# Veröffentlichungen

# Islamic Finance and the UK



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## 1. Scope of this note

This note sets out to describe some of the ways in which the United Kingdom government has tried to make London a more attractive financial centre for Islamic money. There are increasingly large financial balances held by Muslims. Many of these people wish to invest in Sharia compliant investments but often there is a lack of investment opportunities. At the same time there are many Muslims in the UK and some of these wish to make use of Sharia compliant finance such as Islamic mortgages and insurance.

Where there is demand capitalism will normally provide a product. However tax and regulation can inhibit this market response. In various Finance Acts the UK government has tried render the tax and the regulatory systems neutral as between conventional finance and certain alternative forms of finance the most significant of which is Sharia compliant finance.

This note will give a general overview some of the main requirements of the Sharia as regards finance. It will then describe some of the forms of Sharia compliant finance comparing them with their conventional finance equivalents. It will then outline the main changes to UK tax law which were implemented in the 2005 Finance Act (and subsequent Finance Acts) in order to create a level playing field for conventional and alternative finance. It will then consider some regulatory issues.

## 2. Development of Islamic Finance in the UK

Islamic finance has developed considerably in the UK in recent years. The market splits into the following main areas of activity.

Islamic finance has been well-established as part of the project and asset finance industry for many years, driven by high investment in infrastructure in the Middle East.

The UK retail market took off with the abolition of the double Stamp Duty Land Tax charge on Sharia-compliant mortgages in 2003 (as to which see later in this note). Since then, the market for such mortgages has grown from almost nothing to a projected value of US$1.4 billion in 2008. The Islamic Bank of Britain, the first stand-alone Sharia-compliant retail bank in the UK, was granted its licence in September 2004. Many mainstream banks in the UK now offer Sharia- compliant products to the UK's estimated 2 million Muslim consumers.

Sukuk are used for fund-raising on the capital markets. The London Stock Exchange listed its first sukuk in June 2006 and LSE-listed sukuk have now increased in value to approximately US11 billion. At the World Islamic Economic Forum in London in 2013 it was announced that the UK would issue a sovereign sukuk.

There is even a nascent market in Sharia-compliant derivatives.

# 3. Overview of Islamic Finance

## General

There are four important requirements imposed by Islam which affect finance. They are the prohibitions of Riba, Maysir and Gharar and the requirement that investments be ethical. For the purposes of this note the prohibition of Riba is the most important.

## Riba

*"Those who charge usury are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However, God permits commerce, and prohibits usury. Thus, whoever heeds this commandment from his Lord, and refrains from usury, he may keep his past earnings, and his judgment rests with God. As for those who persist in usury, they incur Hell, wherein they abide forever."* (Quran 2.234)

Riba, which is often translated as usury, or interest, comes from the Arabic root meaning *"to* *increase"* or *"to gain"*, and is specifically prohibited in the Quran. In Islamic terminology Riba means effortless gain or the profit which is received without giving anything in exchange. The consensus among Islamic authorities is that all forms of interest are Riba. However, the word has a wider meaning than interest. It also applies to non monetary exchanges such as exchanging one commodity for a larger quantity of the same commodity. Both receiving and paying Riba are prohibited.

It is worth noting that interest was prohibited by medieval canon law (with an absolute ban imposed by Pope Clement V in 1311) and only started to become a matter for private conscience in the early sixteenth century.

## Maysir

Maysir means a game of chance or gambling.

## Gharar

Gharar has the literal meanings of uncertainty, hazard or risk. It includes the sale of a thing which is not present, or at hand, or the sale of a thing the consequences of which are not known, or a sale involving risk or hazard in which one does not know the final outcome. An example would be the sale of an asset one does not possess and may never come to possess.

## Ethical investments

Islamic finance must not be connected with anything which is forbidden such as alcohol or pork. This would prohibit, say, an investment in a pub company, or even a hotel where the sale of alcoholic drinks made an appreciable contribution to turnover.

These requirements mean that Islamic business transactions often need to be structured differently from conventional business transactions if they are to comply with the requirements of the Sharia. Some examples of some of these alternative structures are set out below.

## Commodity Murabaha (commodity lending)

There is a type of arrangement known as a Commodity Murabaha" which is appropriate where a borrower is seeking to arrange cash for general purposes. It will be necessary to buy something that can be sold easily afterwards and with little difference between the bid/offer prices. A typical example would be a quantity of copper bought in a commodity market.

The Islamic bank or finance house will buy the copper, immediately paying, say, £100 for it, and transfer ownership to the customer at a price of £110 payable in, say, one year's time. The customer can then immediately sell the copper for a price of about £100. He will have the obligation to pay the bank the deferred purchase price in, say, one year's time.

The economic effect of this transaction is similar to an unsecured loan for a year with a rate of interest at 10% per annum.

## Property Murabaha (mortgage lending)

The Islamic bank or finance house buys the property and immediately sells it on to the person seeking the finance for the original price plus an agreed profit margin. The person seeking the finance pays the higher price on a deferred payment basis in line with a fixed repayment schedule and to secure repayments. The bank or finance house takes a first charge over the property.

The economic effect of this transaction is similar to a mortgage with periodical payments of principal and interest.

## Diminishing Musharaka (mortgage lending)

An alternative to a conventional mortgage is to provide for the ownership of the asset to pass in stages. On day one the Islamic bank or finance house buys 99% of the building while the person seeking finance buys 1%. Under the arrangements the eventual owner is granted an immediate right of exclusive possession under a lease. The eventual owner acquires the bank's 99% share over time in instalments and at cost. Thus the payments over the period of the transactions will be a varying mixture of payments for the transfer of tranches of ownership and payments of rent.

The economic effect of this transaction is similar to a mortgage with periodical payments of principal and interest.

## Mudaraba (deposit arrangements)

A typical arrangement would involve the Islamic bank opening a deposit account that instead of paying interest pays a return based on the profit generated from the use of its customer's deposits in a deposit account. The customer deposits are to be invested in "green" companies and there are penalties for withdrawing the deposits within the first year.

The bank would aim to pay a return equivalent to an interest rate of, say, 4% per annum payable twice yearly. The bank uses the percentage figure in its publicity but makes it clear that the return will be based on the profits generated.

In the first year the profit share return generated by the bank, managing the investment in green companies, might be equivalent to an interest rate of, say, 7% from which the bank is able to pay the expected return to its customers (i.e. the equivalent of an interest rate of 4%).

The bank might not be as successful in managing the investments in the second year and might only be able to generate a return equivalent to interest at, say, 3%. Nevertheless because of the relatively high return in the previous year the bank would still be able to pay its customers a return equivalent to 4% interest for the second year.

The economic effect of this arrangement is similar to an ordinary deposit account at a bank with a rate of interest.

## Wakala (profit share agency arrangements)

These arrangements are similar to the Mudaraba deposits referred to above. The main difference is that the Islamic bank or financial institution acts as the depositor's agent in undertaking the activities which generate profit. The bank's remuneration is the fee received for undertaking the agency transactions.

This distinction between Mudaraba and Wakala is important in the event of the Islamic bank's insolvency. In a Mudaraba contract if a bank has taken what is legally a deposit and then becomes insolvent the investor is limited to claiming in the bank's insolvency along with its other creditors. In a Wakala contract, if the agent bank becomes insolvent the investor has a direct legal claim on the underlying asset.

The economic effect of this arrangement is similar to a fixed term deposit arrangement with a rate of interest.

## Sukuk (Islamic bonds)

A bond is an interest bearing debt instrument issued by a corporation or a government entity and which would normally be traded on a stock exchange. It is a contradiction in terms to refer to an Islamic bond because of the prohibition of Riba, nevertheless this term is frequently heard. These instruments are properly called Sukuk. The most common form of sukuk is an instrument entitling the holder to the profit arising from an asset belonging to the government or the corporation.

Thus a Sukuk is close to a Wakala (profit share agency arrangement). The main difference is that the Sukuk will normally be issued as a security and traded on a stock exchange.

## Takaful (Islamic insurance)

Takaful companies are often known as Islamic insurers. They 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 (Maysir), interest (Riba) and an ethical investment strategy. Investment strategy will differ from that of a conventional insurer because a conventional insurer will invest much of its premium stream in fixed interest securities so as to secure a high income and liquidity. This is a problem for a takaful operator due to the prohibition of Riba. To deal with these concerns Takaful products have three distinctive features: 1. 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; 2. an element of profit sharing; 3. and limitations on acceptable investments.

## 4. Tax Treatment

There are a number of consequences of achieving financial objectives by unconventional forms. One of these is that often the tax consequences of such transactions are different from what they would have been had they been carried out conventionally. This can have the effect of penalising banks and providers of finance who seek to provide alternative finance including Sharia compliant finance. It can also penalise the customers of those banks and financial institutions.

The UK government has attempted to address this issue by altering tax law to provide for equivalent tax treatment for alternative finance. This was first done in the 2003 Finance Act following which there were major changes in the 2005 Finance Act followed by regular changes in subsequent Finance Acts. The changes were not just for the benefit of those providing Islamic finance but were expressed to cover certain types of alternative finance whether it was Islamic or not. The UK government does not concern itself with whether there has been Sharia compliance. It is solely concerned with the legal form of the transaction so that non Islamic finance can benefit from the tax legislation so long as it complies with the requirements of the taxing statute.

An example of the disadvantages of alternative finance before the tax changes was the SDLT treatment of both the Property Murabaha and Diminishing Musharaka forms of mortgage lending. SDLT (Stamp Duty Land Tax) was payable when the house was transferred to the bank. It was then payable again when the house was transferred into the name of the bank's customer. SDLT is payable according to a sliding scale but the top rate for an expensive house is now 7% (where the property is held by an individual) or 15% (where the property is held by a company) so the tax penalty for those using an Islamic mortgage to buy a house in the UK would be considerable were it not for the UK government's tax reforms. In the case of a conventional mortgage the only transfer of the property is the transfer to the buyer. There is no SDLT on the mortgage itself. The 2003 Finance Act removed this disadvantage so that conventional mortgages and Islamic mortgages pay the same SDLT.

Another example of the disadvantages of alternative finance before the tax changes is the treatment of the Commodity Murabaha (commodity lending). If the borrower is borrowing for business the interest is normally deductible for the purposes of computing his profits. In the case of finance obtained through a Commodity Murabaha the tax treatment is different since there is no interest – only a trading transaction. This disadvantage has now been removed so that the tax treatment of Commodity Murabaha is the same as that of an ordinary loan.

Finally, Mudaraba (deposit arrangements),Wakala (profit share agency arrangements) and Sukuk (Islamic bonds) all give rise to profit not interest. Clearly this means that the tax treatment of the payer and the receiver is different from what it would be if they had invested in conventional deposits and bonds. This could have been a considerable disadvantage to Islamic finance. This disadvantage has been removed.

As indicated earlier in this note UK Government policy was to alter the law to allow alternative forms of finance to be treated for tax purposes in the same way as the conventional forms which they replace.

For the purpose of the legislation the alternative tax forms can be put into the following three broad categories:

- arrangements involving the sale of assets, comprising purchase and resale arrangements and diminishing shared ownership arrangements;
- arrangements replicating a conventional deposit, comprising deposit arrangements and profit share agency arrangements; and
- alternative finance investment bonds.

Section 47 and 47A Finance Act 2005 applies to the first type of arrangements. The alternative finance return is assimilated to interest and the transaction is treated as if it were a loan for tax purposes.

The Finance Act 2005 provisions also deal with arrangements giving rise to a "profit share return". This is akin to an interest return save that the return is dependent on profit. Section 49 deals with deposit arrangements while Section 49A deals with profit share agency. The tax treatment is similar to that which applies in relation to Section 47 arrangements. Profit share return is assimilated to interest in a manner similar to alternative finance return.

The Finance Act 2005 provisions also deal with alternative investment bonds. The profit element is assimilated to interest.

# 5. Regulatory Aspects

## General

The UK government has adopted the same approach to regulation of alternative finance as to taxation of alternative finance. In the UK, Islamic banks are licensed as banks, and Takaful operators are licensed as insurance companies. There is no special regulatory regime for Islamic banks or for Takaful companies. The regulation is not concerned with compliance with the Sharia but with economic substance and legal form.

It goes without saying that if Islamic finance falsely represents itself as being compliant with the Sharia investors and others who rely on the representation may be able to sue those guilty of the misrepresentation and the FCA (Financial Conduct Authority) may conclude that those guilty of the misrepresentation are not fit and proper persons to carry on a financial services business.

## Regulation of Islamic financial institutions (Sharia scholars)

To operate as a financial institution in the UK it is necessary to be authorised by the FCA under the Financial Conduct and Markets Act 2000. The approach taken is that all those seeking regulation are subject to the same standards.

A problem which has arisen is the role of the Sharia scholars. An Islamic financial institution will have a Sharia board composed of scholars whose job is to assess whether new financial products offered by the institution are Sharia compliant. In addition to this the Sharia board will also assess continuing compliance.

When considering authorisation the FSA needs to know from a financial and operational perspective exactly what is the role of the Sharia scholars in each authorised firm. The FSA has to be clear whether the Sharia scholars have an executive role or an advisory one. This is because any person acting as a director of an authorised firm must be registered under the FSA Approved Persons rules. A further point is that if the Sharia scholars are directors, they are more likely to be executive directors than non executive directors. In such cases in would be difficult to justify multiple memberships of the Sharia boards of different firms because of significant conflicts of interests. This would put pressure on a young industry where there is a shortage of qualified Sharia scholars.

## Regulation of Islamic Deposits

The UK government takes the view that all customers depositing money with a UK bank should be entitled to repayment in full unless the bank becomes insolvent. As a result of this UK Islamic banks are not entitled to offer profit and loss sharing investment accounts. The nearest approximation they can offer is an account where the customer’s moneys are invested into a pool from which investment returns are paid. However, if losses arise in the pool, the bank is obliged (unless it is insolvent) to provide funds out of its own resources to ensure that customers are repaid in full. Where there is a deficit in the fund at the time stipulated for repayment customers are given the right to elect at that time to take less than full repayment and are also advised that if they elect to receive full repayment they will not be acting in accordance with the Sharia.

This represents a compromise but enables the authorities to insist on equivalence of protection for depositors in Islamic and conventional banks while allowing Muslims to offer deposit accounts which are arguably compliant with the Sharia.

### Regulation of Sukuk

Under the Financial Services and Markets Act certain types of risky investment structures are characterised as “Collective Investment Schemes” and these are subject to additional regulation and onerous controls. A bond is a debt instrument which pays interest. Although Sukuk are commonly referred to as Islamic “bonds” they are in fact no such thing as they give rise to profits. Lawyers have for some time considered that many forms of Sukuk may fall within the definition of Collective Investment Schemes.

The Financial Services and Markets Act 2000 (Regulated Activities (Amendment) Order 2010 has amended the Financial Services and Markets Act 2000 to include alternative finance investment bonds as a specified investment on the same basis as instruments creating or acknowledging indebtedness. It is noteworthy that the legislation favours alternative finance investment bonds rather than Sharia compliant bonds. The alternative finance investment bonds are excluded from the definition of Collective Investment Schemes and form a separate category of investment for the purposes of the Financial Services and Markets Act.

### Regulation of home mortgages

Mortgages of residential property are regulated by the FSA in the UK. The scheme of regulation is highly prescriptive. Lenders need to be approved by the FSA. Their mortgage documentation has to comply with complex rules and requirements which lay down not only what has to be covered but the manner in which it is expressed.

Property Murabaha mortgages and conventional mortgages have been regulated by the FSA since October 2004.

Diminishing Musharaka mortgages are more commonly used in the UK than Property Murabaha mortgages. In 2007 they were brought within the scope of regulation having previously been unregulated. They are known as Home Purchase Plans (HPPs). Previously customers for HPPs did not enjoy the same levels of protection as customers for conventional mortgages. This meant HPP customers were potentially vulnerable to miss-selling and unfair treatment, with no means of redress.

## 6. Attitude of Courts to Islamic Finance

It was held in Beximco Pharmaceuticals v Shamil Bank of Bahrain 2002 the governing law clause provided that:

> *"subject to the principles of Glorious Sharia'a, this agreement shall be governed by and construed in accordance with the laws of England."*

It was held that:

- A contract can only have one governing law.
- Parties to a contract can only agree to adopt the law of a country as the governing law of a contract.

It is not open to the parties to adopt a non-national system of law (such as Sharia) as a governing law of a contract. However this does not preclude the parties from incorporating by reference into their contract, a non-state body of law or international convention.

The contractual capacity of a corporation is governed both by the law governing the constitution of the company and the law governing the transaction in question. A corporation does not have capacity to enter into transactions unless authorised to do so by its constitutional documents. An ultra vires act is invalid.

The case of *The Investment Dar Company v Blom Developments Bank* reveals that the validity and effectiveness of Islamic financing contracts my be called into question on the ground that one or more parties lack the capacity to enter into the transaction where those parties are required to act in accordance with Sharia and where there is a lack of precision in drafting relevant provisions.

These questions involve the same issues.  English law only recognises national systems of law. Thus the proper law of a contract can be the law of Malaysia or England. It cannot be Shariah. However, within limits, English law has always allowed people to set their own rules. Thus you can settle the terms of your partnership agreement and the law will accept this as a contractually enforceable agreement. Thus, parties which wish to comply with specific requirements of the Shariah may do so long as these requirements are adequately defined and so long as they do not contradict any mandatory requirements of English law.

This is illustrated by a case with which Laytons is currently dealing. A rich individual made inter vivos dispositions of his estate. He died and one part of his family questions these dispositions on the ground that they exclude succession in accordance with the Shariah. However they have to argue that the dispositions should be treated as testamentary dispositions under the law of Kuwait. Thus the English court will seek evidence of Kuwait law not the Shariah. On the other hand if you sell a financial instrument on the ground that it is Shariah compliant and it is not you will have sold it under false pretences. The problem here is that might be deemed Shariah compliant in KL might not be deemed Shariah compliant in the Gulf.

In 2013 the UK courts considered the application of SDLT anti-avoidance measures in a large transaction involving Sharia compliant finance. In 2007 Project Blue Ltd, a Guernsey company agreed to purchase the freehold of a large army barracks in London from the Ministry of Defence. In January 2008 the company entered into a sale and leaseback agreement with a Qatari bank. The Ministry of Defence conveyed the freehold to the company, the company conveyed the freehold to the bank, and the bank leased the property to the company for the finance period On the following day the company granted a 999 year lease to an associated company.

Because of the application of the anti-avoidance rules the court held that value for purposes of calculating SDLT was the lease back. The deemed consideration was held to be the £1.25 billion payable in respect of the sale and lease back (which included the finance charges) rather than the £970 million actually paid to the Ministry of Defence. The company has appealed and until the appeal is heard there will be uncertainty as to the application of SDLT to certain types of Sharia compliant finance.

## 7. European Union Jurisdictions

Under the relevant European Union directives, one way UK financial institutions including Islamic ones may expand is to "passport" their business activities into any one of the European Union member states. UK authorised institutions may offer products throughout the European Union without the need for separate authorisation in each member country. The Bank of London and the Middle East was the first Islamic bank to have done this thereby becoming entitled to offer products and services across all EU member states, without a physical presence in the host country.

## 8. Contact

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