



Update on the Development of Islamic Finance in the UK and the Regulation of Alternative Finance Investment Bonds (Sukuk)

On 10 December 2008, HM Treasury, together with the Financial Services Authority, published a paper setting out the UK government's perspective on Islamic finance in the UK,¹ as well as a joint consultation paper (the "Consultation")² on the legislative framework for the regulation of alternative finance investment bonds ("AFIB" or "sukuk"). Together the documentation serves to demonstrate the strength of political will to "enhance the UK's competitiveness in financial services by establishing the UK as a gateway for international Islamic finance," while also suggesting some of the ways in which this might be achieved.

The Focus on Islamic Finance

In 2008, shariah-compliant assets in the United Kingdom amounted to a total value of over \$18 billion. It is therefore unsurprising that there are now five standalone Islamic retail and wholesale banks, as well as a shariah-compliant insurance company. Many other conventional banks in the UK also provide shariah-compliant services through "Islamic windows," whereby they can offer expertise in Islamic finance to businesses and members of the public. It is against this background that the UK government is now seriously considering the role of the UK as a centre for Islamic finance.

Thus far, we have seen limited political desire for the UK government to take a more direct role in offering Islamic products to the UK market. In April 2007, the government announced that it would be considering the issue of a wholesale sovereign sukuk, as well as the feasibility of offering shariah-compliant retail banking products via National Savings & Investments. However, by June 2008, the government had concluded that neither of these measures would provide value for money, although they would keep the matter under review.

Instead the government has opted to support Islamic finance via more indirect means by identifying the various market barriers, which they believe exist, and using legislation to ensure that shariah-compliant products can be offered and can compete on an equal footing with more conventional forms of finance. In particular, efforts have been made to ensure that existing tax and regulatory systems in the UK do not distort the market for investors wishing to invest in those types of products.

¹ http://www.hm-treasury.gov.uk/d/islamic_finance101208.pdf.

² http://www.hm-treasury.gov.uk/d/consult_sukuk101208.pdf.

Alternative Finance Investment Bonds

As part of the UK government's approach of regulating Islamic products on a more equal basis with other more conventional debt products, the UK Treasury has looked specifically at an issue arising in the context of AFIBs. These are essentially sukuk or Islamic bonds, but they can also refer to any other financial instrument with similar characteristics. The term encompasses a broad range of financial instruments which replicate the economic effect of conventional bonds and are typically issued by either corporates or sovereigns and listed on a recognised investment exchange.

Regulation of AFIBs

There is, at present, a distinct lack of clarity with respect to the categorisation and treatment of AFIBs within the UK regulatory framework. In its consultation, the Treasury accepts that, until now, AFIBs have had to be regulated on a case-by-case basis. This is primarily a result of the wide variety of structures available in the Islamic finance market, making it difficult to slot each product into an appropriate place within the existing legal framework. Some AFIBs, for example, are structured such that the risk of the security is directly linked to the credit risk of the originator ("Fixed Income Sukuk"). Others relate the potential security risks to the performance of the underlying assets ("Asset Backed Sukuk") or combine this structure with a Fixed Income Sukuk to generate a hybrid product.

The resultant ad hoc approach has meant that some AFIBs have been found to fall within the definition of a Collective Investment Scheme ("CIS"), as set out in the Financial Services and Markets Act 2000.³ As a consequence, AFIB issuers have become subject to additional regulatory controls which are not necessarily appropriate for these types of products. These might include restrictions on gearing, marketing and even the range of assets for investment. Such limitations, therefore, potentially disadvantage AFIB issuers compared to more conventional debt issuers.

Proposals for Amendment to AFIB Regulation

The proposals as set out by the government in the Consultation focus on the need to create a new category within UK legislation, tailored specifically to cover AFIBs. Four approaches have been suggested:

- 1) to create a new specified instrument (AFIBs) under the Regulated Activities Order (RAO),⁴ and then to specifically exempt AFIBs from the regulations governing CISs;
- 2) to follow the first approach, although the definition of AFIBs will come from an existing tax definition;⁵
- 3) to follow the first approach, although AFIBs would be included as a sub-category of "an instrument creating or acknowledging indebtedness;" or
- 4) to "do nothing."

In addition, it is proposed that all AFIBs should be subject to mandatory listing requirements on a recognised stock exchange. This is in order to prevent regulatory arbitrage as a result of the proposed legislative changes. The risk being addressed here is that other instruments not intended to be covered by the new (or existing) AFIB definition could otherwise potentially benefit from the proposed carve-out where that was not the intention.

³ A CIS is "any arrangement with respect to property of any description...the purpose or effect of which is to enable persons taking part in the arrangements...to participate or receive profits of income arising from the acquisition, holding, management or disposal of the property."

⁴ <http://www.opsi.gov.uk/si/si2001/20010544.htm>.

⁵ As used in the Finance Act 2005.

Conclusion

The Consultation is open to the public until 4 March 2009. Given the current demand for new sources of funding and strength of political will for change, it seems unlikely that the “no change” approach will be adopted. Any of the first three approaches, however, should provide much needed clarity and, therefore, facilitate the issuance of AFIBs as a result of a reduction in both legal and compliance costs.

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