

# Regulation of Islamic Finance in the UK and France

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## Islamic Finance Regulation Mechanisms in Post-crisis Period

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ISLAMIC FINANCE ADVISORY & ASSURANCE SERVICES

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# ISLAMIC FINANCE IN THE UK

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- Islamic products have existed for over 2 decades now
- 5 fully-fledged Islamic banks authorised and operating
- 1 Takaful company authorised
- 20+ conventional banks including major British brands offering Islamic products and services
- Several corporate deals in place
- Sukuk listed on London Stock Exchange
- Corporate Sukuk issuance in the pipeline
- Sovereign Sukuk on the horizon
- Islamic indices

# WHAT HELPED THE UK IN LEADING THE WAY?

- The strategic vision of the UK government supported by all key stakeholders (*the new government has expressed their commitment to pursue the existing policy on Islamic finance*)
- The official policies of attracting inward foreign investments and eliminating domestic financial exclusions
- FSA's policy of providing a "Level Playing Field" - (*no favour, no discrimination*) to all financial institutions
- The excess liquidity in the Gulf and London's attractiveness as financial market
- Most of the Muslim countries follow the 'Common Law' and the relevant professional expertise is available in the UK
- The timely and pragmatic tax reforms to accommodate the nature of Shariah-compliant products

# UK REGULATIONS AND ISLAMIC FINANCE - I

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- The existing regulatory and legal frameworks did not hinder establishing Islamic financial institutions or windows
- The major regulatory challenge was “Capital Guarantee” in deposit accounts
- The remaining challenges were related to taxation due to the different nature of Islamic products
- The taxation issues disadvantaged Islamic products and made them less competitive in the market
- The main issues were:
  - Tax treatment of profit generated by Islamic accounts
  - Double stamp duty on property transactions
  - VAT treatment of the profit charged by the banks

# UK REGULATIONS AND ISLAMIC FINANCE - II

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- Instead of going down the legislative route, the taxation issues were gradually resolved by way of annual amendments in the Financial Acts
- The main approach was to officially recognise that whilst Islamic financial products have significantly different structures and processes, they achieve similar financial objectives as their conventional counterparts
- The objective was to allow providers to offer Shariah compliant products without facing commercial disadvantage, and to enable customers to take up these products without encountering uncertainty or disadvantage over tax treatment

# TIMELINE OF ISLAMIC FINANCE TAXATION CHANGES IN THE UK

**2003**

Finance Act 2003:  
Relief from double Stamp Duty Land Tax “SDLT” on Home Finance Murabaha and Ijara Products

**2005**

Finance Act 2005:  
Alternative Finance Arrangements:

- Profit Share Return “Mudaraba”
- Alternative Finance Return “Murabaha”
- Extending “SDLT” exemption to include Musharakah home finance products

**2006**

- VAT treatment of Islamic Financial Products (Murabaha, Mudaraba, Musharakah, Wakala and Ijara)
- Finance Act 2006: Extend “SDLT” relief on property finance to all entities, including companies, clubs and LLPs.
- Taxation of Wakala based deposits

# TIMELINE OF ISLAMIC FINANCE TAXATION CHANGES IN THE UK

**2007**

- Finance Act 2007 introduced legislation which provided for Sukuk to be taxed similar to conventional bonds.
- Introduced further amendments to the SDLT relief

**2008**

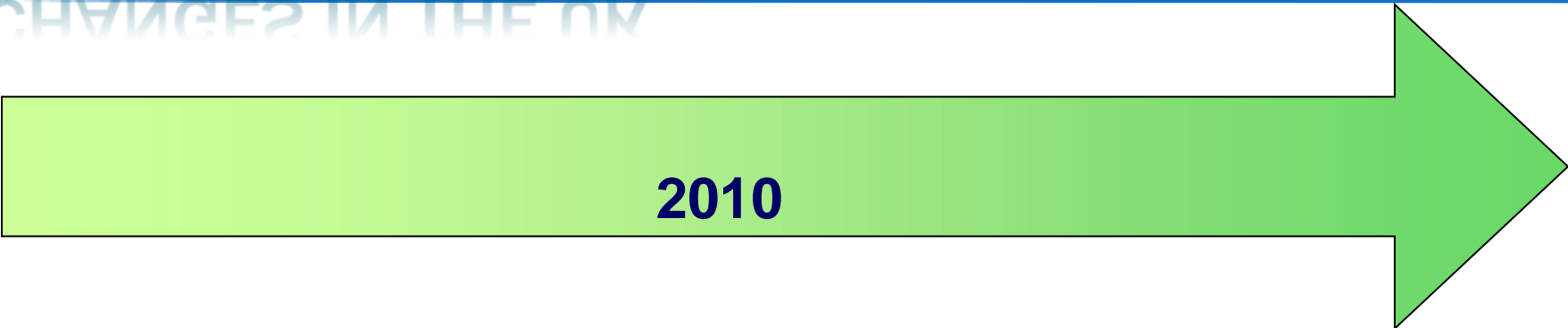
- The Finance Act 2008, added amendments for Stamp duty and stamp duty reserve tax for Sukuk
- Gave power to Treasury to raise funds using Sukuk
- Introduced anti-avoidance measures on alternative property finance transaction

**2009**

- The Finance Act 2009 introduced provisions to exempt land which is used for Sukuk purposes from “SDLT”.
- The Statutory Instrument No 2568 2009, extending the definition of financial institution under the alternative finance arrangement to include Insurance Company



# TIMELINE OF ISLAMIC FINANCE TAXATION CHANGES IN THE UK



**2010**

- The Statutory Instrument No 814 2010 amended the rules on anti avoidance to ensure that the SDLT relief available for Sukuk “alternative finance investment bonds” (AFIBs) operates as intended.

# REGULATORY REQUIREMENT OF CAPITAL GUARANTEE FOR DEPOSIT ACCOUNTS

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- The initial savings accounts in the UK were structured on the basis of Mudaraba (risk of capital loss) and represented a conflict between regulatory and Shariah requirements
- After long debates, a clause was added in the Terms & Conditions that in case of a loss (and after exhausting the “Profit Stabilisation Reserve”) the customer will have the choice to either accept the loss or to request the bank to make good their loss however this will not be compliant with Shariah
- This solution allowed Islamic Bank of Britain to launch the first ever Islamic savings account in the UK but it was seen as controversial by some scholars and consumer groups
- The issue is now resolved as the new savings accounts are based on Wakala (structured to provide “Capital Protection” instead of “Capital Guarantee”)

# ISLAMIC FINANCE IN FRANCE

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- Strong political will to embrace Islamic finance and shorten the strategic gap between UK and France
- Main focus on wholesale finance (target of raising €100 billion fresh capital)
- Strategy to position Paris as the leading hub for Islamic Finance
- No Islamic bank in France at present but some basic products are available and few limited transactions have taken place
- 2 applications for new Islamic banks in progress
- All major French banks heavily involved in Islamic banking but outside France
- 3 UK Islamic banks already “passport” into France
- First Corporate Sukuk for 1 billion Euro being structured
- More corporate Sukuk are on the horizon

# MAJOR CHALLENGES IN FRANCE

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- Absence of the equivalent of the “English Trust” - an obstacle in the issuance of Sukuk
- Capital Guarantee for deposit accounts
- Regulatory requirement of having a European bank as “Sponsor” (with minimum 20% shareholding) for incorporating a new Islamic bank in France (banks authorised in the EU are exempt of this restriction and remain subject to simplified “Passporting” formalities)
- Taxation issues:
  - Double stamp duty
  - Tax treatment of profit
  - VAT treatment of Islamic transactions

# SOLUTIONS IMPLEMENTED IN FRANCE - I

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- The “Fiducie” may serve as the equivalent of the “English Trust” for the issuance of Sukuk and structuring real estate transactions
- The authorities are working to resolve the issue of Capital Guarantee (the UK solution is not acceptable for the French). They are quite likely to accept the “Capital Protection” mechanism offered by Wakala contracts as the solution
- Some tax reforms were introduced in 2009 to abolish Double Stamp Duty in Murabaha transactions and provide level taxation framework to Sukukholders
- Further tax reforms are currently being prepared to provide a specific tax regime for Murabaha, Ijara, Istisna, Wakala, Musharaka and Salam based structures

# SOLUTIONS IMPLEMENTED IN FRANCE - II

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- The objective is to provide the same level of taxation to Islamic products as their conventional equivalents
- The Sukuk in the new reforms will be recognised as “Alternative Financial Instruments” giving them the same tax regime as conventional bonds. This will provide the investors/Sukukholders the same tax advantages as the conventional bondholders
- These reforms are expected to be introduced in autumn 2010
- These tax reforms are being gradually introduced by way of amendments in the tax regulations
- No legislative changes are anticipated or required
- There is no restriction on the existing banks in France to offer Islamic products or open Islamic windows

# FIDUCIE – THE FRENCH EQUIVALENT OF THE “ENGLISH TRUST”

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- The French Civil Code does not recognise the separation between “legal ownership” and “beneficial ownership” hence the underlying assets in a Sukuk structure cannot be “externalised”
- The concept of “Fiducie” (special vehicle close to English trust in its form) was introduced a few years ago. The major difference in Fiducie and English Trust is that the ownership (legal and beneficial) is transferred to the “Fiduciary” (Trustee)
- A bill pertaining to Fiducie was adopted by the French Parliament in 2009 but later rejected by the French Constitutional Council who instructed to represent the bill for approval through the proper channel (the rejection was based on the form of the presentation of the new law – the substance is fully acceptable from the constitutional point of view)

# FIDUCIE AND SHARIAH COMPLIANCE

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- The Fiducie was accepted by the Shariah scholars as a solution for transferring the underlying assets in a Sukuk structure subject to the following conditions mentioned clearly in the contractual agreement:
  - The Fiduciary will hold the assets in his name “For” and “On behalf of” the beneficiaries of the Fiducie
  - The Fiduciary will have the “Right” and “Duty” to dispose off the assets if required and pay the beneficiaries of the Fiducie (in case of a default by the originators/issuers of the Sukuk)
- The Fiduciary may also be replaced if required
- Being a relatively new concept in France, Fiducie is still being actively debated particularly by those who see it as a potential loophole for tax evasion



# OTHER CHALLENGES FOR ALL NEW MARKETS

- The understanding of Shariah principles by the regulators, the professionals and the consumers
- Arbitration of Shariah (lack of standardisation)
- Major dilemma - Islamic window or fully-fledged Islamic institutions?
- Shariah governance and the regulators' view
- Human resources (no expertise readily available)
- Where do we get the right help from?

# ISLAMIC WINDOW OR FULLY-FLEDGED BANK?

- Having fully-fledged Islamic financial institutions is ideal, however;
  - Capital issues (seed capital requirements)
  - Regulatory restrictions (sponsoring)
  - Capacity challenges (system, management and operational)
  - Hefty setup and ongoing costs
  - Supervision and monitoring
- Islamic window is not the ideal solution however;
  - Quicker route to market
  - Minimum budget required
  - Less capacity challenges
  - Bigger Shariah-compliance onus (segregation of funds)
  - Possibility of conversion into fully-fledged Islamic institution or setting up a subsidiary later on

# SHARIAH COMPLIANCE AND THE REGULATORS

- Which interpretation of Shariah is applicable?
- AAOIFI Shariah standards enforceable or not?
- What happens in case of a conflict between Shariah view and the legal view?
- Supervision of Shariah compliance – part of regulator's responsibility or not?
- The lender of last resort and on what basis will they intervene?
- National Shariah Board or institutional Shariah Boards?
- National capacity in Shariah compliance
- Shariah, Shari'a, Sharia'h, Syariah, Shar'ia or Charia?

# SHARIAH BOARD AND THE REGULATORS

- The role and responsibility of Shariah Board
- The remit of Shariah Board
  - Influence in credit decisions?
  - Influence on management?
  - Day-to-day running of the business?
- The scholars
  - Where are they from? (local or from abroad)
  - Their background and qualifications
  - Are they “fit and proper”?
  - Conflicts of interest
  - Language barriers
  - Understanding of local market and legal system

# CONCLUSION

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- Islamic Finance is a very exciting opportunity but it requires a pragmatic approach
- The first and most important requisite is to develop a good awareness of Shariah requirements among the key stakeholders (many of the issues are generated by simple lack of understanding of Shariah requirements)
- Human capital development and capacity building remain critical in the establishment and growth of this industry
- Advice and training in Shariah from experienced professionals make the challenges much easier
- The changes required may be implemented in a much simpler and practical way than usually perceived

**THANK YOU**

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