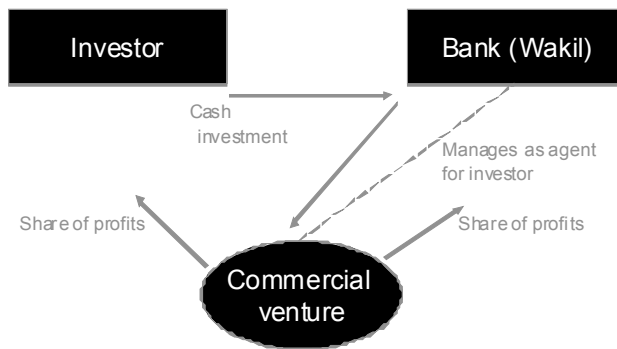
In a mudaraba transaction, the investor (the depositor in the bank) provides cash to the bank (acting as mudarib) to invest that money in a commercial venture, with the bank as mudarib managing that commercial venture. Typically, in the case of a bank the commercial venture will consist of the full range of its operating assets, both finance facilities made available to customers and financial assets held in the bank's treasury operations to ensure that the bank has sufficiently liquidity to repay its current account and savings accounts customers when required.

If there are profits from the bank's operations, those profits are shared between the bank and the customer on an agreed basis. Typically, the customer obtains a return similar to market interest rates while the bank keeps any excess return as a reward for organising the transactions.

9.5 Wakala in a banking context

Another form of contract which can be used for an investor to provide money to a bank to earn an economic return is a wakala contract.

Wakala



9.6

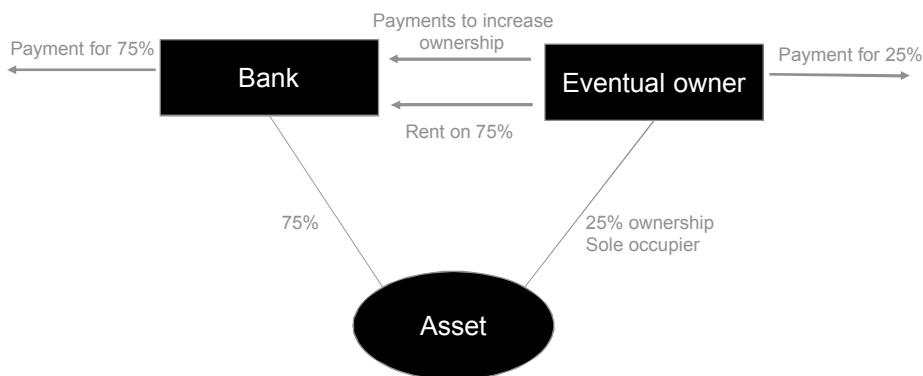
In wakala, as with mudaraba, cash is going from the customer as an investor and is used to finance a commercial venture with the profits of the commercial venture being shared between the investor and the bank (the wakil) in agreed proportions.

The main difference from mudaraba is that the bank is acting as an agent for the investor. If the documentation is appropriately drafted, for example with the bank acting as a trustee for the investor, the investor can be protected from the risk of the bank becoming insolvent. Instead the investor would be exposed only to the performance of the commercial venture.

9.7 Diminishing musharaka

This is often used for people buying houses for owner occupation instead of a conventional mortgage, and can also be used for the purchase of investment property. It is illustrated in the following diagram.

Diminishing musharaka



Diminishing musharaka is used when one party, here called the eventual owner, wants to buy an asset but cannot afford to pay for all of it. In the diagram, on day one the bank buys 75% of the asset, for example a building, while the eventual owner buys 25%. Under a lease between the eventual owner and the bank, the eventual owner is granted rights to sole occupation.

The eventual owner pays rent to the bank on the 75% of the property that it doesn't own. Then, over the life of the arrangement, as well as paying the rent, the eventual owner will make additional payments to the bank to purchase additional slices of the asset.

The price for the additional slices of the asset will be set out in the diminishing musharaka agreement. While any price formula can be used, in practice two arrangements are most common:

- (a) The price is equal to the original cost to the bank. In this situation, the bank does not benefit from increases in the value of the property; its economic return derives entirely from the rent that it receives.
- (b) The price of each slice is equal to the market value of that fraction of the property on the date when the eventual owner purchases that slice. In this case, the bank is also benefiting from any growth in value of the property.

9.8 Ijarah

An ijarah contract is very similar to a lease. The financier purchases an asset and rents it to the customer. The customer may or may not have the right to purchase the asset at the end of the ijarah contract.

9.9 Sukuk

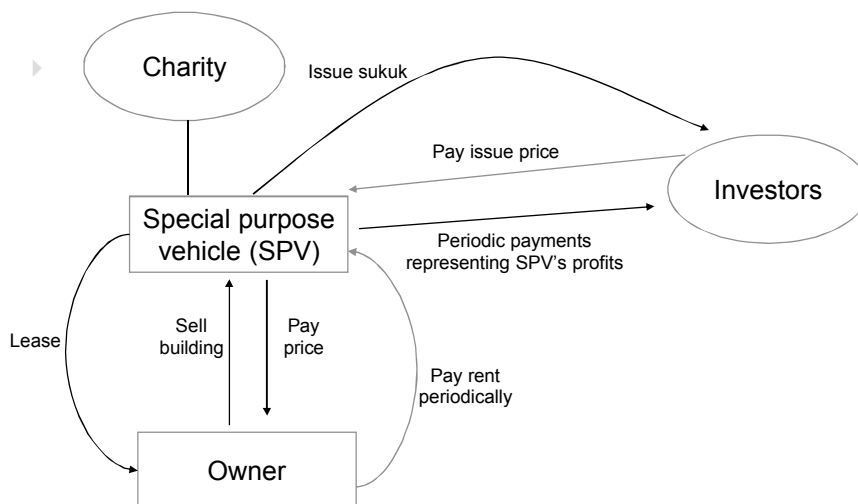
The goal when structuring a sukuk is to replicate the economic characteristics of bonds without infringing the rules of Shariah. The most important requirement is that there must be no interest, which in turn means that there can be no legal debt involved.

The goal is to design an instrument which:

- can be bought and sold between different holders,
- provides finance for a fixed period of time, typically three to five years although longer periods of time are used, and
- from the perspective of investors, provides a flow of regular payments which has priority over the payment of rewards to ordinary shareholders, without involving interest.

The manner in which these goals are achieved is most easily considered by looking at an example of a sukuk based upon an ijarah contract.

Ijarah sukuk



The owner of a building wishes to use that building to raise finance. Accordingly, the owning company (the obligor) arranges for the creation of another company, typically a special purpose vehicle (SPV). This is a company which is not part of the obligor's group; the shares of the SPV

are normally held by a charity. The SPV raises the cash needed to purchase the building from the obligor by issuing sukuk to the investors.

Legally, the sukuk are certificates which entitle the investors to a fractional share of the income that the SPV will receive from renting the building back to the obligor. The SPV will normally declare itself as a trustee of the building on behalf of the sukuk investors, so that they have a beneficial entitlement to a proportionate share of the building and of the rent receivable from leasing it.

During the life of the sukuk, the obligor will pay rent to the SPV which in turn will pay that money on to the investors. In economic terms, the investors have a prior claim on the profits generated by the owner from its business because part of those profits must be used to pay rent on the building to the SPV prior to any distribution of profits to the equity shareholders. However, this is achieved without creating a debt since leasing a building does not involve a debt claim.

At the maturity of the sukuk, the obligor will purchase the building back from the SPV and this provides the SPV with cash to redeem the sukuk.

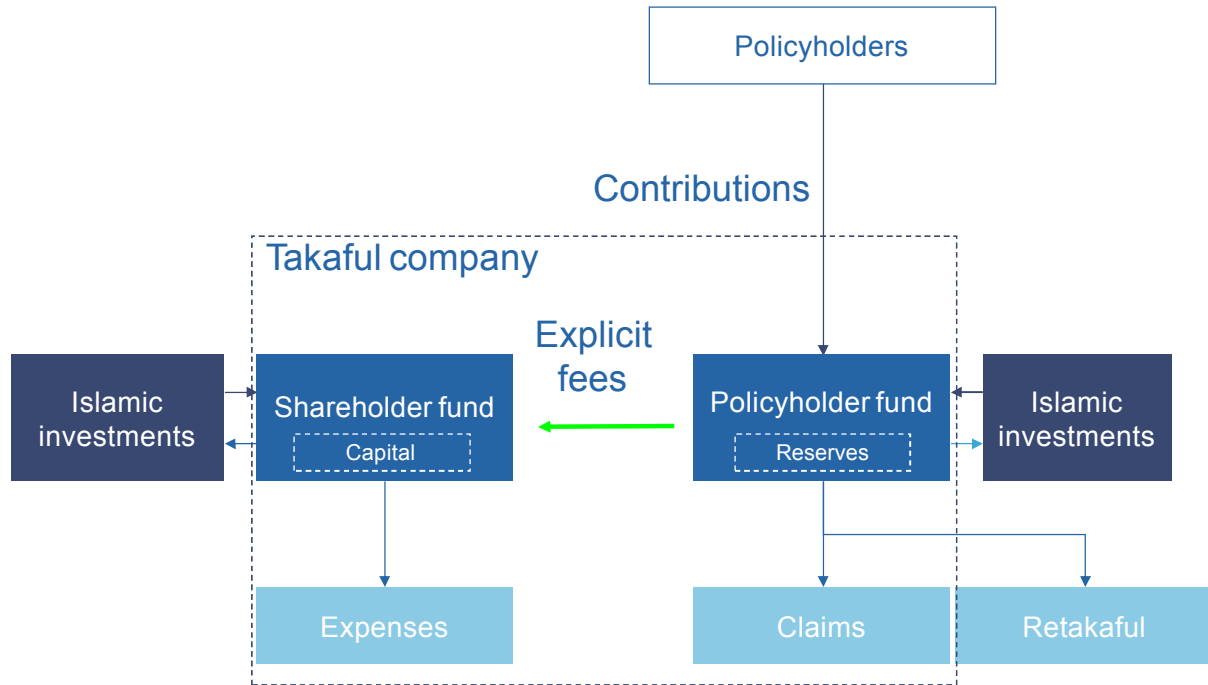
9.10 Takaful

Islamic scholars have ruled that Muslims should not buy conventional insurance except where it is required by law (for example in the UK motor insurance and employer's liability insurance).

Two factors underlie this prohibition:

- (a) Conventional insurance companies invest much of their funds in interest bearing investments, and also in companies carrying on activities prohibited to Muslims such as running casinos or pubs.
- (b) The transfer of risk from the insured to the insurance company involves an unacceptable level of gharar, an Arabic word which can be broadly translated as "uncertainty." At the end of the year, if the insured event has happened, the insured will typically receive many times his premium as a claim payment from the insurer. Conversely, if the insured event has not happened, the insured has paid his premium and in the eyes of the religious scholars received nothing in return.

While proscribing conventional insurance, the scholars expressly approved of takaful, which is another Arabic word loosely meaning "guaranteeing each other". The operation of a takaful company is illustrated in the following diagram.



At first sight, this looks almost identical to the operation of a conventional insurance company. Premiums (referred to as contributions) are received from policyholders, who are thereby indemnified against specific insured risks. The company invests the money and pays expenses and claims. Instead of buying conventional reinsurance to protect the company from catastrophic losses, the company takes part in retakaful arrangements.

Apart from the fact that the investments are Islamically approved, the key difference between takaful and conventional insurance is that in the above structure the shareholders of the company do not participate in any actuarial underwriting surpluses; those belong only to the policyholders and are either paid to them in cash or used to reduce future premium (contribution) rates.

To ensure that the shareholders do not participate in underwriting surpluses, the company maintains two distinct funds, the Shareholder fund and the Policyholder fund. The shareholders earn a return for running the company and providing the capital by the Shareholder fund charging transparent and explicit fees to the Policyholder fund.

If there is an underwriting deficit (broadly claims and expenses exceed contributions and investment return) that deficit is funded by an interest free loan from the Shareholder fund to the Policyholder fund. That interest free loan is repaid from future Policyholder fund surpluses.

Accordingly, the effect of underwriting profits or losses overall falls only on the policyholders collectively, and is not shared by the shareholders. That is considered by the scholars to eliminate the unacceptable level of gharar (uncertainty) that exists within conventional insurance.