The development of Islamic finance in the UK:
the Government's perspective

December 2008

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Foreword

The purpose of this paper is to raise awareness about the growing role of Islamic finance in the UK and highlight remaining barriers to development. The Government's objectives for Islamic finance are clear. First, we value the contribution it makes to London's position as an international financial centre and the benefits that this confers to all UK taxpayers. Second, we value the role it plays in expanding consumer choice and ensuring that nobody in the UK is denied access to competitively priced financial services due to their religious beliefs.

Islamic finance has developed rapidly in the UK over the past five years. We currently host the only standalone Islamic financial institutions in EU and have the highest value of Shariah compliant assets of any non-Muslim country. In some ways, this development was inevitable. The UK has a strong and proud tradition of openness and flexibility which, combined with London's position as a leading international financial centre and a significant Muslim population, provides a strong foundation for growth.

However, as this document illustrates, these general advantages have been supported by concerted and consistent collaboration between the Islamic financial services industry, community groups and UK Authorities to foster the growth of Islamic finance through the years. The Bank of England first identified the sector's potential in the UK in 2000 and, since then, the Financial Services Authority and the Treasury have introduced a steady flow of legislative changes to minimise any legislative barriers preventing the development of Islamic finance in the UK. UK Trade and Investment has also played a role championing the UK's success.

Our analysis of the remaining barriers to development was informed by a wide range of industry experts and I am grateful for their insights and advice. Many of the issues identified are common to all nascent industries and these will most likely fall away as the industry continues to develop. In other areas, like continuing to review legal impediments or providing unbiased, authoritative analysis, the Authorities have a clear role to play.

Looking to the future, the Government's approach to Islamic finance will continue to be characterised by three principles. First, we will be fair. We will not champion Islamic finance over conventional finance, but will instead strive to create a level playing field between Islamic and conventional finance. Second, we will be collaborative. Progress can be delivered most effectively when it involves industry, community groups and the Authorities working together to achieve shared objectives. Finally, we will be committed. Where there is a clear role for Government to play, we will continue to do so.

Since July 2007, the global economy has experienced levels of financial instability not seen for generations, and this has had a profound impact on all parts of the financial services sector. However, during this time, it is critical that we neither lose sight of our long-term objectives for the sector in general, nor our objectives for Islamic finance. Therefore, led by industry and guided by our principles, the Government will continue to support the development of Islamic finance in the UK, to the benefit of UK consumers and taxpayers alike.

Ian Pearson, Economic Secretary to the Treasury

Executive summary

The purpose of this paper is two-fold: first, to raise awareness about Islamic finance and its recent development in the UK. Second, to highlight the unique challenges faced by the sector, identifying areas where good progress has been made and providing the Government's perspective on where further barriers to development lie.

Islamic finance describes the subsection of the financial services industry that complies with the principles of Shariah (Islamic law). Though it has obvious appeal to some Muslims, Islamic finance is available to all consumers and investors.

The Government's policy objectives for Islamic finance are clear. First, to establish and maintain London as Europe's gateway to international Islamic finance. Second, to ensure that nobody in the UK is denied access to competitively prices financial products on account of their faith. The Government's approach to achieving these objectives is characterised by the principles of fairness, collaboration and commitment.

Significant progress towards meeting these objectives has been made. The UK is now the leading centre for Islamic finance outside of the Gulf Cooperative Council and Malaysia. London and Birmingham now host the only standalone Islamic financial institutions in the EU. UK consumers can now access a wide range of Shariah compliant retail financial products and services, which are regulated to the same standard as conventional financial products, conferring the same degree of consumer protection.

The role of the Government in achieving this progress has been important, particularly through the removal of tax and regulatory barriers. The Treasury and the Financial Services Authority will continue to work towards creating a level tax and regulatory playing field between conventional and Islamic finance. Furthermore, the Government will continue to keep the feasibility of issuing sovereign wholesale and retail Islamic finance products under review.

However, it is clear that much of the future work in developing the sector and removing barriers to growth in areas such as standardisation, awareness and skills, must be for industry to take forward, with Government providing support and encouragement where appropriate. Particular areas where the Government has identified opportunities for further progress include:

- through collaboration between industry and international standard setting bodies, creating a set of robust and accessible term-sheets for the main Islamic products;
- through collaboration among industry and community groups, raising awareness of, and knowledge about, Islamic finance at the grass roots level; and
- through collaboration between industry and trade bodies, highlighting the UK's strength as a provider of education, training and skills in Islamic finance.

Many of the remaining barriers will be addressed as the sector grows and develops. However, where there is a need for further intervention, the Government stands ready to help.

1 Context

1.1 Islamic finance describes financial transactions which are in accordance with the principles of Islamic law, known as Shariah. Shariah is derived from the Quran (considered by Muslims to be the revealed word of God) and the Sunnah (the sayings and practices of the Prophet Muhammad). Although frequently referred to as Islamic law, Shariah is perhaps best characterised as moral guidance or a set of principles governing all aspects of the day-to-day activities of Muslims.

1.2 The most important principles on which the modern Islamic financial framework rests are:

- prohibition of the payment or receipt of interest: money itself is considered to have no intrinsic value – it is merely a store of wealth and medium of exchange;
- prohibition of uncertainty or speculation: everybody participating in a financial transaction must be adequately informed and not cheated or misled;
- prohibition of financing certain economic sectors: investment is forbidden in what are considered to be socially detrimental activities. These include gambling, pornography, alcohol and armaments;
- importance of profit and loss sharing: the investor and investee must share the risk of all financial transactions; and
- asset-backing principle: financial transactions should be underpinned by an identifiable and tangible underlying asset.

1.3 It is the role of Shariah scholars to determine whether a financial product or service is compliant with the Shariah principles. The interpretation of Shariah is known as Fiqh, or Islamic jurisprudence, and is carried out by Islamic scholars. While there are many areas of consensus, scholars sometimes differ in their opinions depending on their method of reasoning. On a practical level, this means that for Islamic finance, certain contractual terms considered to be permissible under Shariah by some scholars, may be deemed unacceptable to others. Some commonly accepted Islamic finance contracts are explained in Annex A.

Who is Islamic finance for?

1.4 Islamic finance is available to everybody. Although the main market for retail and wholesale Islamic financial services in the UK is the domestic and international Muslim community, it provides an alternative financing option to all consumers and investors. In order to succeed, Islamic finance needs to compete with conventional finance and everyone is attracted to competitively priced financial products and services.

1.5 Indeed, there are particular aspects of both retail and wholesale Islamic finance that could extend its appeal beyond the Muslim market. For example, in the retail market, it is often suggested that Islamic finance products may be particularly attractive to those interested in ethical finance, due to certain shared characteristics, such as the ban on investing in certain economic sectors including gambling, pornography, alcohol and armaments. And in the wholesale market, non-Muslim businesses may be attracted to Islamic finance to increase their sources of funding or liquidity, for example from the Gulf region and South East Asia, or to diversify their investments.

The history of modern Islamic finance

1.6 It is generally agreed that modern Islamic finance started in Egypt in 1963 with the Mit Ghamr savings project, a social banking initiative. This was followed in 1975 by the establishment of both the Islamic Development Bank and the Dubai Islamic Bank, the world's first commercial Islamic bank. The industry expanded steadily through the 1980s and in the early 1990s the demand for Shariah compliant investments and loans began to grow more rapidly.

1.7 In recent years, Islamic finance has expanded sharply. Estimates by The Banker show that in the last two years the annual growth rate of Shariah compliant assets has approached 30%[1], prompting some assertions that it is the world's fastest growing financial sector.[2] And this growth has not just been focussed on the Middle East region; in the same report The Banker looks at a total of 614 registered Islamic finance institutions spanning 47 countries.[3] Although it is difficult to find accurate data on the size of the industry, it has been estimated that the amount of assets under Islamic management has grown from US$150 billion in the mid-1990's to around US$700 billion in 2007.[4]

Future prospects for Islamic finance

1.8 The ratings agency Standard & Poor's has forecast that the industry could potentially control up to $4 trillion of assets. This contrasts with US$190 trillion in global assets that are currently under management. Others have suggested that the growth in the sector could be far higher, as Muslims account for 20 per cent of the global population yet currently only hold approximately 1 per cent of global financial assets.[5] Whatever the case, it is likely that Islamic finance will become an increasingly important component of the international financial system.

Islamic finance in the UK

1.9 Islamic retail products first appeared in the UK in the 1990s and in the last five years there has been significant growth in both the wholesale and the retail sectors. With over $18 billion in Shariah compliant assets, the UK comes eighth in The Banker's league table of Islamic assets worldwide, the highest of all Western countries[6] (see table 1.A).

1.10 The UK Islamic finance sector is not confined to London; recent years have seen the development of regional hubs in both Birmingham and Edinburgh for example. According to a report produced by International Financial Services London (IFSL)[7], at the beginning of 2008 the UK hosted:

- five stand-alone Islamic retail and wholesale banks, over twenty conventional banks with Islamic windows, and one stand-alone Shariah compliant insurance provider;
- at least nine fund managers providing opportunities for investment in Shariah compliant funds and one Shariah compliant hedge fund manager;
- a number of advisory firms (law, accountancy, consultancy, etc) with considerable experience and expertise in dealing with Islamic finance;

[1] The Banker (November 2008), *Top 500 Islamic financial institutions*, 2008
[2] Ali, Rahail ed. (2008) *Islamic Finance: a practical guide,* Global Law and Business, 2008
[3] The Banker (November 2008), *Top 500 Islamic financial institutions*, 2008
[4] Economist (2008) *Savings and souls,* The Economist Magazine, 2008
[5] Economist (2008) *Savings and souls,* The Economist Magazine, 2008
[6] The Banker (November 2008), *Top 500 Islamic financial institutions*, 2008
[7] International Financial Services, London (2008) *Islamic Finance 2008*, IFSL 2008

- the exchange upon which almost half of all global sukuk (Shariah compliant investment certificates) by value are listed; and
- a succession of partnerships offering qualifications in Islamic finance.

Table 1.A: Top countries by value of Shariah compliant assets

Rank	Country	Shariah compliant assets $bn
1	Iran	235.3
2	Saudi Arabia	92.0
3	Malaysia	67.1
4	Kuwait	63.1
5	United Arab Emirates	49.1
6	Bahrain	37.4
7	Qatar	21.0
8	United Kingdom	18.1
9	Turkey	15.8
10	Pakistan	6.3

Source: The Banker (November 2008), *Top 500 Islamic financial institutions,* 2008

Explaining the UK's success

1.11 Irrespective of any specific intervention from the Authorities in the Islamic finance sector, five main factors explain the recent growth of Islamic finance in the UK[8]:

- global expansion of Islamic finance: the global Islamic financial market was estimated to be worth about $700bn[9] in 2007 and there are hundreds of institutions around the world offering Islamic financial products. This has affected developments in the UK;
- markets and skills base: London has a strong history of financial innovation, with deep and liquid markets and exchanges that are among the most frequently used platforms for listing and trading financial instruments in the world. Furthermore, the UK has a large pool of legal, accounting and financial engineering skills which have played an important role in the global expansion of Islamic finance;
- Islamic windows: many major international institutions have had a regional presence in Middle Eastern and South Asian markets for decades, allowing them to develop knowledge and expertise of local markets. To accommodate the rising demand for Islamic financial services, in the last ten years many have established 'Islamic windows', Shariah compliant sections, which have contributed to the development of Islamic finance through their institutional knowledge of product development;
- excess liquidity in the Middle East: the last few years have seen an increase in the levels of excess liquidity in the Middle East, with a commensurate rise in demand for both conventional and Islamic financial assets. Local financial markets have been unable to accommodate this liquidity leading to a significant spillover into international markets. The UK, with its established history of financial openness, has been a favoured destination for these financial flows; and

[8] Financial Services Authority (2007), *Islamic finance: regulation and challenges*, FSA, 2007
[9] Economist (2008) *Savings and souls,* The Economist Magazine, 2008

- **single financial regulator**: the establishment of the FSA in 1997 combined eleven different regulators into a single body under a single piece of legislation (the 2000 Financial Services and Markets Act). This has resolved many of the complications and conflicting views that characterised the previous regulatory system and allows the FSA to look across the system, including the Islamic financial system, as a whole.

The role of the UK authorities

1.12 Against the backdrop of these global drivers of Islamic finance, the Government, the FSA and the Bank of England have actively supported the development of Islamic finance in the UK over the past decade.

- in 2000, the Bank of England recognised the potential for retail and wholesale Islamic finance in the UK and, together with HM Treasury, established a working group to investigate the obstacles facing the industry. This led to the first of many legislative measures introduced by HM Treasury to enable the development of Islamic finance in the UK;
- since 2003, HM Treasury, HM Revenue & Customs and the FSA have introduced several changes to the tax and regulatory systems in order to enable UK companies to offer a range of Islamic financial products including Child Trust Funds, asset finance, mortgages and ISAs;
- since 2004, the Financial Services Authority (FSA) has authorised a number of Islamic financial firms, which are currently the only standalone Islamic financial institutions in the European Union. This has been achieved by applying exactly the same authorisation criteria to both Islamic and conventional financial institutions, working towards a level regulatory playing field;
- in early 2007, UK Trade & Investment (UKTI), through their Financial Services Advisory Board, agreed to set up a separate sub group to produce a strategy for the promotion of the UK as a centre of excellence and global partner for the provision of Islamic financial services. The sub group consisted of 15 practitioners and representatives from UKTI and HM Treasury. Four private sector working groups were set up to feed into the sub group on Banking & Insurance, Legal, Accountancy and Education, Training and Qualifications (ETQ). The internal strategy was agreed in late 2007 and the group and its sub groups continue to meet on a six monthly basis to gauge both the implementation of the strategy and market changes; and
- in April 2007, HM Treasury hosted an Islamic finance summit at Number 11 Downing Street, on the back of which an Islamic Finance Experts' Group (IFEG) was established. The group consists of a number of UK and internationally based experts from financial, legal and advisory firms as well as Government and Muslim community groups. The IFEG has met a number of times, providing advice to the Government on how to best support the development of Islamic finance in the UK.

Box 1.A: HM Treasury and UK Debt Management Office feasibility study into sovereign sukuk issuance

In April 2007, the Government announced that it would consider the feasibility of issuing wholesale sovereign sukuk. The Government's objectives for the development of Islamic finance in the UK and the need to ensure that sukuk issuance was value for money for the Government underpinned the feasibility study.

Since April 2007, HM Treasury and the Debt Management Office, which jointly undertook the feasibility study, have consulted extensively both formally and informally. In November 2007 the Government issued a consultation paper *Government sterling sukuk issuance: a consultation*. The Government received a total of 41 responses to the consultation, from a range of respondents, including investment banks and their Islamic 'windows', Islamic banks, law firms, consultancies, ratings agencies, individuals and academics. Respondents presented a wide range of views on the questions raised in the consultation document.

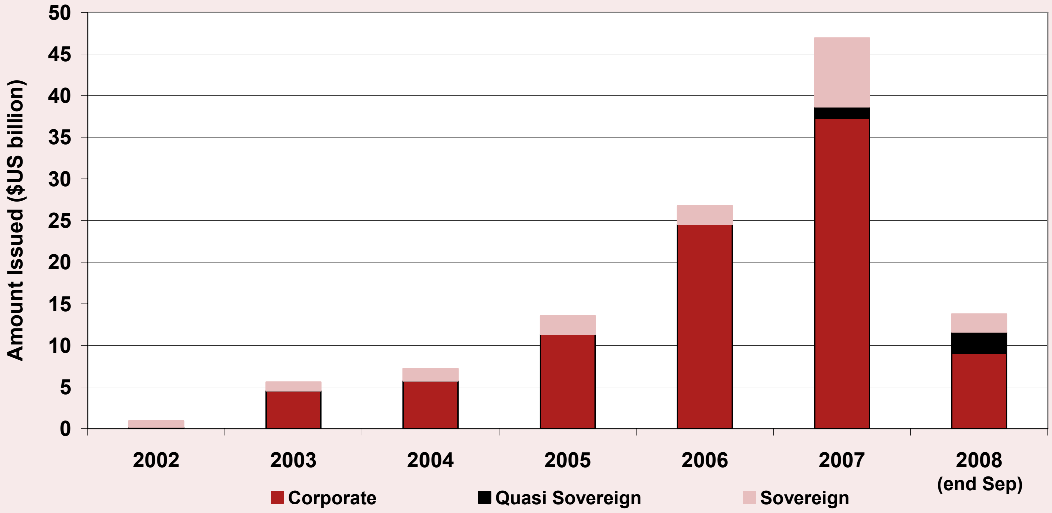
The Government published its full response to the consultation in June 2008, in which it decided upon certain features of a potential sovereign sukuk issuance.

The Government has looked carefully at the case for issuing sovereign sukuk and has considered the following factors:

- the current situation in world financial markets, including sukuk markets;
- the Government's debt management policy of minimising long-term costs of debt issuance while taking into account risk;
- the size and nature of potential demand for UK Government wholesale sterling Islamic financial instruments;
- the potential cost and risk characteristics of wholesale sovereign Islamic financial instruments, including in relation to the cost and risk characteristics of the Government's debt portfolio;
- any implications for the Government's established financing strategy;
- the experience of other sovereign issuers of wholesale Islamic financial instruments; and
- the impact on the markets, including the development of London as an international centre for wholesale sterling Islamic financial instruments.

Following this analysis, the Government has concluded that issuing sovereign sukuk would not offer value for money at the present time but it will keep the situation under review.

Chart 1: Total world sukuk issuance since 2002 ($US billions)



Source: HM Treasury and Islamic Finance Information Service

Box 1.B: National Savings and Investments work on feasibility of issuing Islamic retail products

In April 2007, HM Treasury asked National Savings and Investments (NS&I) to conduct a study on the feasibility of offering Shariah compliant retail banking products to the UK market. NS&I's review comprised four elements:

- understanding the Shariah rules and how these may be used to develop offers
- sizing the target market
- assessing the costs of making these offers; and
- identifying risks to both NS&I and the Government

The findings of the study, published in June 2008[10], drew a number of conclusions as to what such a retail offer might look like. However, the overall conclusion was that an NS&I retail offer would not constitute value for money at that time. NS&I have committed to revisit the work in the event that the UK Government issue a sovereign sukuk, once a secondary market is established, or in eighteen months time, whichever is sooner.

Islamic finance and financial stability

1.13 Since July 2007, the global economy has experienced levels of financial instability not seen for generations, and this has had a profound impact on all parts of the financial services sector, including Islamic finance. The Government's policy response during this period is detailed in the 2008 Pre-Budget Report[11]. Throughout this period, the Government's objectives for addressing threats to the financial system have been consistent and focused around the need to:

- support stability and restore confidence in the financial system;
- protect depositors' money; and
- safeguard the interests of taxpayers.

1.14 As detailed below, the UK Authorities' support for Islamic finance is characterised by an approach of equal treatment for conventional and Islamic finance. Therefore, the Government's financial stability objectives apply equally to all conventional and Islamic financial institutions. As a consequence, although the Government acknowledges that Shariah prohibits a risk free return on capital, Islamic finance depositors at FSA-authorised banks are entitled to the same degree of protection as depositors at conventional banks. On a broader level, standalone Islamic financial institutions and the UK subsidiaries of foreign Islamic finance institutions are regulated by the FSA to the same high standards as conventional financial institutions.

Looking to the future

1.15 The Government believes that the growth of Islamic finance in the UK is beneficial to all UK citizens. On the retail side, all consumers gain from a wider choice of retail financial services, in particular those consumers whose religious beliefs prevent them from accessing conventional finance. On the wholesale side, the entire country benefits from the UK financial services industry's success as the leading Western centre for Islamic finance. The Government will, therefore, continue to support the development of Islamic finance in the UK and the next chapter describes the principles that will guide that support.

[10] The full text of this report can be found at www.nsandi.com/about/corporateinformation.jsp#sharia

[11] The full text of the Pre-Budget Report 2008 is available at www.hm-treasury.gov.uk/prebud_pbr08_index.htm

2 UK objectives and guiding principles for Islamic finance

2.1 The Government's objectives for supporting the development of Islamic finance in the UK remain consistent:

- to enhance the UK's competitiveness in financial services by establishing the UK as a gateway for international Islamic finance; and
- to ensure that everybody, irrespective of their religious beliefs, has access to competitively priced financial products.

2.2 In working towards these objectives, three key principles guide the Government's approach: fairness; collaboration; and commitment.

Fairness

2.3 In supporting Islamic finance, the Government is not extending special favours, nor is it supporting one minority interest over another. The Government believes that everybody in the UK will benefit from the UK becoming a global centre for Islamic finance, through the increased tax receipts, private spending and economic dynamism that flow from the financial services industry. More directly, there are no faith-based requirements for the take-up of Islamic products and many non-Muslim consumers may benefit from an expanded choice of financial products

2.4 The Government wishes to see, where relevant and practical, a level playing field established for Islamic finance. The tax and regulatory system should not distort the market for investors or consumers wishing to choose Shariah compliant products. Similarly, it would not be reasonable for the Government to extend any preferential treatment to Islamic finance over conventional finance.

Collaboration

2.5 The Government believes that the growth of Islamic finance in the UK brings clear benefits for the UK economy. To this end, there are areas where the Government is able to support the industry, for example with its work to establish a level tax and regulatory playing field between Islamic and conventional financial products. However, there is a limit to what the Government can do before it ceases to be supportive and instead becomes interventionist, which could distort the practices of the market and be anti-competitive.

2.6 Through its work with the industry, the Government has been able to identify certain challenges facing Islamic financial services in the UK. These are detailed in the next chapter. However, many of these barriers cannot and should not be addressed by the Government. Therefore, a collaborative approach between the Government, industry and the third sector is essential if Islamic finance in the UK is to continue to develop.

Commitment

2.7 Since 2003, the Government has introduced a number of legislative measures to remove tax and regulatory barriers to Islamic finance in the UK. A clear indication of the Government's commitment to promoting the industry and engaging more closely with practitioners is reflected in the establishment of the Islamic Finance Experts' Group and the Tax Technical Working Group. These fora have been valuable in identifying priorities for the Government's involvement in the sector and will continue to meet where necessary.

2.8 The Government's objectives for Islamic finance are ambitious. However, the Government is committed to ensuring that behind these ambitious objectives, the necessary analysis, consideration and consultation is carried out to deliver real benefits to industry and consumers in the UK.

3 Barriers to development: recent progress and future challenges

3.1 The UK's current success as a centre for Islamic finance has required a concerted and co-ordinated effort between the Authorities, industry and the third sector to address the main barriers to development. These barriers can be grouped under the following themes:

- taxation and regulation;
- standardisation;
- awareness; and
- skills.

3.2 This chapter will examine each theme. It assesses what the challenge is; what has been achieved in recent years; and, where appropriate, what further work needs to be done to promote the development of Islamic finance in the UK. It is clear that the Government is the lead on issues related to tax and regulatory legislation. In other areas however, leadership should come from industry and other groups.

Taxation

3.3 HM Treasury and HM Revenue & Customs have for the past five years supported the development of Islamic finance in the UK through changes in tax legislation. These changes have been introduced to help facilitate growth in both the wholesale and retail markets.

3.4 In terms of taxation of Islamic finance, the Government's primary aim has been to remove uncertainty in current tax legislation. In the UK, unlike some other jurisdictions, transactions have tended to be taxed on the basis of their legal form, rather than their economic substance, although the approach adopted by the courts has been far from consistent. While it is possible that some types, at least, of Shariah compliant arrangement might be accorded a sensible tax treatment on first principles, there is usually considerable uncertainty, which the Government is working to avoid.

3.5 The Government wishes to ensure that Islamic finance arrangements are taxed neither more harshly nor more lightly than equivalent structures involving interest-bearing debt or deposits. The Government is striving to remove tax obstacles that might hinder the development of Shariah compliant finance, but will not grant it preferential treatment over other forms of finance.

3.6 The following principles have been applied when considering tax policy on Islamic finance:

- treatment should follow the economic substance of the transaction;
- treatment should be on the same basis as equivalent financial products that bear interest;
- ordinary tax rules should be applied where possible; and
- rules that give undesirable or unpredictable results should be amended.

Recent progress

3.7 In recent years, the Government has taken an active role in helping to facilitate the growth of Islamic finance, which has involved enacting legislation in consecutive Finance Acts since 2005 as well as in Finance Act 2003.

3.8 These measures have been developed in conjunction with industry and through the joint HM Treasury and HM Revenue & Customs Tax Technical Working Group, a group established in 2003 to ensure industry can raise specific, detailed concerns on Islamic finance of a technical nature.

3.9 It is important to note that the legislation uses the term alternative finance arrangements rather than specifically referring to Islamic finance, for example alternative finance investment bonds rather than sukuk. This means that changes are not exclusively for Islamic arrangements. In practice it is likely that arrangements falling within the legislation will generally be Shariah compliant, but it is not the concern of the tax authority whether they are or not.

3.10 The first tax legislation catering specifically for Islamic finance arrangements came in Finance Act 2003, in the area of stamp duty land tax (SDLT). It catered for individuals using alternative property financing arrangements (covering Islamic mortgages), removing the double charge to SDLT that might otherwise arise where a financial institution buys a property and then re-sells it to the individual. The SDLT provisions were extended in 2005 to equity sharing arrangements, and in 2006 to companies.

Borrowing arrangements

3.11 Finance Acts 2005 and 2006 saw the introduction of two types of borrowing concepts. In 2005, Government legislated for murabaha, referred to in the legislation as purchase and resale arrangements. In this type of arrangement, where the return equates in substance to the return on an investment of money at interest, it will be taxed as if it were a loan.

3.12 The second type of borrowing catered for in 2006 was diminishing musharaka, or diminishing shared ownership, a form of property or other asset financing under which the borrower progressively acquires the lender's share in the asset, at the same time paying a rent or financing charge for the share of the assets the lender retains. This type of contract can be used in Home Purchase Plans (see box 3.E).

Deposit arrangements

3.13 Finance Act 2005 introduced the deposit arrangement that is recognised for regulatory purposes, which is based on mudaraba. This is referred to as a profit share return. For the investor the return is taxed as if it were interest and the legislation switches off the tax rules that might otherwise treat it as a distribution, so the deposit-taker receives a deduction for the payment. In Finance Act 2006, wakala, or profit share agency, was introduced where the investor appoints an agent to manage a sum of money being invested, receiving a return out of the investment proceeds that equates in substance to an interest-like return.

Investment bonds

3.14 The provisions in Finance Act 2007 looked to help facilitate sukuk issuance in the UK. For this type of transaction, known as alternative finance investment bonds, legislation seeks to apply the same tax treatment that would be applicable were the alternative finance investment bond to be a debt instrument. This was seen by industry as an important first step in facilitating sukuk issuance. However, it was recognised that, while these rules would help, technical issues still remained from the issuer's perspective. These have been addressed in Finance Act 2008 with regards to SDLT and stamp duty reserve tax and with further changes to be addressed through Finance Bill 2009 for SDLT on alternative finance investment bond transactions.

3.15 The Government has also looked to act following discussions with industry in other areas such as Community Investment Tax Relief (CITR), where the principles of Islamic finance were seen to fit well with the CITR scheme, but required amendments to allow for money received or onward-investment through alternative finance to be included within the scheme.

3.16 Finally, following consultation with organisations such as the Muslim Council of Britain, Child Trust Fund rules have been specifically designed to allow the provision of accounts that are compliant with Shariah law.

Future priorities

3.17 The Government will continue to monitor developments in growth areas such as takaful (Islamic insurance) and sukuk, acting where necessary. At present there is no explicit takaful regime because current rules on mutual insurance appear to be sufficient. Should this change as the market develops, the Government will be ready to reconsider the situation.

3.18 In the short-term the Government will continue to address concerns on issues such as SDLT, stamp duty and capital gains tax on sukuk (alternative finance investment bonds) transactions, subject to the results of consultation and discussions with industry. Further measures in these areas will be introduced in 2009.

3.19 In the medium-term, through such groups as the Tax Technical Working Group, the Government will continue to engage regularly on taxation issues relating to Islamic financial products to ensure a level playing field with conventional equivalents.

3.20 In Finance Act 2008, the Government introduced regulation-making powers to allow for amendments to the alternative finance rules through secondary legislation. This will ensure for the long-term that the Government has sufficient flexibility, either through these powers or future Finance Bills, to adapt UK tax legislation in response to issues raised now and in the future.

Box 3.A: Regulation of Islamic finance in the UK

Regulatory challenges

All types of financial activity should be regulated on a fair, transparent and consistent basis. Maintaining an appropriate regulatory framework for financial markets with rapid evolution, increasing cross-border financial flows and technological sophistication creates challenges for regulators; an issue which is perhaps particularly pronounced in the nascent Islamic finance sector, as the concepts, structures and practices are still being developed.

Because Islamic financial institutions are prohibited from using interest-based instruments and are restricted from investing in certain industries, the Islamic finance sector has developed alternative transaction structures and a different set of market practices. As a result, there are a number of issues which have posed challenges for regulators around the world, including issues related to capital, deposits, legal risk, corporate governance and reputational risks.[1]

Financial legislation has been created to deal with conventional products. As such, Islamic products, which are structured to replicate the function of conventional products, may be categorised differently, or not captured at all, under the existing framework, due to differences in their underlying legal, economic or risk structures.

This issue is exacerbated by the fact that within the Islamic finance industry, conceptual definitions can give rise to products with differing risk, legal and economic characteristics. Terms such as musharaka, mudaraba and murabaha (see Annex A) are generic categories. These terms define the types of transaction which underpin specific products – but they are not the products themselves. As a result, different products utilising the same underlying contracts (or indeed a combination of contracts) may vary significantly in terms of their risk profiles and economic substance.

The UK approach

The Financial Services Authority (FSA) is the single regulator for financial services in the UK.[2] The FSA has authorised a number of stand-alone Islamic financial institutions including banks and insurance firms (the first bank was authorised in 2004). In its November 2007 publication[3], the FSA outlined its approach to regulation of Islamic finance in the UK. The paper covers its approach to authorisation and risk management and assesses the risks and challenges facing the industry. For example, in the paper the FSA further clarified its position on listing sukuk, which helped to further facilitate sukuk listing in London.

In general the FSA has sought to regulate Islamic institutions and products in a fair, consistent and transparent manner. For example, in 2004 regulations were extended to cover Home Purchase Plans (HPPs) a type of Shariah compliant mortgage (see box 3.E). In order for HPPs to compete fairly in the mortgage market, and for consumers to be afforded the same protection as others, it was important they were regulated in the same way. Islamic financial institutions are subject to the same rules and supervisory framework as other UK financial institutions.

Regulatory developments

The FSA examines its rules and regulations in light of the development of new products and market practices including developments in the Islamic finance market. For example, the FSA and HM Treasury are currently consulting on the regulatory treatment of sukuk in the UK.[4]

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[1] Davies and Green (2008), *Global financial regulation: the essential guide*, 2008

[2] More information about these issues is available at www.fsa.gov.uk or contact the FSA at islamic.finance@fsa.gov.uk

[3] Paper can be accessed at www.fsa.gov.uk/pubs/other/islamic_finance.pdf

[4] HM Treasury and the FSA (2008), *Consultation on the legislative framework for the regulation of alternative finance investment* bonds (sukuk), 2008

Standardisation

What is the challenge?

3.21 The lack of commonly accepted standards for products and practices in any industry can be a barrier to development. This is because it is likely to increase costs, thereby reducing competitiveness relative to substitutes. This has been particularly true for Islamic finance, where the sector has had to address the standardisation challenges that face all rapidly evolving industries, while also taking into account the dynamic nature of Shariah interpretation (see box 3.B).

3.22 Greater standardisation in the Islamic finance industry could have many benefits, including:

- reducing transaction costs for firms, thereby enabling the lowering of prices for investors and consumers;
- reducing the time to market for new products;
- reducing the burden on Shariah scholars, of which there is currently a pressing shortage;
- improving documentation standards and mitigating the risk of legal challenges; and
- improving confidence in the Islamic finance industry.

Box 3.B: Standardisation and the role of the Shariah scholars

The Shariah is derived from the Quran (considered by Muslims to be the revealed word of God) and the Sunnah (the sayings and practices of the Prophet Muhammad). The Shariah provides a guiding set of principles that govern all aspects of a Muslim's life. However, often these principles are not sufficiently expounded to cater explicitly for every modern situation, including those pertaining to finance.

Shariah scholars interpret the principles of Shariah in light of community consensus and analogical reasoning, issuing a fatwa in order to give the go ahead to a product they deem to be permissible. Because the Shariah principles can be subject to varying interpretations, scholars may disagree about their application. This means that for Islamic finance there can be differences of opinion, either within or across national borders, on the permissibility of certain instruments.

UK policy on standardisation

3.23 Many jurisdictions are eager to support the development of the Islamic finance industry, and establish themselves as regional hubs. Approaches to doing this vary, with some governments eager to intervene in the sector's development more than others. Some jurisdictions, for example, have established national Shariah boards, which both pronounce and enforce Shariah compliance. This has occurred most notably perhaps in Malaysia, which has seen a rapid expansion of the domestic Islamic finance market.

3.24 However, the Government does not intend to adopt a state-led approach to improving standardisation in Islamic finance. The Government believes that such an approach would be inappropriate in the UK for the following reasons:

- the UK Authorities are secular bodies, not religious regulators;
- it could fragment the industry along regional lines where different jurisdictions prescribe different systems; and

- it could stifle industry innovation and development by adopting a rigid approach to standardisation.

Standardisation in the retail market

3.25 In the retail market there is a smaller range of available products, which are generally less complex than wholesale market products. Many of the preferred forms of documentation have been prepared by individual banks themselves, which is an expensive process, thereby increasing the costs to that firm of bringing a product to market. This can result in a certain degree of commercial pressure to protect this work. Nonetheless, greater standardisation is likely to occur alongside further growth in the size of the industry for the sake of expediency.

Box 3.C: International Islamic Standard Setting Bodies

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established in 1990 in Algiers. As an independent international organisation, AAOIFI is supported by institutional members (155 members from 40 countries) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. AAOIFI's standards are now adopted in Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria.

AAOIFI's standards currently cover: accounting (using international financial reporting standards as the basis); auditing; corporate governance; capital adequacy and ethics. Future standards will include corporate social responsibility and presentation and disclosure.

The Islamic Financial Services Board (IFSB), based in Malaysia, was established in 2002 and currently has more than 150 members, including regulatory and supervisory authorities, the World Bank, the IMF, the Bank of International Settlements, the Islamic Development Bank and the Asian Development Bank.

IFSB has issued five standards and guiding principles for the Islamic financial services industry, focusing on risk management, capital adequacy and corporate governance, supervisory review processes and transparency, and market discipline.

The International Islamic Financial Market (IIFM) was founded with the collective efforts of the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank based in Saudi Arabia, as an infrastructure institution with the mandate to take part in the establishment, development, self-regulation and promotion of Islamic capital and money markets.

Recent progress

International Islamic standard setters

3.26 There has been some movement towards standardisation of practices and documentation in recent years. This has been achieved in part through the adoption of standards that have been created by international Islamic finance standard setters (see box 3.C). However, in practice, the global adoption of Islamic finance standards has not taken place beyond a few jurisdictions where their take-up is mandatory.

3.27 The UK Authorities maintain close links with all the international standard setting bodies. The FSA meets with these bodies bilaterally, attends their conferences and also reviews their material. Recently, the FSA has also led a review on behalf of the International Organization of Securities Commissions (IOSCO) on Islamic securities products.[5]

3.28 Greater standardisation has also been achieved through less formal means, by applying to Islamic finance practices used in conventional finance with minimal adaptation. Within the UK, the Islamic finance sector has been quick to adapt itself around existing financial infrastructure and market practices; for example, London's robust infrastructure for secondary trading has been widely used for Islamic capital market trading. As well as the 18 sukuk currently admitted to trading on various markets of the London Stock Exchange, seven Islamic exchange-traded funds are listed with a further two Shariah compliant funds and two Shariah compliant banks quoted on AIM, the market for smaller growing companies.[6]

Future priorities

Publicising London's existing strengths

3.29 As discussed above, much progress on achieving greater standardisation in Islamic finance has been achieved simply by adopting practices that prevail in conventional finance. This should particularly benefit London as one of the world's leading international financial centres. Relevant parties, such as UK Trade & Investment, International Financial Services London and the City of London Corporation, should therefore continue to promote London's existing infrastructural strengths as a centre for Islamic finance.

Supporting the international standard-setters

3.30 In developing international standards, it is important to ensure that they are accessible to those at all levels who want to consult them. This could be addressed by the creation of a concise term sheet summarising how the standards apply to different situations. In order to ensure the credibility of such a term-sheet, it could be developed by industry or third sector organisations, with a view to being endorsed by the international standard setters.

Awareness

3.31 All industries and sectors need to raise awareness about the availability of their products, as evidenced by the £19 billion spent on advertising in the UK in 2007.[7] For Islamic finance to expand, it is critical that more consumers and investors are made aware of the products available and understand them.

3.32 Islamic finance does face particular challenges in this area. In addition to raising general levels of awareness by ensuring consumers know that these products exist, the Islamic finance sector also needs to give consumers confidence about the authenticity of the products and the manner in which they are regulated. The final aspect to the awareness agenda concerns the importance of raising the profile of the UK as an international centre for Islamic finance internationally.

3.33 The Government and FSA have an interest in raising awareness of Islamic financial products, in line with their objectives for raising financial capability in the UK (detailed in other HM Treasury publications[8]). The Authorities are also keen to make consumers aware that all FSA-regulated financial services are regulated in the same way and are covered by the Financial

[5] Paper available at www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf

[6] For sukuk to be treated as alternative finance investment bonds they need to be listed. In order to have their securities listed, issuers need to comply with relevant Listing Rules.

[7] www.adassoc.org.uk

[8] www.hm-treasury.gov.uk

Services Compensation Scheme (FSCS).[9] To this end the Authorities have adopted the following approach to raising levels of awareness about Islamic finance:

- raising overall levels of financial capability and inclusion, in which the availability of a Shariah compliant alternative provides an additional choice for consumers;
- regulating Islamic finance to the same high standards as conventional finance, so consumers can be confident that they are protected by the same safeguards as they would be with conventional finance; and
- taking action to ensure that the Islamic finance consumers are provided the same level of advice and transparency as would be afforded to conventional finance consumers, so they can make well-informed purchases.

Recent progress

Industry leadership

3.34 Industry has been the key driver behind the progress that has been made so far on raising awareness. There have been numerous initiatives including bank-specific marketing material, stand-alone seminars and representation at events and conferences.

3.35 Over the past few years there have been attempts to get banks to cooperate and hold coordinated events or to collaborate on longer-term projects. One recent example of such collaboration is the Islamic Finance Council in Scotland (see box 3.D for more detail).

Box 3.D: Islamic Finance Council

The Islamic Finance Council (IFC)[10], based in Scotland, was established in 2005 with the aim of promoting the Islamic finance industry. Since its inception it has successfully organised a number of round table awareness events, been appointed as advisor to the Scottish Government and launched a global scholar development programme endorsed by UK Trade and Investment (UKTI).

To promote awareness the IFC has held a number of roundtable seminars involving imams, community leaders and key figures from the business and Islamic finance industry. At these events participants discuss key trends in the industry and how they can help each other in achieving their shared objectives.

3.36 In October 2008 the Muslim Council of Britain (MCB), in association with the Islamic Finance Council and the Utrujj Foundation, published a consultation document on their proposals to create an Islamic Finance Transparency Standard. The proposed standards seek to give consumers increased confidence in the authenticity of Islamic finance retail products, by ensuring that providers have taken prudent steps to ensure that the product, its documentation and implementation are in compliance with Shariah and that the specific steps that they have taken are made known to customers in the interests of greater transparency. The MCB and its partners intend to publish a summary of the responses to this consultation by 1st January 2009.

[9] For more information on the FSCS, see their website: www.fscs.org.uk

[10] For more information on the IFC email: info@islamicfinancecounciluk.com

Help from the UK Authorities

3.37 In terms of specifically raising awareness of Islamic finance, Treasury ministers have attended a variety of industry events[11] and, along with officials, have maintained an important dialogue with industry. One of the four core objectives of the FSA is to help consumers achieve a fair deal. Within this treating customers fairly (TCF)[12] initiative, the FSA stipulates that consumers should be provided with clear information. To this end the FSA provides clear advice on a range of financial products on their Money Made Clear website[13], including the Home Purchase Plan brochure (see box 3.E), which provides an introduction to Shariah compliant home financing.

Alongside help from UKTI

3.38 UKTI works through their Islamic finance group, to implement their strategy for the promotion of the UK as an Islamic finance hub, utilising their overseas staff and the Lord Mayor's office to hold several events across the globe. UKTI has also been involved directly in World Islamic Banking Conference events, both in Bahrain and London, including a keynote address from their CEO, Andrew Cahn, at the London event.

3.39 UKTI have also produced a case study brochure highlighting the involvement in Islamic finance by UK-based organisations across the spectrum of activity including legal work, accountancy, banking, consultancy and education, training and qualifications (ETQ). This brochure is now in its third edition with 30 entries and is distributed at all events that UKTI are involved with, both in the UK and overseas.

[11] Transcripts of the main speeches by Treasury ministers can be found on the HM Treasury website at: www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/speech_index.cfm

[12] More information on the FSA's TCF work can be found on their website at: www.fsa.gov.uk/pubs/other/tcf_towards.pdf

[13] www.moneymadeclear.fsa.gov.uk

Box 3.E: Home Purchase Plans using diminishing musharaka contracts

Home Purchase Plans, available from a variety of UK banks, enable you to purchase a home in a way that does not involve interest payments and is deemed permissible by a number of Shariah scholars. Your contract with the bank stipulates the length (term) of the contract, the size of the deposit you need to pay upfront and how much money you are required to pay each month (which will reduce over the term). You will also have a leasing agreement with the bank, which allows you to live in the property. Each payment you make goes toward buying an extra slice of the ownership of the property from the bank. At the end of the term your payments will end and you will own the property.

A diminishing musharaka contract is one way of structuring an HPP. This is explained in the illustration below.

Diminishing musharaka home purchase plan – 15-year term

This information was taken from the Money Made Clear guide to home purchase plans published by the Financial Services Authority (FSA). The guide, part of their 'buying a home' series, can be found on the FSA's Money Made Clear website at www.moneymadeclear.fsa.gov.uk.

Future priorities

Industry collaboration

3.40 The need to raise awareness is industry-wide. As such, the Government believes that there are potential economies of scale to be exploited through collaboration between industry, community groups and the third sector.

Involving community leaders

3.41 In order to raise awareness amongst the 2 million British Muslims who constitute the main market for retail products, it may be effective to use existing community infrastructure, such as mosques, to disseminate information on issues of personal finance. As such, increasing knowledge amongst community leaders could be a valuable step in reaching the wider community. Some industry practitioners have previously considered a roadshow-style event, where a group of Shariah scholars would travel to different areas of the UK to educate Imams about the basics of Islamic finance.

Involving the media

3.42 It is sometimes felt that there is currently relatively little mainstream media interest in Islamic finance and that those stories that do appear are can be inaccurate or misrepresentative. Greater involvement with Islamic finance among journalists would therefore support industry efforts to raise awareness more widely. A conference programme specifically targeted at increasing awareness and understanding of Islamic finance for delegates from the media could be one way of addressing the issue.

Reliable information

3.43 Seminars and speeches are helpful in raising awareness by attracting publicity. However, it is clear that in order for awareness and education efforts to be effective, they need to be accompanied by up to date, credible and easily accessible sources of information for subsequent reference. Aside from the FSA's brochure on Home Purchase Plans (see box 3.E), there is currently little by way of jargon-free and impartial literature targeted at consumers.

3.44 To address this issue, the Muslim Council of Britain (MCB) has begun working on an Islamic finance FAQ document intended to demystify Islamic finance, both wholesale and retail. This will be a collaborative effort involving a wide range of Islamic finance providers.

Trusted advice from the FSA

3.45 The FSA's work on the Money Made Clear initiative is a good example of where the involvement of the regulator can benefit consumers because they are trusted to be unbiased and to work in the interest of the consumer. The need to produce guidance on retail products, or indeed republish existing guidance, is assessed by the FSA as necessary.

3.46 Given the increase in the Islamic mortgage market, the FSA have decided to republish the Home Purchase Plan brochure and distribute more widely, for example by providing copies to financial institutions.

Government commitment

3.47 Raising the profile of the Islamic finance industry in the UK is one of HM Treasury's objectives in publishing this paper. However, the Government wants to ensure that its message reaches the grass roots level as well.

3.48 The Home Office and the Department for Communities and Local Government (DCLG) have existing programs that reach out to the Muslim community in the UK. HM Treasury has agreed with the Home Office and DCLG to explore the scope for using these existing contacts and distribution channels to disseminate information on Islamic finance to ensure that it reaches a wider audience.

Skills

3.49 A steady flow of suitably qualified people is critical to the survival of any industry. The Government fully acknowledges that the strength of the UK financial services industry depends on the skills of a broad range of people, from a variety of disciplines, from the UK and abroad.

3.50 The Government is working towards ensuring that this pool of talent is maintained. The Leitch Review of Skills[14] set out the vision for the UK to become a world leader in skills by 2020 and over the last decade major reforms and investments have been made to raise skills levels.

3.51 There are additional factors which impact upon Islamic financial services specifically. First, this is a relatively new sector that requires specialist training and specialist training takes time to set up. Second, the industry is underpinned by what is currently a very limited number of Shariah scholars who decide whether firms and products are indeed compliant with Shariah law.

New sector

3.52 At the working level, the UK Islamic finance industry is not currently constrained by skills shortages. As the industry is still young, there are not large numbers of vacancies waiting to be

[14] The *Leitch Review of Skills* was published in December 2006 and can be accessed at www.hm-treasury.gov.uk/leitch_review_index.htm

filled with qualified practitioners. However, the pool of potential applicants in the UK will have to keep up with the rapid growth of the market. This issue merits attention now, as there is a time lag between the development of training provision in Islamic finance and these skills filtering through to the market.

Shariah scholars

3.53 One concern for the industry is a global shortage of Shariah scholars with expertise in both finance and Islamic jurisprudence. This is important because of the crucial role they play in the industry. It has been estimated that there are only around 100 such experts, approximately twelve of whom form the group most heavily used by much of the industry.[15] Furthermore, the wide skill set that is needed for scholars to practise in the UK, including knowledge of the conventional UK system for example, can pose an additional constraint.

3.54 This shortage has two main impacts on the industry in the UK. First, the scholars' heavy workload can impact upon the process for obtaining a fatwa, the sign off from the Shariah board which is needed on all contracts. Second, it means that many scholars sit on numerous Shariah boards, which can cause concern about conflicts of interest and proprietary information. It is clear that an increase in the number of scholars will be a necessarily gradual process and the UK Authorities have no intention of getting involved in this area.

3.55 In order that companies might try to speed up the process for obtaining a fatwa, there are an increasing number of consultancies that offer preliminary Shariah advice on structuring and audit.

Recent progress

3.56 The UK has a deep and wide pool of skilled financial practitioners. Many of the skills available are transferable across different financial sectors and this has been a significant factor in the City's recent emergence as a centre for international Islamic finance. The UK's strength is not restricted to the domestic market; many British institutions offer training abroad.

3.57 The UK is already leading Europe in the development of Islamic finance training courses. These range from introductory and entry level courses, to postgraduate level study and continuing professional development programmes. As such, providers range from specialist companies and community institutions to top universities.

3.58 There are programmes that focus on developing the skills base at practitioner level, such as the Islamic Finance Qualification (IFQ), which was launched in the UK in 2006. The IFQ is a joint initiative between the École Supérieure des Affaires, a Lebanese business school, and the Securities and Investments Institute (SII). The IFQ has recently been included on the Financial Services Skills Council 'Recommended List for the sectors of Wholesale Banking and Financial Advice'.[16]

3.59 There are also programmes available to address the shortage of Shariah scholars in the UK. For example:

- the Scholar Development Programme is a joint initiative by the Islamic Finance Council and the SII, which provides established scholars with the knowledge of the conventional system that they need to be able to practice in the UK; and

[15] Roula Khalaf, Financial Times, 17th June 2008

[16] www.fssc.org.uk

- some firms provide in-house training to scholars via internship programmes. This enables "junior" scholars to gain experience of working in top financial institutions in the UK. This sort of initiative has many benefits for both firms and scholars.

Future priorities

3.60 The Government believes that industry should take the lead in addressing the skills issues that face the sector. Where industry finds that it requires Government action in order to meet its objectives, this should be communicated to the Government. The Chancellor's High Level Group on City Competitiveness and the Islamic Finance Experts' Group are two of the Treasury-led fora where industry can share their concerns with the Government. There could also be a role here for organisations such as the Financial Services Skills Council (FSSC) in facilitating an active dialogue between industry and the Government.

General Islamic finance literacy

3.61 Islamic finance largely remains a niche area in terms of training. As such there is a general lack of awareness about Islamic finance amongst many financial practitioners whose training has been exclusively focussed on the conventional system. There are a number of recent examples of Islamic finance modules being included in mainstream financial courses. The effect of this should be to increase the general level of Islamic finance literacy across the conventional sector, which will be important to the industry going forward.

Knowing what's available

3.62 In order to improve the information available about Islamic finance training courses that exist in the UK, International Financial Services London (IFSL) have announced that they, with help from UKTI, will compile a brochure of such courses and qualifications. This will be made widely available to both learners and employers.

A Modern Islamic finance contracts

There are a variety of commonly used Islamic finance contracts. In practice, transactions can involve a combination of these contracts and fully Shariah compliant firms will structure products using a mix of them. Some of the most common examples are listed below.

These contracts define types of transaction which underpin specific products – but they are not the products themselves. As a result, different products utilising the same underlying contracts (or indeed a combination of contracts) may vary significantly in terms of their risk profiles and economic substance.

- Ijara: Leasing contract. The owner of an asset (the lessor) leases the asset to a lessee, who pays a pre-determined rental to the lessor for the use of the asset. An example of this would be that a bank buys a car and leases it to a customer. The duration of the lease and the terms of the rental are determined at the start. The bank retains ownership throughout and is the owner of the car at the end of the contract.

- Mudaraba: Profit sharing agreement. This is a variety of joint venture whereby two parties collaborate on a project, one providing the investment and the other providing the expertise. The profits of the venture are then shared between the two parties in proportions previously agreed in the contract.

- Murabaha: Purchase and resale contract. This is when one party, such as a bank, purchases an asset identified by a second party with the intention of immediately reselling it to the second party for payment of a pre-arranged sum at a set date in the future. This resale price will be higher than the original sale price and may be paid in instalments.

- Musharaka: Joint venture. An entrepreneur and an investor agree to collaborate on a project, both contributing capital in agreed measures. The contract also clearly sets out arrangements for the sharing of both the profits and the losses of the venture.

- Diminishing musharaka: Declining balance partnership. In this variation, regularly used for property transactions, the ownership of the asset is divided in to units, which one party gradually buys from the other, thus incrementally increasing their share until the full ownership of the asset is transferred to the single party. For a practical example of how this can work in Home Purchase Plans see box 3.E.

- Sukuk: Investment certificates. These are investment certificates that are economically equivalent to bonds. Unlike bonds, which are debt-based instruments that pay interest, sukuk are asset-backed or asset-based instruments and represent the ownership (actual or beneficial) by the sukuk holders in an underlying asset. Returns are paid to the investors in line with their proportional ownership in that asset. Sukuk may be issued by governments or by private companies.

- Takaful: Insurance. This is a Shariah compliant mutual insurance arrangement. A group of individuals pay money into a fund, which is then used to cover payouts to members of the group when a claim is made.

B Acknowledgements

In order to inform this paper, four small working groups were formed, each consulted on two occasions, to solicit views and prioritise issues. The groups consisted of representatives from Government and the FSA, industry, academia and community groups.

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