

# ROOM FOR MORE SHARIA COMPLIANCE

A new Islamic bank has opened for business in London, bringing the number of standalone, wholly Islamic banks in the UK to three. Is the market big enough? **Michael Imeson** reports

**I**slamic banking may be only a minor force on the European financial scene, but it is growing in importance, as shown by the launch in July of Bank of London and The Middle East (BLME). The new sharia-compliant institution, based in Cannon Street in the City of London, is offering wholesale banking services to businesses in Europe, the Middle East and north Africa.

It is the third UK bank to provide only Islamic financial products. The other two are European Islamic Investment Bank, set up last year, and the Islamic Bank of Britain, created in 2004 as a retail bank only. Although there are another 21 banks in the UK providing sharia-compliant products to the country's 1.8 million Muslims, they are all conventional banks with bolt-on Islamic finance divisions.

BLME has raised £175m from a number of institutional shareholders. The biggest is Kuwait's Boubyan Bank, with a 20% share. Other shareholders include Kuwait's ruling Al-Sabah family, employees, pension funds and investment companies.

The bank has four business lines: treasury and financial institutions; corporate banking; investment banking; and private banking and investment management for high net-worth individuals. It has no plans to offer premium or mass-market retail financial services.

The three executive directors – chief executive Humphrey Percy, finance director Richard Williams and head of markets Nigel Denison – have many years of experience but relatively limited experience of the Islamic market. However, three of the five non-executive directors are Arab Muslims with Islamic and conventional banking and finance backgrounds. They are

chairman Yacob Yousef Al-Muzaini, who is also chairman and managing director of Boubyan, and two other Boubyan executives.

## The UK market

Why enter the Islamic banking market now, when so many other banks in the UK offer similar services? The reason, says Mr Percy, is that the market is still young and wide open to new entrants. "We are only the third bank in the country, and only the second wholesale bank, that is wholly sharia-compliant," he says. "Islamic finance in the UK has passed the initial development stage and is now entering a solid growth state. In the past two to three years, since the oil price has risen, an estimated additional \$450bn of wealth has been created in the Middle East and north Africa, generating a lot of liquidity."

It is estimated that about \$500bn will be invested on infrastructure improvements in the region in the next few years, and this will need finance. "There will also be increased trade flows between the UK and the Middle East, which will help our trade finance business," adds Mr Percy.

Mr Al-Muzaini, the chairman, says London was an obvious choice of base because it is already the largest centre for Islamic finance outside the Muslim world. "It is crucial that Muslim businesses have a choice in the range of financial

services they are offered without having to compromise on either service or Islamic principles," he says.

## Principles of Islamic banking

Islamic banking is based on the principles underlying Islamic law, known as sharia, which means:

- Interest (*riba*) cannot be paid or received on transactions.

**WORLDWIDE,  
ISLAMIC BANKING  
AND FINANCE IS  
GROWING AT A  
RATE OF 10% TO  
15% A YEAR**



The Square Mile: the UK's third wholly Islamic bank has set up in the City of London, competing with two other fully fledged sharia-compliant banks

- Transactions must avoid uncertainty (*gharar*), speculation (*maysir*) or anything that could lead to the unjust enrichment or unfair exploitation of one of the parties to a contract.
- Transactions cannot be made that involve prohibited products or activities, such as alcohol, illicit drugs, tobacco or gambling.

Worldwide, Islamic banking and finance is growing at a rate of 10%-15% a year. There are about 300 Islamic financial institutions, with assets worth \$500bn, in addition to conventional banks offering Islamic services.

Being a wholly Islamic bank, rather than just an Islamic 'window' of a conventional bank, BLME's owners and directors hope to appeal to more customers. To ensure that its services and operations are entirely sharia-compliant, it has a sharia supervisory board made up of eminent scholars, which reviews contracts, agreements and transactions to ensure they are consistent with the principles of Islamic jurisprudence.

Won't the fact that Mr Percy and his two fellow executive directives are not Muslims put them at a disadvantage? "Not at all," says Mr Percy. "We have an international team with different backgrounds, including experts in Islamic finance." The fact that it is sharia-compliant, has non-executive Muslims on the board and has Middle East shareholders should satisfy customers of its Islamic credentials.

One of BLME's first transactions was a one-year, £15m revolving *murabaha* (see box) financing facility for Thames

Steel, a Kent company owned by the Saudi Arabian Al Tuwairqi family. The bank intends to list on the Alternative Investment Market in a year or so, when it calculates it will probably need to raise another £75m in capital. An office in the Middle East is also a possibility.

### Sharia compliant

European Islamic Investment Bank (EIIB), which started operations in the City of London in April last year, was the first wholly sharia-compliant investment bank in the UK. It is owned by various Gulf and European investors, has a representative office in Bahrain and provides a similar range of services to BLME.

"We believe that EIIB has an advantage as a fully sharia-compliant institution compared with banks simply operating through an Islamic window," says Danie Marx, the bank's head of treasury and capital markets. "Whereas conventional banks offer Islamic finance as an add-on, our customers can be fully assured that everything EIIB does, every transaction it undertakes, is 100% sharia-compliant. This is a very important differentiator: with a standalone Islamic bank there is no risk of 'cross-contamination' of sharia-compliant and non-sharia-compliant funds.

"We don't have immediate plans to open other offices, although we are establishing strong relationships in other markets, for example Malaysia and other Asian markets."

Mr Marx says that the UK government, tax authori- >>

## A GUIDE TO ISLAMIC FINANCIAL PRODUCTS

**ISLAMIC FINANCIAL PRODUCTS** work on the basis that all forms of interest are forbidden. The customer and the bank share the risk of any investment on agreed terms, and divide any profits or losses between them. Listed below are four common products.

### MURABAHA

This replaces a conventional loan. The bank buys the goods for the customer and then sells the goods to the customer on a deferred basis, adding an agreed profit margin instead of interest. The customer repays the cost of the goods, plus the margin, to the bank in instalments.

### COMMODITY MURABAHA

This also replaces a loan and is often used instead of a conventional inter-bank loan. Bank A (the provider of the facility) buys a commodity (taking title but not delivery) for £10,000 and sells it to bank B (the user of the facility) for £10,500 (purchase price, plus an agreed profit margin instead of interest), allowing bank B to defer payment. The commodity is normally a base metal traded on a major exchange such as the London Metal Exchange. Bank B takes title but not delivery. Bank B, using bank A as its agent, immediately sells the commodity for £10,000 and the £10,000 is credited to bank B's account. The difference between the two prices – £500 – is the profit that bank A makes, and the fee that bank B pays, on the deal.

### IJARA

This is a leasing agreement in which the bank buys and then leases an asset (for example, consumer durables, property or

capital plant) to its customer for a specified rental over a specified period of time. The bank may have the right to adjust the rental charge in line with changes in the cost of finance.

An *ijara* can be used instead of a conventional mortgage, and usually entails the customer making capital payments in addition to the rental charge. The customer's ownership in the property increases and the bank's decreases by a similar amount with each such payment. Once all payments have been made, ownership of the property passes to the customer.

### MUDARABA

This replaces a conventional savings account. The investor/depositor places money with an investment manager, which is then pooled with the bank's and other investors' money and invested in sharia-compliant equities. The investor receives a pre-agreed share of the profits, instead of a return based on speculative gain or interest. However, any losses are borne by the investor.

Under UK law, a depositor is entitled to repayment of the full capital sum, but under sharia law the depositor must accept the risk of a loss in order to have the possibility of return. Islamic banks comply with UK law on deposit-taking by offering full repayment of the capital but telling the depositor that a lower amount may be repayable to comply with the sharia risk-sharing formula. This allows the depositor to choose not to accept full repayment if his or her religious convictions dictate otherwise.

**Sources:** "Islamic Banking in the UK", Briefing Note BN016/06, Financial Services Authority; Guidance on the VAT Treatment of Certain Islamic Products, HM Revenue and Customs; the Islamic Bank of Britain

ties and financial regulator have been finding ways "to foster" Islamic finance. "In March, for example, Gordon Brown, then chancellor, now prime minister, announced measures to put sukuk [similar to bonds] on an equal footing with other international securities from a UK tax perspective. The government has also announced its intention to explore the possibility of issuing a benchmark government sukuk."

Recent EIIB transactions include a sterling-denominated revolving supplier credit financing facility (a *murabaha*) for CCH International to buy steel products; and a committed standby facility (a commodity *murabaha*) to the Islamic Bank of Britain to manage its liquidity.

Some Islamic banks have been accused of being conduits for terrorist financing, but EIIB does not regard itself as particularly susceptible to this threat. "It is known that both Islamic and conventional banks have in the past been used by anti-social elements to finance their activities and launder money," says Mr Marx. "EIIB, as an Financial Services Authority-regulated institution, is required to apply the [same] very high standards of anti-money laundering and counter-terrorist financing measures that are required of all FSA-regulated banks."

Since starting business as a purely retail bank three years ago, Islamic Bank of Britain (IBB) had attracted 30,814 customers by the end of 2006 (up 120% on end-2005) and

deposits of £84m (up 76% on end-2005). "There has been a phenomenal demand for Islamic banking products, and we've been inundated with account applications since we opened our doors to the public," says spokesman Junaid Bhatti.

## Growth strategies

IBB has only eight branches: four in London, three in the Midlands and one in Manchester. "However, all our customers have access to internet and telephone banking, as well as free usage of Lloyds TSB branch counters, therefore it is more than possible to take advantage of *halal* banking without ever having to visit one of our branches," says Mr Bhatti.

The bank's main shareholders include Middle Eastern individuals and institutions, including Qatar International Islamic Bank, but it is also listed on AIM so most of its shareholders are UK-based. The first managing director, Michael Hanlon, retired to be replaced by Gerard Deegan.

IBB plans to open more branches next year, possibly with some in Europe. "We have been involved in high-level detailed discussions with financial regulators and community leaders in two EU countries to discuss the expansion of our services into their territories," says Mr Bhatti. "We will be making public announcements about our expansion when the details have been finalised."

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