Abstract – This article discusses the increasingly important topic of Islamic finance in the United Kingdom. It begins with an introduction outlining the current government’s plan to become the first non-Muslim state to issue an Islamic sukuk bond, before providing an overview of modern Islamic finance and its roots in centuries-old religious principle. The article then discusses Sharia law, the religious law upon which Islamic finance is based, and highlights the five key principles that Sharia law embodies. The discussion then turns to focus specifically on one of these key principles, the prohibition on interest or riba, and examines the financial community’s response to this prohibition in the form of the sukuk bond. Against this general backdrop to the Islamic finance industry and the increasingly popular sukuk bond, the article moves on to consider in more detail the United Kingdom’s own Islamic finance sector. It discusses both economic and social benefits that Islamic finance can bring as well as a selection of the challenges that Islamic finance presents. The article then concludes with suggestions on steps that can be taken to encourage growth in the United Kingdom’s Islamic finance sector in order for its full benefits to be realised.

Keywords: Islamic finance, Riba / prohibition on interest, Sukuk bonds, Sharia law, UK Islamic finance sector

1. Introduction

On 29th October 2013, at the ninth World Islamic Economic Forum, David Cameron announced the government’s plan for the United Kingdom to become the first non-Muslim state to issue an Islamic bond.¹ The bond, known as a sukuk, will be issued on the London Stock Exchange and it is estimated that it will be worth around £200 million. Although the value of the government bond appears relatively small in comparison to the overall sukuk market which is

worth $1 trillion globally,\(^2\) the importance of the announcement is that it is representative of a wider governmental plan to make London into a ‘great capital of Islamic finance’.\(^3\) Having made the announcement in front of more than 1,800 political and business leaders from over 115 countries, Cameron hopes that such initiatives will allow London to ‘stand alongside Dubai and Kuala Lumpur as one of the great capitals of Islamic finance anywhere in the world’,\(^4\) and that such measures will act as a catalyst for greater investment and activity in the UK’s Islamic finance sector.

Therefore, although the term *sukuk* may not be a familiar concept for a large portion of the UK population, and the Islamic finance industry may not be well known, a more active role by the UK government in the industry will no doubt result in an increase in public awareness of what modern Islamic finance entails and its place in the UK economy. This article aims to provide a background to modern Islamic finance and in particular the nature of the *sukuk* bond. It will then examine the UK’s current Islamic finance sector and the opportunities and challenges that this industry presents.

### 2. Modern Islamic Finance

Modern Islamic finance developed relatively recently. Based on centuries-old religious principle, modern Islamic finance is best described as a ‘young industry rooted in very old tradition’.\(^5\) During the 1970s, pan-Islamism became a powerful movement\(^6\) aimed to restore Islamic values in all areas of life. An important part of this movement was the creation of Islamic banks and financial institutions. Alongside a rise in oil prices, which brought an unprecedented amount of wealth to a number of oil-rich Middle Eastern states,\(^7\) the right conditions existed to spur a growth of what has now become modern Islamic banking.\(^8\) A number of key institutions were established during this period, providing a framework for

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\(^2\) George Parker and Robin Wigglesworth, ‘Osborne to launch Islamic bond plan’ (*FT.com*, 28 October 2013) [http://www.ft.com/intl/cms/s/0/1e8c9c2c-3ff9-11e3-a890-00144feabdc0.html#axzz2sz1JBg3H] accessed 1 March 2014.


\(^8\) *Ibid.*
cooperation between Islamic states. The Organization of the Islamic Conference Movement, which later changed its name to the Organization of Islamic Cooperation, was formed in 1970\(^9\). The Organization now boasts a membership of 57 countries\(^10\) and its modern day goal is to act as the collective voice of the Muslim world and to ensure that Muslim interests are safeguarded and protected.\(^11\) Shortly after the Organization was established, the inter-governmental Islamic Development Bank\(^12\) was founded (in 1974) to further the economic development of its member states in accordance with the principles of Sharia law.\(^13\) Today, the Bank has a 56-country membership and plays an active role in providing financial assistance, grants and equity to its members.\(^14\)

The creation of these institutions led many Muslim countries to establish their own Islamic banks. The Dubai Islamic Bank was created in 1975 followed by the Faisal Islamic Bank of Sudan in 1977. 1978 saw the establishment of both the Faisal Islamic Egyptian Bank and the Islamic Bank of Jordan.\(^15\) From only one bank in the early 1970s, the number had grown to nine by 1980.\(^16\) 1980 was also the year that the first Islamic Bank in a non-Muslim country was established: the International Islamic Bank of Investment and Development in Luxembourg.\(^17\) Growth of the Islamic banking sector continued between 1981 and 1985 during which time twenty-four more Islamic banks and financial houses were created.\(^18\) Islamic banking was therefore the first sector of the Islamic finance industry to develop, and it still maintains a central role in the modern day global economy. However, today’s modern Islamic finance industry is not limited to Islamic banking. It also incorporates related fields such as the Islamic capital markets and the Islamic insurance industry. It is fair to say that modern Islamic finance has grown and diversified to become a powerful force on in the twenty-first century global financial stage.

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\(^11\) Ibid.


\(^14\) Ibid.


\(^18\) Saeed (n 16) 15.
2.1 Five Key Principles

Islamic finance is based on Sharia law, the law of Islam, and stems from two main sources: the Quran and the sunnah.\textsuperscript{19} The former is the holy book of Islam and the latter is the way of life adopted by the Muslim Prophet Mohammed. These sources form the basis for Sharia religious law which addresses all areas of Islamic society from marriage to commercial dealings.\textsuperscript{20} For the purpose of the financial industry, Sharia law has created a set of ‘interrelated norms’\textsuperscript{21} that must be respected in order for financial transactions and services to be Sharia-compliant. It is this compliance that distinguishes Islamic finance from conventional finance. One writer has identified five key principles that underlie Sharia-compliant finance: a belief in divine guidance, the prohibition of interest, the prohibition of haram investments, the encouragement of risk sharing and financing based on real assets.\textsuperscript{22}

The first principle is the belief that the universe was created by Allah and humans must always obey Allah’s commands, including when engaging in financial transactions. Religious teaching therefore dictates how the Islamic finance sector will operate in contrast to conventional financing in which religion and governance are usually separated or have only a passing connection with religion.

The second principle prohibits interest. This means that a lender cannot require a borrower to pay interest on a loan, nor can a lender earn interest on a loan. The paying of interest in a conventional financing structure is therefore proscribed. However, this does not mean that money is borrowed or lent for free. Rather than paying interest, the borrower must pay a fee for the loan or share the profits acquired from the loan with the bank or financial institution that originally lent the money.

The third principle, the prohibition of haram investments concerns the nature of financial investments. Haram means forbidden\textsuperscript{23} or sinful, and prohibits financial investments in industries such as tobacco, alcohol or arms. Although such investments are not prohibited in

\textsuperscript{20} Vogel and Hayes (n 7) 4.
\textsuperscript{21} Ibid.
conventional financing, the prohibition of *haram* investments has some similarities with socially responsible investing. Socially responsible investing encourages investors in conventional financing investments to consider environmental, social and corporate governance issues as well as financial return.24

The fourth principle encourages risk-sharing and is intended to promote the equal distribution of risk, profits and losses between business partners. It is also intended to promote transparency and trust in financial transactions. It is predicted that current market instability will increase demand for products that encourage risk-sharing in both the Islamic finance sector as well as within conventional financing25.

The final principle, that financing is to be based on real assets, is intended to curb speculation and credit expansion in business transactions by ensuring that financial transactions are based on the state of the economy at the present time. In contrast, conventional finance can sometimes be based on the promise to pay in the future therefore allowing financing to grow ahead of the real economy.26

These key principles must be adhered to for a financial transaction to be Sharia-compliant and permissible under Islamic law. The Islamic finance industry has therefore created structures and frameworks to ensure an effective functioning financial market which also conforms to the religious law that governs it. The rest of this article focuses primarily on the prohibition of interest, also known as *riba*, and the *sukuk* bond structure. The *sukuk* bond adheres to this prohibition principle but is also an important financial instrument on the Islamic global capital markets.

### 2.2 Prohibition on the Riba and the Sukuk Bond

The prohibition of interest or *riba* is a key feature of Islamic finance.27 The literal translation of *riba* is ‘increase’, but in financial transactions it refers to a general prohibition on interest. In the debt capital markets, the *riba* prohibition means that Islamic investors cannot trade in pure-debt securities which pay interest to the buyer of the security. The capital markets

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26 Abdullah and Chee (n 22) 6-7.
27 Visser (n 19) 31.
have therefore created alternative financial instruments which do not pay interest and so are permissible as Sharia-compliant.

One such alternative financial instrument designed to avoid the prohibition is the sukuk. The sukuk structure was first developed in Bahrain and Malaysia in the 1990s and one of the first sukuk was issued in 1990 by Shell MDS in Malaysia. The sukuk has commonly become known as the Islamic equivalent of bonds, although a close analysis of the sukuk shows that it incorporates elements of both shares and bonds depending on the underlying Islamic financial contracts and structures. The sukuk is designed to generate the same economic effects as conventional bonds but in a Sharia-compliant manner. It is therefore not a pure debt security, which is proscribed by the riba prohibition, but is linked to the performance of an underlying real asset such as a mortgage or home equity loan. Each sukuk holder, unlike pure debt securities, has an undivided beneficial ownership in the underlying asset and is entitled to a share in the revenues generated by the asset, as well as a share in the proceeds of the realisation of the asset. Because the sukuk derives its return from the performance of the asset and not from interest it is Sharia law compliant. The sukuk is issued in the form of a certificate which entitles the certificate holder to trade the sukuk on the international capital markets. The distinction with conventional pure debt securities is that what is being traded on the capital markets is not merely a debt claim but an ownership right in a tangible asset.

The sukuk can be described as a success story on the international stage. It plays an increasingly important role in modern day Islamic capital markets and it is expected to continue to be a key financing tool in the coming years. A recent report concluded that total sukuk

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33 Iqbal and Mirakhor (n 28) 177.
35 Saeed and Salah (n 31) 47.
issuances in 2013 totaled approximately $120 billion and in the United States for example, US-dollar denominated sukuk issuances doubled from $9.5 billion in 2011 to $18.4 billion in 2012.37 It is no surprise therefore that this increasingly successful market is attracting new entrants. As noted above, the UK government plans to issue its first sukuk. A recent news announcement stated that HSBC will provide the necessary financial advice to the government for the sukuk bond issuance to ensure compliance with Islamic finance principles.38 This push from the UK government to be involved in the sukuk industry is also being duplicated in other parts of the world. Hong Kong has recently introduced legislation to allow for the issuance of a sukuk39, and South Africa announced in February 2014 that it plans to debut its international sukuk this year in an attempt to diversify its debt portfolio.40 This has led to predictions, such as that from FitchRatings, that 2014 may be a record year for the Sharia-compliant debt market.41

3. UK Islamic Finance Industry

The Islamic finance industry is not a completely new phenomenon in the UK. Over the past thirty years, a regulatory and legal framework has been established supporting the growth of Islamic finance42, alongside the increased flow of Middle Eastern capital into London.43 Islamic finance is without a doubt a visible part of the UK’s economic skyline. Currently more than twenty UK banks offer Islamic financial products and services. One example is the Islamic Bank of Britain, which offers over thirty Sharia-compliant retail financial products to UK

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37 Hancock (n 36).
consumers.\textsuperscript{44} The London Stock Exchange also has a highly active role in the Islamic finance market. It describes itself as a ‘key global venue’ for the issuance of \textit{sukuk} and has issued forty-nine \textit{sukuk} worth over $34 billion to date.\textsuperscript{45} Islamic finance has also been used to finance major UK infrastructure projects such as The Shard, the Olympic Village as well as Harrods\textsuperscript{46}. Other industries are also developing their Islamic finance capacities. Within the legal sector, twenty-five UK law firms have sizeable Islamic finance departments\textsuperscript{47} and Islamic finance has been described as ‘one of the fastest growing areas of law’.\textsuperscript{48} Similarly, the UK’s largest accountants, consultants and professional service firms now provide Islamic finance advisory services to a range of clients.\textsuperscript{49}

The UK government has played an active role in skilfully pursuing the creation of this Islamic sub-economy.\textsuperscript{50} Considering its success in introducing Islamic finance into the UK, some commentators have said that David Cameron’s announcement to issue a \textit{sukuk} bond ‘represents little more than the logical next step in Britain’s embrace of Islamic finance’.\textsuperscript{51} The announcement does however represent a deeper commitment to engage with the industry going forward and declare that the UK is open for Islamic finance business. Alongside the \textit{sukuk} bond, David Cameron has also announced that the London Stock Exchange is creating a new way of identifying Islamic finance opportunities with the launch of a world-leading Market Index. Furthermore, the government is partnering with the Shell Foundation to create a new £4.5 million grant to boost the work of the Nomou initiative. The Nomou initiative is a growth fund, providing skills and finance to small Middle Eastern and Gulf businesses and is intended to provide opportunities for British companies in the long-term.\textsuperscript{52} There is no doubt that Cameron hopes that the UK economy will reap the benefits of increased investment and activity in Islamic finance and aims to put in place a number of mechanisms to exploit these benefits. At the same time, it should not be overlooked that, alongside the benefits, Islamic finance also

\textsuperscript{44} UK Trade & Investment (n 42) 38.
\textsuperscript{47} Prime Minister’s Office, 10 Downing Street (n 1).
\textsuperscript{49} UK Trade & Investment (n 42) 4.
\textsuperscript{50} Ercanbrack (n 43) 70.
\textsuperscript{51} A.R., (n 46).
\textsuperscript{52} Prime Minister’s Office, 10 Downing Street (n 1).
presents its own challenges. For the industry to truly thrive, these challenges must be identified and adequately addressed by all those who operate within the sector.

### 3.1 Opportunities and Benefits

The *Financial Times* has described industry insiders as thrilled at the announcement of the government’s plan to launch an Islamic bond.\(^{53}\) The *sukuk* structure has always been used as an alternative method for corporates and states to raise financing,\(^{54}\) and for many investors it is an appealing alternative to a conventional bond because it results in a share in an asset rather than a share in a debt.\(^{55}\) Increasing activity in *sukuk* bonds and the Islamic finance sector therefore has the potential to open up the UK economy to new investors and market participants. This is particularly valuable at a time when Western sources of capital are limited and the UK needs to diversify its capital base. Tapping into Islamic private and corporate investors is particularly beneficial considering the recent financial crisis. Whereas many Western investors have suffered since the 2008 downturn, and have less capital as a result, some Islamic investors have considerable oil wealth and as a result have not been damaged by the financial crisis at all.\(^{56}\)

As well as the potential for significant economic benefits, Islamic finance also has the potential to bring further wide-reaching benefits for the UK. George Osborne, writing for the *Financial Times*, highlighted that the Islamic finance industry will bring greater job prospects,\(^{57}\) and Baroness Warsi has pointed out that the Islamic finance industry addresses the UK’s desire for ethical finance.\(^{58}\) In a time when unemployment is an important political and social issue, and the financial industry is coming under increasing scrutiny for irresponsible practices, Islamic finance is a particularly attractive alternative. Furthermore, expanding the

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\(^{55}\) Ibid.


Islamic finance industry also recognises the UK’s diverse multicultural society and the need to provide a range of services and products that address cultural differences. According to the Office for National Statistics, the Muslim population in England and Wales in 2011 was 2.7 million, which equates to 4.8% of the population.\(^5^9\) This is a sizeable portion of the UK who may wish to access Islamic finance products and services. Continuing to grow the Islamic finance sector would therefore help to address this potential demand and encourage diversification in the financial markets.

### 3.2 Industry Challenges

However, alongside the benefits of the Islamic finance industry are multiple challenges. The legal and taxation landscape in the UK has developed around conventional financial transactions rather than the transactional structures of Islamic finance. It is therefore vital that the UK legal and tax framework can adapt to accommodate these differences. For example, because Islamic finance structures are typically asset-backed they could be exposed to multiple tax liabilities that conventional lending structures are not. This is potentially a significant deterrent for industry growth. The London Stock Exchange has introduced some important changes in tax liabilities which support the Islamic finance industry. These include the removal of a double tax on Islamic mortgages, as well as reform of the arrangements for issues of debt so that returns and income payments in Islamic finance can be treated as if they were interest.\(^6^0\) These changes signify a commitment to ensure that the UK economy can support Islamic finance. However, the UK must be able and willing to continually review and adapt its legal and regulatory framework to support the Islamic finance industry as a whole.

For any industry to thrive, it must possess a readily-available and skilled workforce, knowledgeable of how the sector operates. The UK needs an educated pool of individuals ready to play an active role in Islamic finance in order to fully exploit its potential. Recent statistics suggest that the education sector is adapting to meet this need. A Reuters 2013 report claims that sixty UK institutions offer Islamic finance courses, and twenty-two universities offer similar degrees. Bodies such as the Islamic Finance Council also provide training services to people around the world.

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corporate and educational institutions. Still, concerns have been raised about how the UK Islamic finance education sector measures up to its Gulf counterparts. Daud Vicary Abdullah, the chief executive of the International Centre for Education in Islamic Finance (INCEIF) specialising in Islamic finance, says that UK expertise in the industry is ‘spread very thin’ and that the standard of education in UK universities is ‘variable’. A *New Statesman* report also highlights a lack of expertise as an area of weakness for the UK Islamic finance industry. However, the report emphasises that this particular weakness is an obstacle that can be overcome. With determination, forward-planning and investment from both government and private bodies, the UK has the ability to grow its Islamic finance expertise by investing in education and training facilities. In doing so, the UK will increase its ability to make the most of the benefits that the Islamic finance industry has to offer.

Another challenge for Islamic finance operates at a global level. There are a variety of schools of thought concerning the interpretation of Sharia law. Scholars from these competing schools of thought often have contrasting views on Sharia law’s meaning. A particular structure or process may therefore be Sharia-compliant to one school of thought, but not to another. In practice, this means that a financial transaction may be acceptable in one particular Sharia law jurisdiction but not accepted elsewhere. Combating this lack of uniformity requires global standardisation as to Sharia-compliant financial products and services. Some initiatives for such a standardisation have already taken place. The Accounting and Auditing Organization for Islamic Financial Institutions publish Sharia standards in an attempt to provide a degree of harmonisation. Yet the very nature of Sharia law, with its roots in religious historical doctrine, raises concerns over whether true standardisation can ever be achieved.

Challenges for the UK Islamic finance industry therefore operate at both a national and global level. Being aware of such challenges and formulating ways to try and address them is a significant part of creating a thriving Islamic finance sector.

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63 Ibid.
64 Knowles (n 54).
4. Conclusion

With Global Islamic investments having increased by 150% since 2006, and an estimate by accountants that the sector is growing 50% faster than the overall banking sector, Islamic finance presents a potentially profitable area for the UK. In an era when the economy is attempting to grow its way out of recession, Islamic finance is another way for the UK to diversify and attract new business. However, it also presents its own unique challenges which must be addressed. As this article has illustrated, the UK government has taken steps to support the industry and provide an environment in which Islamic finance can operate and flourish. Nonetheless, other countries across the globe can be considered as potential competitors for Islamic finance in the UK such as Istanbul, Hong Kong and New York. It is more important than ever, if the UK wishes to capitalize on the potential benefits of the industry, for government, business and society to work together to collectively embrace and support the Islamic finance industry as a whole. I have sought to highlight some of the key benefits and challenges that the current UK Islamic finance sector presents. The sukuk bond is an attractive source of financing for companies and governments and an increase in sukuk issuances demonstrates that there is growing interest in the sukuk. There is no doubt that the industry has significant growth potential but for the UK to take advantage of this growth it must encourage and develop its Islamic finance sector.

One commentator has outlined four ways that the UK can continue to develop Islamic finance and encourage activity in the sector. First, through engagement with key players in the industry such as businesses, retail groups, Sharia scholars, financial products providers and regulators. Second, by encouraging existing UK Islamic banks and financial institutions to invest in order to ensure that they maintain a competitive edge in the global Islamic finance market. Third, by ensuring that the UK legal, regulatory and financial environment works in coordination to promote London as a competitive centre for future Islamic finance activity. Finally, the UK can develop and encourage the Islamic finance sector by demonstrating to the rest of the world market that London has the necessary conditions for Islamic finance to operate and grow.


68 Ibid.
In relation to this final method of demonstrating to the world the UK’s commitment to the Islamic finance sector, there is no doubt that David Cameron’s recent announcement to issue the UK’s first *sukuk* bond is a ‘positive move’\(^{69}\) in the right direction. When the *sukuk* bond is issued, it should signify to investors that the UK is truly open for business in Islamic finance. The hope is that it will then bring further growth in this sector and allow the UK to take full advantage of all the benefits that can accompany this growth.

\(^{69}\) Asutay (n 67).