

# MIDDLE EAST

## ISLAMIC BANKING



Budget bonanza: UK chancellor of exchequer Alistair Darling announced in March 2008 a number of measures to promote UK competitiveness in Islamic finance

# UK on the verge of sukuk issuance

The UK budget for 2008 announced measures to promote competitiveness with the increasingly attractive Islamic finance sector, paving the way towards sukuk issuance, writes **Stephen Timewell**

In a significant development for Islamic finance on the global stage, the UK chancellor Alastair Darling has taken another major step towards the issuance of a UK sovereign Islamic bond (sukuk) and in doing so enhanced the City of London's reputation as the prime hub for Islamic financial transactions in the western world.

In his March budget speech, Mr Darling announced a number of positive measures to promote UK competitiveness in Islamic finance, to clear technical barriers on the road to sukuk

issuance and to ensure that everyone, regardless of faith, has access to competitively-priced financial products (see box, opposite).

### Global interest

As Islamic finance is expanding dramatically, the global interest in this financial area is huge, both inside and outside the Muslim world. According to The **Banker's** first Top 500 Islamic Financial Institutions global listing in November last year, the total of sharia-compliant assets worldwide grew by

29.7% in the previous year to reach \$500.5bn, and huge growth is still expected.

This latest move by the UK government highlights the attraction of this new financial sector in the West as well as in Muslim regions, such as the six Gulf Co-operation Council (GCC) states, where estimates suggest that Islamic banks have a 15% market share of regional banking assets and are growing faster than conventional banks.

Edging closer to a sovereign sukuk, the UK is realising the broad advantages that closer Islamic finance links could bring and not just for the two million UK-based Muslims who could benefit from better provision of Islamic retail products.

Humphrey Percy, chief executive of the recently licensed UK investment house Bank of London and the Middle East, says: "The budget shows that the UK government is continuing its work towards the issue of a UK government sukuk which will clearly have an impact on the growth of the UK Islamic market as it provides a solid basis for product development. In addition, the issue of a UK government sukuk will further enhance London's prime position as the pre-eminent centre for Islamic finance outside the Muslim world."

### Marketable asset

Mr Percy adds: "For London's Islamic investment banks, the UK government sukuk would be helpful as it heralds, for the first time, the availability of a marketable asset under Financial Services Authority regulations. This development would provide a high-quality hard currency instrument with 'lender of last resort liquidity', which to date has been missing from the market."

Since July 2007, more than 15 sukuk (raising nearly \$10bn) have been listed in London and 20 conventional and three Islamic banks now offer Islamic services in the UK, compared with only four in France. The UK is grasping the opportunity and a possible UK sukuk could open up new avenues in a global market that Standard & Poor's estimates could reach \$4000bn overall.

David Testa, chief executive of Gatehouse Capital says: "Islamic finance is a tool that the (UK) govern-

ment realises it has in its hand, which it can utilise to re-establish some clear blue water between themselves and Wall Street.” Gatehouse Capital is expecting to receive its licence to become the fifth independent Islamic bank in London within weeks.

### Tax treatment

The moves by the UK government to make the tax treatment of Islamic finance no more onerous than conventional finance are a subtle but significant step forward. Davide Barzillai of the London lawyers Norton Rose says: “These tax aspects, coupled with the restated intention to issue a government sukuk, will give a considerable boost to the UK Islamic finance initiative.”

While growth in sukuk continues to be strong, the rate of increase may be slowing. In 2007, the total number of sukuk issued was 207, compared with 199 in 2006 and 89 in 2005, according to the latest report of the Islamic Finance Information Service. In terms of value, the number of sukuk issued in 2007 added up to \$47.1bn, compared with about \$25bn in 2006 and \$10bn in 2005.

While Malaysia remains the biggest sukuk issuer worldwide the market is changing. Firas Abi Ali, Islamic Finance Information Service senior analyst and product manager, said in February: “We expect the number of issuances to continue to increase, both for corporate borrowers and for sovereign borrowers, especially in the GCC, where the market is starting from a much smaller base compared to south-east Asia. The market weathered the global credit turmoil rather well and showed strong resilience.”

### Mega-sukuk

He adds: “We expect this tenacity to survive the coming year. In all likelihood, the number of sukuk issued in Malaysia will continue to exceed the number issued in the GCC. However, with the tendency for mega-sukuk expanding in the GCC, we would not be surprised if total value of sukuk issued there were to exceed that of Malaysia in the coming year or two.”

Besides sukuk, Islamic banking generally in the GCC has been expanding at double-digit annual growth rates over the past decade and new Islamic institu-

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- Legislate, following consultation, in the Finance Bill 2009 to provide relief from stamp duty land tax for sukuk (referred to as alternative finance investment bonds).
- Amend the law to classify sukuk as tax-exempt loan capital for stamp duty and stamp duty reserve tax.
- Adjust legislation to allow existing corporation tax and income tax rules on Islamic finance arrangements (referred to as alternative finance arrangements) to be amended by regulation, and work with the UK banking regulator (the Financial Services Authority) and stakeholders to clarify the regulatory treatment of sukuk.
- Continue to examine the feasibility of a sovereign sukuk issue and in the Finance Bill 2008, take legal powers to facilitate any future sovereign issuance, and provide a full response to the recently closed public consultation on sukuk issuance in the summer of 2008.

tions are being launched at a great pace. With Islamic institutions growing at twice the rate of conventional (banking) businesses, some bankers believe that Islamic finance could account for up to 30% of the GCC market in five years, double its market share today (The **Banker**, March 2008, p86).

This heightened growth and demand for Islamic financial services is transforming this nascent industry and providing not only growing diversification but also increasing competition and new business models.

A recent report by rating agency Moody's, *Islamic Banks in the GCC: a Comparative Analysis*, notes that the traditional commercial banking business model, dominated by both the corporate and retail business lines, is now being enhanced by the emergence of two new key activities that are underpinning a new wave of institutions.

### Market analysis

Moody's analyst Anouar Hassoune says: “On the one hand, sharia-compliant investment banking has grown as a viable, profitable and successful way to manage alternative Islamic asset classes; and on the other

sukuk, specialised financial institutions focusing on mortgage, housing and consumer banking have been providing financing solutions to households facing unprecedented needs in terms of access to consumption and property.”

### Expansion potential

The three emerging Islamic banking models all have strong expansion potential. Moody's says: “Although commercial banking in the Islamic financial industry is expected to remain dominant, specialised and investment houses will continue to grow as the financing and investment needs of regional clients are getting far more specific.

Moody's adds: “Given the successful evolution of the industry as a whole, newcomers (such as Masraf Al Rayan, with its equity base in excess of \$1bn after just 18 months of operations) will intensify competition, forcing established players to seek opportunities in non-core, non-traditional business lines and to explore new territories outside home markets.”

The report continues: “Kuwait Finance House, Al Rajhi and Qatar Islamic Bank have already crossed the line by establishing operations in the Malaysian hub, seeking a wider audience in a larger part of Muslim Asia. Several GCC-based financiers are also sponsoring the recent foray of Islamic finance in the UK: both European Islamic Investment Bank and Europe Finance House have Gulf banking investors as reference shareholders.

“Even sharia-compliant investment banks such as Gulf Finance House, Arcapita Bank and Unicorn Investment Bank have been structuring transactions outside their regional Gulf markets, both in the western hemisphere and Asia.”

With new giants such as Dubai's Noor Islamic Bank and Saudi Arabia's Al Inma Bank, and new investment banks such as Bahrain's Global Banking Corporation and Capinvest, there is no shortage of sharia-compliant institutions creating new market niches. With HSBC Amanah and other Islamic windows expanding too, competition is booming. The only question is whether all of the new institutions emerging will remain viable in the medium to long term; investors clearly think they will.

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