Financial Services Authority

Islamic Finance in the UK: Regulation and Challenges

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1 Introduction

In recent years, Islamic finance has grown rapidly across the world, conservatively estimated at 10-15% a year.[1] Given the UK's position as one of the leading international financial centres, it is no surprise that part of this growth has taken place in London which is now seen as an emerging global 'hub' for Islamic finance. At the same time, the government has wanted to give the UK's relatively large Muslim community (around 3% of the population) access to financial services consistent with their religious beliefs.[2]

The Bank of England and the Financial Services Authority (FSA) have been closely involved in these developments, and this paper gives a regulatory perspective. It covers four main areas:

- why the UK is now emerging as a global 'hub' for Islamic finance;
- the important role which the FSA has played in this;
- the risk and challenges which Islamic firms in the UK face in the retail and wholesale markets; and,
- the outlook for future growth of Islamic finance in the UK.

The paper draws on work across the FSA, coordinated by a small team. The views expressed are those of the authors and not necessarily those of the FSA; and they are no way intended to set policy or be guidance for market participants. Rather, the paper is designed to highlight important questions and contribute to the current debate in this area.

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2 The Islamic economic model

The beliefs of Islam encompass all aspects of a Muslim's life, determining the articles of their faith and the relationships between man and God, and between human beings. They also determine their moral and behavioural code, as well as giving the framework for their daily activities. Islamic law or Sharia – as revealed in and derived from the Qur'an and Sunnah (the sayings and practices of the Prophet Muhammad) – governs all economic and social activities and undertakings of Muslims.

The Islamic economic model has been developed over time, based on the rulings of Sharia on commercial and financial transactions. The Islamic financial framework, as seen today, stems from the principles developed within this model, some of which are outlined below:

- The Islamic economic model emphasises fairness. This is reflected in the requirement that everyone involved in a transaction makes informed decisions and is not misled or cheated. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific Sharia rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society.[3]
- Islam encourages and promotes the right of individuals to pursue personal economic wellbeing, but makes a clear distinction between what commercial activities are allowed and what are forbidden. For example, transactions involving alcohol, pork related products, armaments, gambling and other socially detrimental activities.
- One key Sharia ruling on economic activities of Muslims is the strict and explicit prohibition of Riba, most usually described as usury or interest. Sharia scholars consider exchanging interest payments within the conventional banking system as a type of Riba. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct (the right to use an asset), for example, rental income.[4]

- The Islamic economic model is based on a risk and profit-sharing (and loss-bearing) philosophy. So, in this respect, Islamic transactions are similar to, if not the same as, equity-based transactions in rewarding performance. However, Sharia requirements go further to ensure that in distributing profits more emphasis is placed on reward for effort rather than reward for merely owning capital.[5]
- The Islamic Law of Contracts plays a pivotal role within the Islamic financial system. Islamic commercial jurisprudence consists of principles and rules that must be observed for transactions to be acceptable in Islam; and the Islamic Law of Contracts is at the heart of this. One important principle is contractual certainty. Under this body of law, uncertainties or ambiguities that can lead to disputes may render a contract void under Sharia.

While some of these principles and rules are based on clear and explicit rulings of Sharia, others are derived from Sharia scholars' interpretations and understanding of the law, known as Fiqh, as set out in the Qur'an. These interpretations can and do differ between Sharia scholars. Certain contractual terms deemed to be valid under Sharia by the scholars of one school of Fiqh may not be acceptable to scholars from another school. This has had significant implications for the development of Islamic finance, which we discuss later in this paper.

3 The development of Islamic finance in the UK

Most of the growth of Islamic finance in the UK has taken place in the last five years, but the existence of Sharia-compliant transactions in the London financial markets goes back to the 1980s. Commodity Murabaha* type transactions through the London Metal Exchange were used, in significant volumes, to give liquidity to Middle Eastern institutions and other investors that fostered the development of a wholesale market in the UK. This did not, however, cater for retail Muslim consumers, as the products developed at the time were aimed exclusively at wholesale and high-net-worth investors. These products were relatively uncomplicated in structure and fell outside the scope of the regulators.

Retail Islamic products first appeared in the UK in 1990s but only on a very limited scale. A few banks from the Middle East and South East Asia began to offer simple products such as home finance. However, these compared unfavourably with their conventional equivalents in several respects, including their generally uncompetitive pricing. Most of these products did not fall within the regulatory framework, so consumers did not have the same protection as other consumers, for example, the availability of the Financial Ombudsman Service and the possibility of redress from the Financial Services Compensation Scheme. The growth of the retail market remained slow throughout the 1990s and early 2000s.

Much has changed since then. Both on the wholesale and the retail side, the quality of products has improved; a wider range of products has become available; and more players have entered the market. Today, London is seen by many firms, including Islamic as well as non-Islamic, as an increasingly important global centre for Islamic finance. Some of the reasons are outlined below.

* Murabaha is an agreement of sale of goods at a pre-determined profit mark-up on the price. Commodity Murabaha is a mechanism used to create a Sharia-compliant form of short term deposit/placement by way of transactions in commodities, usually metals.

Reasons for growth

There are, perhaps, six main reasons:

1. Global expansion of Islamic finance

The first experience of Islamic banking in modern times seems to have been in the Middle East in the 1960s.[6] It is, therefore, a relatively young industry and nobody really knows the exact size today. But from a small base, the market size is now estimated to be about £250bn globally.[7] There are also around 300 financial institutions around the world offering Islamic products.[8] Not surprisingly, the growth of the industry in the Middle East and South East Asia has influenced the UK market. Initially, products created in the traditional markets were brought into the UK by some of the key industry players, but now products developed in London are being marketed in other countries, for example in the Middle East.

2. Markets and skills base

London is well placed to take advantage of these trends. It has a tradition going back to the seventeenth century, if not before, of being willing to innovate and respond flexibly to new ideas. London has deep and liquid markets and the exchanges are among the most frequently used venues for listing and trading financial instruments globally. The London Metal Exchange has already been mentioned. The UK financial services industry has a proven record of developing and delivering new products and a large pool of legal, accounting and financial engineering skills on which to draw.[9] Several of these firms have now established or expanded offices in other Islamic centres. English law is already the preferred legal jurisdiction for many Islamic finance transactions.[10]

3. Islamic windows

Several major international institutions such as Citi, Deutsche, and HSBC have had a presence in the Middle East and South East Asia for several years. As a result, they have developed considerable knowledge and experience of local markets, including Islamic ones. To accommodate the new and growing demand for Islamic products, they have established business lines known as 'Islamic windows', some of which are based in the UK and others in the Middle East and South East Asia. These windows have contributed significantly to the development of Islamic finance because of the institutions' global experience in product development and their access to far greater resources than those available to local institutions in the Middle East and South East Asia.

4. Excess liquidity in the Middle East

The sharp rise in oil prices since 2003 has resulted in huge liquidity surpluses and a surge in demand for Islamic as well as conventional assets in the countries of the Gulf region. The capacity of the local financial markets has not, however, been able to develop at the same speed. As a result, demand for assets has considerably outpaced supply and Middle Eastern investors have been looking, in large numbers, for suitable alternatives. This demand was quickly identified by Islamic and conventional

institutions that now provide a channel through which assets within other markets are sold to these investors, often by way of Sharia- compliant transactions.[11] This has been particularly notable in the UK. A recent example is the acquisition of Aston Martin by two Kuwaiti financial institutions, using Sharia-compliant financing.[12]

5. Public policy and taxation

Since the early 2000s the government, for reasons of wider public policy, has introduced a series of tax and legislative changes specifically designed to remove obstacles to the development of Islamic finance. The first significant change came in the Finance Act 2003 which introduced relief to prevent multiple payment of Stamp Duty Land Tax on Islamic mortgages (see below).[13] The Finance Acts 2005 and 2006 contained further measures aimed at putting other Islamic products on the same tax footing as their conventional counterparts. Most recently, the Finance Act 2007 clarified the tax framework further, in the case of Sukuk*. This is very much work in progress.

6. Single financial regulator

Another contributory factor is institutional. The establishment of the FSA in 1997 combined 11 different regulators into a single body under a single piece of legislation. This has done much to resolve several of complications and conflicting views stemming from the previous regulatory regime where functions were divided. In particular, the FSA is able to look across the system as a whole, to assess Islamic financial institutions and products.

Regulatory developments

As banking regulators, the Bank of England and, from 1998, the FSA have been open to the development of Islamic finance in the UK for some time. The first important signal was given in a speech by Lord Edward George, then Governor of the Bank of England, in September 1995 at a conference organised by the Islamic Foundation. In this, he recognised the 'growing importance of Islamic banking in the Muslim world and its emergence on the international stage' as well as the need to put Islamic banking in the context of London's tradition of 'competitive innovation'. In pointing out that the supervisory issues raised were similar in many respects to those of conventional banks, he also noted there were a number of potentially difficult questions to resolve, such as liquidity and risk management. But the problems, he said, should prove 'more tractable', the more they were understood by Western supervisors.

These sentiments were first translated into practice in 2001 when a high-level working group, chaired by Lord George with representatives from the City, government, the Muslim community and the FSA, was established to examine the barriers to Islamic finance in the UK. One of the main ones identified was the fact that Islamic mortgages attracted double stamp duty, both on the purchase of the property by the bank and on the transfer of the property by the bank to the customer at the end of the mortgage

* Sukuk, plural of Sak, are trust certificates representing individual ownership of the underlying assets. Sukuk are comparable to bonds.

term. As noted above, any change here was clearly a matter of public policy; and government legislation in 2003 to remove this anomaly was welcomed by both the Bank of England and the FSA.

This open approach was taken forward by Sir Howard Davies, when he was Chairman of the FSA. For example, in a speech to a conference on Islamic Banking and Finance in Bahrain in September 2003, he told his audience that he had ‘no objection in principle to the idea of an Islamic bank in the UK’.[14] He went further in saying that, provided Islamic banks met the FSA’s regulatory requirements, the UK had ‘a clear economic interest in trying to ensure that the conditions for a flourishing Islamic market are in place in London’. A soundly financed and prudently managed Islamic institution would, he argued, be ‘good for Muslim consumers, good for innovation and diversity in our markets and good for London as an international financial centre’.

These high-level contacts with the Muslim community have since been reinforced by working level contact with Islamic institutions. The FSA now has good and growing links with the industry, other regulators and Islamic working groups in international organisations. It is also a participant in the recently established HM Treasury Islamic Finance Experts Group.[15] These and other links have laid the foundation on which the FSA has been able to consider the authorisation of wholly Islamic firms.

4 The FSA's approach to authorisation

To date, the FSA has authorised three wholly Islamic banks, initiated by Middle Eastern investors and institutions. The Islamic Bank of Britain began operations as an authorised firm in 2004 and by June 2007 had a balance sheet of around £140m.[16] On the same date, the European Islamic Investment Bank, which was authorised in 2006, had a balance sheet of £302m.[17] The Bank of London and the Middle East was authorised in July 2007, with a start up capital of £175m.[18] The first of these is retail and the last two wholesale. Other applications are in the pipeline. The FSA has also authorised one Islamic hedge fund manager and is considering an application from the first wholly Islamic Takaful* provider.[19] [20]

This section examines the authorisation process and how it is applied to wholly Islamic finance firms. It is, however, worth noting that the operations conducted by conventional banks for retail and wholesale clients through their Islamic windows do not require separate authorisation. These activities are covered under their existing authorisations and permissions from the FSA. Separate authorisation, however, would be required if such banks were to establish subsidiaries or separate legal entities to carry out this business.

The Financial Services and Markets Act 2000

Anyone seeking to conduct a regulated activity in the UK is required to apply to the FSA for permission under Part IV of the Financial Services and Markets Act 2000 (FSMA).[21] FSMA deals with the regulation of financial services in the UK and is the legislation under which bodies corporate, partnerships, individuals and unincorporated associations are permitted by the FSA to carry on those financial activities which are subject to regulation.

Under Section 19 of FSMA, any person who carries on a regulated activity in the UK must be authorised by the FSA or exempt.** A breach of section 19 may be a criminal offence.

* Takaful is a form of Islamic insurance, based on the concept of collective risk pooling.

** Examples of exemptions are appointed representatives or professional firms, such as a firm of solicitors, accountants or actuaries, who are carrying on regulated activities that are incidental to the firm's main business.

Regulated activities

The activities that are subject to regulation are specified in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).[22] Examples include accepting deposits, effecting or carrying out contracts of insurance and advising on investments.

Before the FSA was established as the single financial regulator in the UK, several separate regulators oversaw different financial markets. The Bank of England, for example, was responsible for supervising banks under the Banking Act 1987 and the Securities and Investment Board was responsible, under the 1986 Financial Services Act, for investment regulation which was carried out by several self-regulatory organisations. However, under FSMA, and subject to any specific restrictions*, firms now seek a scope of permission from the FSA to be authorised for the full range of regulated activities they wish to undertake.

Most of the Islamic applications the FSA has received so far have been to establish Islamic banks. Banking itself is not a defined regulated activity; rather, the generally understood meaning is an entity which undertakes the regulated activity of 'accepting deposits' (and is not a credit union, building society, friendly society or insurance company). As defined by the RAO, this covers money received by way of deposit lent to others or any other activity of the person accepting the deposit which is financed, wholly or to any material extent, out of the capital of or interest on money received by way of deposit. This activity warrants classification as a credit institution under the EU Banking Consolidation Directive and firms undertaking it are subject to the appropriate capital requirements.[23] A firm claiming to be a bank will therefore be expected to seek this activity within the scope of its permission.

Non-discriminatory regime

All financial institutions authorised by the FSA and operating in the UK, or seeking to do so, are subject to the same standards. This is true regardless of their country of origin, the sectors in which they wish to specialise, or their religious principles. This approach is fully consistent with FSMA's six Principles of Good Regulation, in particular, facilitating innovation and avoiding unnecessary barriers to entry or expansion within the financial markets.[24]

There is, therefore, a 'level playing field' in dealing with applications from conventional and Islamic firms. The FSA is happy to see Islamic finance develop in the UK, but it would not be appropriate, nor would it be legally possible, to vary its standards for one particular type of institution. This was clearly articulated by Sir Howard Davies in his speech in Bahrain in September 2003. The FSA's approach can be summed up as 'no obstacles, but no special favours'.[25]

* For example, other than pure reinsurers, insurance companies are not permitted to carry on any commercial business other than insurance business and activities directly arising from that business.

Authorisation requirements

All firms seeking authorisation are required to provide a credible business plan and meet, and continue to meet, five basic requirements known as the 'Threshold Conditions'. These are set out in FSMA and described in further detail in the FSA Handbook.[26] In summary, the five conditions are that:

- The firm must have the right legal status for the activities it wishes to undertake. This recognises, for example, that European directives place certain limits on the legal form that a firm accepting deposits or effecting and carrying out contracts of insurance may take.
- For a firm incorporated in the UK, its head office and 'mind and management' must also be in the UK.
- If the person or firm has 'close links' with another person or firm, these are not likely to prevent the effective supervision of the firm.
- The firm has adequate resources, both financial and non-financial, for the activities which it seeks to carry on.
- The firm is 'fit and proper'. This takes into account its connection with other persons, including employees and shareholders, the nature of the activities it wishes to undertake and the need to conduct its affairs in a sound and prudent manner.

These conditions can readily be applied to any type of firm, although the exact requirements may need to be shaped to fit differing sectors. For example, the requirement for adequate resources, which includes capital, would be different for a bank and an insurance company. However, the capital requirements for an Islamic and a conventional bank would be applied on the same basis. Another example would relate to the requirement that a business must have reasonable systems and controls to manage the type of business it wishes to undertake. In this case, the threshold conditions are flexible enough to be as readily applied to an Islamic firm as to a conventional provider, whatever sector the firm is operating in.

Applying FSMA

In applying FSMA to Islamic firms, there are several areas where more work or clarification is needed. So far, however, they have not presented any obstacles that could not be overcome. This owes much to the collaboration between the FSA and the applicants to develop pragmatic solutions.

The FSA has identified three main areas of potential difficulty which are common to Islamic applications. These are: the regulatory definition of products; the role of Sharia scholars; and financial promotions.

Regulatory definition of products

The definition of products offered by Islamic firms is a key factor that firms and the FSA need to consider as part of the authorisation process. As explained earlier, the structure of Islamic products is based on a set of contracts acceptable under Sharia. So,

while their economic effect is similar to or the same as conventional products, their underlying structure may be significantly different. This means the definition of these products under the Regulated Activities Order may not be the same as the conventional equivalent.

This has two important implications for applicants. First, firms need to be sure they apply for the correct scope of permission for the regulated activities they wish to undertake. This, in turn, highlights the need for firms to assess whether the structure of Islamic products can be accommodated within the Regulated Activities Order. Second, the regulatory definition is relevant in determining the framework in which products can be sold, for example in the application or otherwise of conduct of business rules. If a product falls outside the FSA's regulatory framework, there may be restrictions on who the product can be sold to. For these reasons, new applicants are encouraged to engage at an early stage with the FSA and their legal advisers about the regulatory definition of the products they intend to offer.

The role of Sharia scholars

The FSA also has to consider the role of the Sharia Supervisory Board (SSB). The industry defines the key objective of SSB scholars as ensuring Sharia compliance in all an entity's products and transactions. In practice, Sharia scholars examine a new product or transaction and, if satisfied it is Sharia compliant, issue an approval. The FSA is, however, a secular and not a religious regulator. It would not be appropriate, even if it were possible, for the FSA to judge between different interpretations of Sharia law. However, the FSA does need to know, from a financial and operational perspective, exactly what the role of the SSB is in each authorised firm. It needs, in particular, to know whether and if so how the SSB affects the running of the firm. The FSA has to be clear as to whether the Sharia scholars have an executive role or one that is simply advisory.

This matters for two reasons. First, in the UK, any person acting as a Director of an authorised firm must be registered under the FSA Approved Persons rules. To assess the suitability of a person, the FSA has a standard known as the 'Fit and Proper test for Approved Persons'.[27] One of the factors looked at is 'competence and capability'. So, for an individual to become a Director of an authorised firm, we would expect them to have relevant experience. If, therefore, Sharia scholars are seen to have a directorship role, it is possible that some of them may not meet the competency and capability requirements. Second, and assuming that Sharia scholars are Directors, their role is more likely to resemble that of an Executive Director than a Non Executive Director as it might involve active participation in the firm's business. In such cases, it would be very difficult to justify multiple memberships of SSBs of different firms because of significant conflicts of interests. This would put further constraints on an industry already facing a shortage of Sharia scholars with suitable skills.

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 it does not interfere in the management of the firm. The firms already authorised have been able to show this. The factors that the FSA typically looks at with regards to SSBs include the governance structure, reporting lines, fee structure and the terms and conditions of the SSB's contracts.

On a related point, we understand from the industry that complex products, having gone through a long process of development, are sometimes rejected by the SSB for non-compliance with Sharia. To some extent, this is seen to be a result of the lack of Sharia knowledge internally in the firm. One solution put forward by some practitioners is greater involvement by Sharia scholars in the product development process. While this may prove beneficial, it could lead to a more executive role as outlined above. A good industry practice, now developing, is that firms are starting to recruit more staff with an understanding of Sharia law. This could help to identify a product's potential non-compliance with Sharia at a much earlier stage.

Financial promotions

The third issue, financial promotions, is more relevant on the retail side. Reflecting its statutory objective to protect consumers, the FSA's requirement is that all advertising should be 'clear, fair and not misleading'.[28] This has been important in the context of Islamic finance as the products are still new and their structure differs from more conventional products. This, together with the fact that by necessity those who will wish to use them may be relatively inexperienced in financial services, reinforces the need for the promotion of Islamic financial products to include the risks as well as the benefits. The example below shows how these issues have been dealt with in practice.

Authorisation of the Islamic Bank of Britain

In August 2004, the FSA authorised the Islamic Bank of Britain (IBB), the first wholly Islamic retail bank in a country where most of the population is non-Muslim. Inevitably, the process raised new questions and it took some 18-24 months to complete. The FSA was then able to carry over the lessons to later applications.

The main issue that arose concerned the definition of a 'deposit'. In the United Kingdom, a deposit is defined as a 'sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by parties'.[29] The point is important because deposit-takers are regulated and the customer is assured of full repayment as long as the bank remains solvent. A savings account originally proposed by IBB as a 'deposit' was a profit-and-loss sharing account, or Mudharaba*, where Sharia law requires the customer to accept the risk of loss of original capital. This was not consistent with the FSA's interpretation of the legal definition of a 'deposit' which requires capital certainty.

After extensive discussions, the solution IBB adopted was to say that, legally, its depositors are entitled to full repayment, thus ensuring compliance with FSA requirements. However, customers had the right to turn down deposit protection after the event on religious grounds, and choose instead to be repaid under the Sharia-compliant risk sharing and loss bearing formula. The solution for IBB may, however, not necessarily be appropriate in other contexts. The FSA is prepared to review each case on its merits and will try to reach solutions that are acceptable to all those involved.

* Mudharaba is a form of partnership or joint venture where one party provides the capital and the other provides management expertise. Profit is shared on a pre-determined ratio and loss is borne by the capital owner.

Another area which was new to the FSA was the role of the Sharia Board, which we have already discussed above. Financial promotions are particularly important as the IBB was, and is, marketing its products directly to retail consumers. The FSA and the IBB looked at how the risks associated with its products were to be presented to customers. This has presented no problems so far. The FSA is currently taking a similar approach to the first Takaful firm which has recently applied for authorisation.

The IBB now offers a range of retail and business banking services. It has established eight branches in cities with large Muslim populations, around the country. According to recent figures, the bank had over 50,000 accounts and some 42,000 customers.[30]

5 Risks and challenges

The FSA expects all authorised firms to identify, monitor and mitigate the risks they face. Islamic firms are no exception. Although there are many risks which are common to Islamic and conventional firms, the FSA's experience shows there are several risks which are specific to Islamic firms. This section looks at some of these risks. The list is not exhaustive and not all of the risks apply to all Islamic firms. There are differences too in the risk management practices of wholly Islamic firms and conventional firms operating Islamic windows, some of which we also discuss here.

Risks specific to Islamic finance

1. Sharia 'arbitrage'

There is a diversity of opinion as to whether particular practices or products are Sharia compliant. This means that some products and services may be approved as being Sharia-compliant by some Sharia scholars but not by others. On a global level, the approval of Islamic firms' products and services may also depend on the jurisdiction they are to be offered in. This can add another layer of complication for regulators.

The FSA is in no position to assess the suitability of the scholars consulted by Islamic firms. It does, however, want to see the basis on which an Islamic firm claims to be Sharia -compliant is communicated appropriately to the consumer. More generally, it supports moves to develop common Sharia standards by organisations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).[31] The IFSB, for example, has recently called for a dialogue within the industry to adapt current insurance regulations to meet the specifics of Islamic finance.[32] Greater standardisation could reduce the potential for Sharia 'arbitrage' as well as making it easier for bankers and investors to understand the market.

2. Sharia compliance throughout the product life cycle

For Islamic finance providers, gaining approval from the SSB on Sharia compliance of a product before its launch is vital. Equally important for firms is recognising that Sharia compliance is a continuous process that means their products and services are

adequately monitored. Unlike conventional finance, this has implications for an Islamic firm's prudential requirements as well as conduct of business: some products, if they breach Sharia compliance rules, can adversely affect a firm's solvency by converting an asset into a liability on the balance sheet. Effective monitoring of Sharia compliance by an Islamic firm may involve reinforcing more remote SSB oversight through the Internal Sharia Audit process and by developing more knowledge and expertise within the firm.

3. Issues for Sharia scholars

Several of the potential issues for Sharia scholars were outlined in Section 4. It is worth highlighting two more. The shortage of appropriately-qualified Sharia scholars in the Islamic financial industry means it is common for individual scholars to hold positions on the SSBs of a number of Islamic firms. This raises concerns over the ability of SSBs to provide enough rigorous challenge and oversight of firms' products and services. Another issue is where the SSB of a firm is responsible for the yearly Sharia audit as well as approving products for Sharia compliance. As with conventional firms, the FSA would like to see these conflicts recognised and carefully managed.

4. Human resources

It is widely acknowledged that there is a global shortage of experienced professionals in the Islamic finance sector. There is clearly scope for more education and training in the UK and some positive steps are now being taken. These include university degrees and professional training courses.

As explained earlier, the shortage of resources also extends to Sharia scholars who have relevant banking experience. To address this, some firms have placed less-experienced scholars alongside experienced ones on their SSB, thus helping to develop more knowledgeable scholars.

5. Contract and documentation risk

In contracts for Islamic transactions, the enforceability of terms and conditions depends on the governing law. In the case of a dispute, it is unlikely that a UK court will give a verdict based on Sharia law. The precedent here is the case of Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd et al, in 2004, when the Court of Appeal ruled that it was not possible for the case to be considered based on principles of Sharia law.[33] There were two main reasons. First, there is no provision for the choice or application of a non-national system of law, such as Sharia. Second, because the application of Sharia principles was a matter of debate, even in Muslim countries.

To mitigate this risk, contracts have to be written very carefully to minimise potential disputes and state the governing law. This is well understood by the industry. At present, most Islamic contracts are governed by English law, and a few under New York law. There are also advantages in standardisation of documentation and a number of initiatives are under way in this field (see Section 8).

6. Risk of contagion

In the UK, the risk of contagion to the wider economy and financial markets through a failure of an Islamic financial institution is limited as the market is currently relatively small. In countries where Islamic institutions have a larger share of the market the impact would be wider.

The industry is still very young and it is still building its reputation and credibility. Additionally, in some countries, Islamic finance and its various business models (which have so far tended to be conservative) have not yet been tested in a severe economic or market downturn. Given these factors, a significant failure now in the Islamic market might have a damaging impact on the future development of this sector.

Risk management framework

This section outlines some of the financial risk management tools and practices used by Islamic finance providers, together with the challenges they face. It also looks at differences in risk management between wholly Islamic firms and Islamic windows of conventional firms.

Sharia scholars of a wholly Islamic firm require all transactions within the firm to be in compliance with Sharia, including risk management. Many of the commonly used tools (for example, certain types of derivatives which are used for hedging against currency, interest rates and other risks), are not acceptable to almost all Sharia scholars. In the past, this has made risk management more difficult for wholly Islamic firms as Sharia compliant substitutes have been slow to develop. However, new products and techniques are gradually emerging – for example, Sharia-compliant, derivative-like products for managing foreign exchange and interest rate risk.

Liquidity management has also been a challenge because of the lack, or limited availability, of Sharia-compliant instruments. Two of the instruments widely used by conventional banks, namely inter-bank deposits and government and corporate bonds or notes, are interest bearing, so are viewed as non-Sharia compliant by scholars. Again, Islamic firms are having to develop other methods. In the UK, as elsewhere, Commodity Murabaha transactions, which have a long history, are being structured so as to have almost exactly the same effect in terms of liquidity as the inter-bank deposits of conventional banks. Other products have been developed but their use is very limited. Some methods such as Tawarruq* are controversial and no consensus has been reached on whether they are Sharia compliant. Islamic securities markets are still relatively small in volume and quite illiquid. Nevertheless, volumes are now expanding and markets are beginning to develop around the world.

For banks with 'Islamic windows', the industry practice is that the risks arising from Islamic business and products are often pooled with risks from conventional business. Conventional tools are used to manage risks, at business unit or group level, but with certain limitations. For example, a firm that runs both Islamic and conventional mortgage books may have to keep the books separate at the start; but it may still pool

* Tawarruq is a form of reverse Murabaha involving three independent parties and three sale contracts, and is usually used as a non interest bearing lending tool.

the risks from the two books together and use a conventional tool to manage them. This practice has been accepted by the scholars of these firms.

In short, the constraints in risk management for Islamic firms are due mainly to lack of availability of suitable products and the relatively small size of the markets. However, if Islamic finance continues to develop as it has done over the past five years or so, many of these constraints should reduce as more institutions enter the market and new tools evolve.

Basel 2 and risk management

The new Basel 2 capital risk framework has been recently introduced in the UK, in the form of the EU Capital Requirements Directive.[34] Basel 2 is a revision of the existing Basel accord, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices. The broad framework consists of three pillars. Pillar 1 sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and regulators have to decide whether a firm should hold additional capital against risks not covered in Pillar 1, and must take action accordingly. Examples of Pillar 2 risks include concentration, liquidity and reputational risk. The aim of Pillar 3 is to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

If, in practice, certain risks affected Islamic institutions more than conventional firms, the FSA would expect these to be identified and quantified under Pillar 2. Where this is not possible or capital is not an appropriate mitigating tool, then other ways of managing these risks would need to be identified. Similar to conventional firms, these will include sound corporate governance and appropriate systems and controls. The FSA is in the process of putting this approach into practice across the firms it regulates but this is still work in progress. The FSA's approach to both Islamic and conventional financial institutions will develop over time.

6 Islamic finance in retail markets

After a slow start in the 1990s and early 2000s, the retail market has witnessed growth and some significant milestones in the last five years. Even so, establishing the market has not been as fast as some commentators predicted. Although reliable estimates of the overall size of the Islamic retail market are hard to come by, volumes appear to be relatively small. The size of the Islamic mortgage market in the UK, for example, is estimated at only £500m compared with the stock of mortgage lending of over £1.1 trillion in the UK as a whole and nearly 12 million borrowers.[35] As far as we are aware, there are around nine or ten regulated financial institutions, including major high street banks, active in the Islamic retail markets.

There are perhaps two main reasons for this modest growth. First, that demand may originally have been overestimated. Research by some commentators shows that financial decisions in the Muslim community, as in the population as a whole, are influenced by a variety of factors.[36] Similarly, the Muslim community is not a uniform group in terms of relative affluence. In the past, there have been tax and regulatory hurdles and it is too early to judge whether recent reforms will result in an increased market share for Islamic products.

Islamic mortgages

In the UK, Islamic mortgages have been structured under two different Sharia-compliant contracts, namely, Murabaha and Ijara*. Under the Murabaha method, the provider buys the property and sells it on immediately to the consumer for the original purchase price plus an agreed profit margin. The consumer pays this higher price in deferred payments in line with a fixed payment schedule. This method of financing falls within the definition of a regulated mortgage contract and has been regulated by the FSA alongside conventional mortgages since October 2004. It has rarely been used in the UK.

Ijara based contracts – Ijara and Diminishing Musharaka** – are the commonly used methods in the UK. In an Ijara contract, the finance provider buys the property and

* Ijara literally means leasing.

** Musharaka is a partnership where all parties to the agreement provide capital.

becomes the legal owner. The customer agrees to buy the property from the provider at a defined price at the end of a set period, and signs a lease agreement to occupy the property. During this period, the customer makes regular payments to the provider, consisting partly of the rental payment and partly a payment towards buying the property. At the end of the term, the legal ownership of the property is transferred to the customer. In the case of Diminishing Musharaka, the transfer of the ownership is gradual, as the payments made by the customer gradually buys the provider's equity in the property. Until recently, this type of home financing was not regulated by the FSA.

Regulation

Under the Finance Act 2007, the government brought Ijara-based contracts within the FSA's regulatory framework. For regulatory purposes, these contracts are called Home Purchase Plans (HPPs). The reasons for doing so included the need for a level playing field, as customers for HPPs did not enjoy the same levels of protection as customers for conventional mortgages. This meant HPP customers were potentially vulnerable to mis-selling and unfair treatment, with no means of redress.

The regulatory requirements that were introduced took account of the relatively small size of the market and the FSA's commitment to a more principles-based approach. It was recognised that imposing an expensive regime could have led some firms to cease offering the products altogether and to other distortions in the market. The FSA's requirements were generally kept at a high level and proportionate to the expected benefits for consumers. There is now a single sourcebook for the conduct of business for 'Mortgages and Home Finance'.[37] To date, the FSA has received a few applications to offer HPPs by existing providers and more than 50 by intermediaries to enter this market.

Prudential requirements

Under Basel 1, Murabaha-based home finance products were considered to have the same risk as conventional mortgages, risk weighted at 50%. Ijara-based products, however, were risk weighted at 100%, making them slightly more expensive for providers than conventional mortgages. Under the EU Capital Requirements Directive, the risk weights of all three products are the same in the UK, set at 35%, under the standardised approach.

Takaful

Takaful operations are mutual in nature and similar to conventional mutual insurers. Takaful firms and products are structured in a manner to address the specific concerns of Sharia scholars with conventional insurance products, namely uncertainty (gharar), gambling (maisir), interest (riba) and investment strategy. To deal with these concerns, Takaful products have three distinctive features – greater transparency in providing a clear distinction between the Takaful fund, which consists of contributions from policyholders akin to premiums, and the Takaful operator who manages the fund; an element of profit sharing; and limitations on acceptable investments.

Specific models for Takaful will vary, but Takaful operations often have a two-tier structure consisting of one or more funds belonging to policy holders, above which sits

a limited company with share capital which is responsible for overall governance, underwriting of risks, and investment management. Like conventional insurers, Takaful companies can generate a return based on their underwriting activity and their investment activity. The remuneration is either based on fixed fee or performance, but is commonly a combination of both, with underwriting subject to a fixed fee and investment management performance related. At times when the Takaful operator's activities generate a loss and the funds are in deficit, this can be made up by an interest-free loan provided by the limited company, to be repaid once the funds are in surplus again.

As yet, Takaful activity in the UK remains very limited, with only one provider active and a second having applied for authorisation. A Lloyd's syndicate was established to underwrite risks in a Sharia-compliant manner in 2006 with backing from a Takaful provider based in the Gulf, but this was wound down within a few months before it accepted any business.[38]

From a regulatory perspective, the FSA would treat a Takaful provider as it would any other insurance provider, assuming there was enough similarity in function and form. Given the parallels drawn between Takaful providers and conventional insurers, particularly mutual insurers, ratings agencies are also assessing them using the same method.[39]

Treating Customers Fairly (TCF)

Principle 6 of the FSA's Principles of Good Regulation states that 'a firm must pay due regard to the interests of its customers and treat them fairly'.[40] The FSA's TCF programme, which includes financial promotions, is designed to put this into practice.[41] The outcomes the FSA wants to achieve include giving consumers clear information, suitable advice and an acceptable level of service. In addition, the FSA would wish to see products and services in the retail market targeted to meet the needs of identified consumer groups.

Many of these requirements fit naturally with the principles and requirements of Sharia law, such as the requirement for Islamic financial institutions to disclose faults and avoid misrepresentations. However, owing to the sometimes complex or uncommon nature of Islamic financial products, these institutions should ensure consumer understanding is adequate. This will become more important as the industry develops and new products are introduced. These requirements and the additional layer of Sharia compliance can give firms a good basis for embedding TCF across their business.

Financial capability

Education to familiarise Muslims and other consumers with new products and new forms of finance will be critical. In this context the FSA has devoted considerable resources to launching and implementing a 'National Strategy for Financial Capability' across the whole population.[42] The strategy brings together the financial services industry, consumer and voluntary organisations, government and media to find ways to improve the UK's financial capability. As part of this strategy, the FSA gives clear,

impartial information to help consumers make informed financial decisions. This is done through helplines, a 'Moneymadeclear' website and a range of printed guides.[43]

With respect to Islamic finance, the FSA cannot and does not give guidance on Sharia principles, nor on whether particular products are Sharia compliant. The FSA does, however, provide explanation of products and the associated risks. The factsheet on HPPs issued in March 2007 is a good example, setting out the key messages for consumers, giving a step-by-step guide to each product and the associated risks and benefits.[44] We have also tried to ensure the factsheet gets to the right audience and some 5,000 copies have already been distributed. In this way, the FSA can provide a platform to raise public awareness but it will clearly rely on support from other institutions and organisations, private and official, which are involved in this sector.

7 Islamic finance in wholesale markets

In the last few years, the number of firms offering Sharia-compliant products and services has increased significantly. This has been particularly the case in London, as many international banks have situated their Islamic banking and advisory activities here. London's strength in financial engineering and product design has meant that many Islamic products and solutions are now structured in London and marketed in the Middle East as well as to Western markets. The wholesale Islamic finance activities offered by the 25 or so firms active in London, including the two wholly Islamic banks, range from traditional banking activities and project and trade financing to structured products, asset management and private banking. The number of firms involved is growing.

Market developments

The greatest growth has been in Sukuk markets. The volume of outstanding issues is estimated to be $70bn globally, a considerable portion of which is listed in Bahrain and Dubai.[45] London has, however, started to follow suit. It recently took a positive step towards becoming a global centre for Islamic finance and a centre of choice for listing Sukuk by establishing the world's first secondary market for Sukuk. According to the Financial Times, trade volumes in London 'rose from a trickle in December 2006 to about $2bn in January 2007'. The first Sukuk was listed on the London Stock Exchange in July 2006. A few more have been listed since then with the listing by 'Aldar Properties' the largest to date.[46]

The industry is also very supportive of the idea of the UK government issuing a sovereign Sukuk (see Section 8). Their hope is that a sovereign Sukuk will provide a benchmark for pricing, enhance liquidity in the markets and boost London's ability to attract further Sukuk structuring activity.

Sukuk structures

In the light of Sharia law's prohibition on interest payments, conventional bonds and debt instruments are forbidden in Islam. So Sukuk are structured to generate the same economic effects as conventional bonds, but in a Sharia-compliant manner. This is achieved through using assets and various contractual techniques acceptable under Sharia.

Initially, these instruments were viewed by the industry as 'asset-backed' debt instruments. Structuring Sukuk is in many aspects similar to securitisation, one common characteristic being that the payouts are based on the performance of the underlying assets. However, some practitioners think Sukuk are 'asset-based' rather than 'asset-backed'. In their view, there are two key differences between Sukuk structures and securitisation. First, for Sukuk there is no de-linkage of the assets from the originator (in other words, there is no 'true sale' of the assets by the originator to the Special Purpose Vehicle). Second, investors in Sukuk are exposed to issuer's risk rather than the assets' risk. The implication for the issuer is that cash flow segregation is only a book entry.

Regulatory treatment of Sukuk

The structures of Islamic products have created some challenges over their regulatory definitions in the UK and other centres around the world. Sukuk have been no exception to this. While similar in economic terms to conventional bonds, Sukuk may have significantly different underlying structures. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has identified at least 14 possible structures for Sukuk and more are being developed.[47] It is therefore evident that it may not be possible to find one overarching regulatory definition for all types of Sukuk. These instruments need to be examined on a case-by-case basis.

The issues are not straightforward. The FSA has conducted a review based on a 'Mudaraba Sukuk' and has identified two possible treatments of this instrument under FSMA. These are to treat it as an unregulated Collective Investment Scheme (CIS), and for the purpose of listing as a debt instrument.

The term 'Collective Investment Scheme' is defined in Section 235 of FSMA, and describes a wide range of arrangements that provide for the collective investment of investor contributions. The definition says the arrangements must be such that the participants do not have day-to-day control over the management of the property and the arrangements must have one or both of the following characteristics:

a) the contributions of the participants and the profits or income out of which the payments are to be made are pooled; and,

b) the property is managed as a whole by or on behalf of the operator of the scheme.

This type of Sukuk appears to have both of these characteristics. If regarded as a CIS then there are two main consequences. First, the promotion of such schemes, being unregulated, would be subject to certain restrictions under FSMA. This means the product may not be freely marketable but may only be promoted according to the exemptions under FSMA and in the FSA Handbook. A second consequence would be that a person operating a CIS in or from the United Kingdom will need to be authorised under FSMA. This should not be a relevant issue as the Sukuk vehicle is found outside the United Kingdom, although the exact analysis will depend on the circumstances.

A Sukuk will not, however, be categorised as a CIS under FSMA if the arrangements under which the rights of the participants are represented is a debt security within the definition set out in Article 77 of the Regulated Activities Order. The FSA's consideration of the characteristics of this Mudaraba Sukuk suggests there may be an

overlap between an instrument which is a CIS and an instrument which may fall within the broad categories of debt instruments as specified under the RAO.

At this stage, it seems this kind of Sukuk would fit better under FSMA as an unregulated CIS. But the possibility of treating it as a contractual debt obligation of some kind cannot be ruled out. The FSA's work on Mudaraba Sukuk and other types of Sukuk is continuing in consultation with industry practitioners.

Treatment of Sukuk for listing purposes

Any entity wishing to list an instrument, including Sukuk, on the London Stock Exchange is required to apply to the UK Listing Authority (UKLA), a division of the FSA. Listing procedures, prospectus and transparency regime and classification of instruments are based on the governing EU Directives and/or FSA listing rules. The classification of Sukuk as a CIS under FSMA does not conclusively determine how it should be classified for listing purposes. In this context, it has been and is possible for Sukuk to be classified as a debt security, subject to the information from the issuer being supplemented by including appropriate additional information as required. This appears to be better than, say, treating the Sukuk as an 'asset-backed' security since this would detract from the role of the originator as providing what could be said to amount to credit protection for the periodic dividend payments and repayment of principal. Nor would it seem appropriate for the Sukuk to be treated, for listing and prospectus purposes, as a collective investment undertaking as, for example, the purpose of the Sukuk may be to provide finance for a single project rather than an opportunity to participate in a range of investment situations. Treating the Sukuk as a debt security appears to provide the most appropriate fit with the Prospectus Regulation but, as said above, each structure will need to be considered separately.

8 Outlook

The foundations for the future development of Islamic finance in the UK have been firmly laid. Although the likely growth cannot be predicted accurately, there is scope for expansion, as set out below.

Retail markets

To date the industry has largely concentrated on providing mortgage and savings products for retail consumers, and growth has been modest. The tax and regulatory developments already outlined could benefit the market and there are signs of firms expanding their product ranges through providing new saving and investment products. Interest-free student overdrafts have recently emerged and there seems to be demand for new products targeted at the personal finance and the small and medium-size enterprise (SME) markets. Elsewhere in the retail market, some regional stockbrokers are providing services to consumers at all levels of the wealth spectrum and some financial advisers are offering tailored advice to the Muslim community.

Wholesale markets

The Sukuk market in London is now well established. The volume of Sukuk trading is still small but this could change if the government goes ahead with a sovereign issue (see below). There are also indications that a few inter-dealer brokers in London may be trying to develop closer links with Islamic firms in the Gulf, possibly by establishing regional offices there.[48]

Takaful

Takaful markets in other countries are considerably more mature than in the UK. These include the Gulf States and particularly Malaysia, which has been active in this area for several decades. The prospects for growth in the UK are unclear; but it is possible that as products are rolled out in these more established markets, there may be some transfer of activity to the UK. The growth of Takaful products in the UK could help to develop the Islamic mortgage market. As with conventional firms, Islamic finance firms would then be able to offer a combined package to prospective home buyers.

One of the biggest obstacles for Takaful providers is the limited amount of Sharia-compliant reinsurance capacity. Precise data is unavailable but, based on anecdotal evidence, Islamic reinsurance is able to provide only a fraction of the cover needed by the Takaful industry. As a result, Takaful providers sometimes have to obtain dispensation from their SSBs to take cover with conventional reinsurers. As already mentioned, the FSA is willing to consider further applications from firms in this sector on the same basis as conventional firms.

Complex products

Although derivative products are well established tools for managing risks in conventional financial markets, there has been considerable difficulty developing Sharia-compliant products which mirror these instruments. These products are controversial and have not been readily accepted by scholars because of their speculative nature. A small number of products have been developed by various banks, for example, Citi have products for managing currency and interest rate risk and other firms such as Deutsche Bank have developed a technique for Islamic derivative products. Indicative of the widening interest in this area, the International Swap and Derivatives Association (ISDA) and the International Islamic Finance Market (IIFM) have signed a Memorandum of Understanding (MoU) to develop a master agreement for Sharia-compliant derivative products. It is difficult to assess exactly what type of instruments may result but the FSA is following this closely.

Hedge funds

Several hedge fund managers have Sharia-compliant funds within their portfolios. In January 2007, Amiri Capital was authorised as a stand alone Islamic hedge fund manager and more applications may be in prospect. The growth will to a great extent depend on whether the investors approve the methods proposed by fund managers.

As with the UK managers of conventional hedge funds, managers of Islamic funds would also be regulated by the FSA. As now, the main regulatory focus would be on systems and controls, valuations, disclosure and conflicts of interest. So far as we know, there are currently no major regulatory issues with regard to Islamic hedge fund managers.

EU passporting

Under the relevant European Union directives, one avenue for financial institutions in the UK, including Islamic ones, to expand is to 'passport' their business activities into any one of the European Union member states (and vice versa). Concerted efforts have been made within the European Union to form a single market for financial services; and UK-authorised institutions may offer products throughout the European Union without the need to have separate authorisation in each member country. This means that Islamic institutions that 'passport' would have access to an estimated 15 million potential customers. The Bank of London and the Middle East is the first Islamic bank to have taken advantage of a cross-border services passport, which enables it to offer its products and services across all EU member states, without a physical presence in the host country.

Government initiatives

The government has recently taken important steps to promote the industry. In April 2007, the Treasury established an 'Islamic Finance Expert Group' representing a broad cross-section of opinion from the industry, the City, Muslim organisations and other bodies, including the FSA. The general objective is to advise the government on opportunities to help Islamic finance in the UK.

More specifically, as confirmed in the Chancellor's pre-Budget Report in October 2007, the group is overseeing an official study by the Treasury and the UK Debt Management Office on the possibility of the UK government issuing a sovereign Sukuk in the wholesale market. As to be expected, the study is examining the practical, legal and tax implications of doing so as well as structural issues such as the need for primary legislation. It has already generated a good deal of interest among market participants and the government will publish a consultative document later in 2007.

At the same time, the government has asked National Savings and Investments (NS&I) to begin a detailed study on the feasibility of offering Islamic retail products. This study will cover similar ground to the one on Sukuk, namely looking at the costs and benefits, the range and structure of products that might be offered, and the likely demand. NS&I will publish their report by Autumn 2008.

The longer term

Looking further ahead, there is scope to expand the market for Islamic products and services to non-Muslims as well as Muslims. The market is not confined to a particular group of consumers and Islamic finance providers can position their products to appeal more to the much larger non-Muslim population. Their success in doing so will in part depend on the ability to demonstrate how the products are underpinned by generally-accepted ethical principles. If Sharia-compliant products are no longer seen as 'exotic' or niche products, the industry could benefit from economies of scale which would help to sustain it over the longer-term.

9 Conclusion

The potential for the future growth of Islamic finance, in the retail and wholesale markets, is clear and both the government and the City are actively promoting this objective. London's emerging role as a hub for Islamic finance is underpinned by the factors outlined in this paper, in particular, a wide skills base, innovation and flexibility and historical links with the Middle East. These will remain strong. The government's tax and legislative framework has established a level playing field for a variety of Islamic products such as mortgages, bonds and insurance. This could lead to the availability of new retail products, the expansion of wealth and asset management services and the development of Sukuk and other wholesale markets.

The FSA has been, and is, willing to play its part in supporting these developments, within its regulatory powers under FSMA. Although we cannot promote Islamic finance (or any other particular kind of finance), we can give a clear regulatory framework which is flexible enough to adapt to changes in the market. We are keen to see the industry expand, although we recognise this will bring new regulatory challenges. If there is future growth in this market, it should benefit UK consumers and develop London further as an international financial centre.

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