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Practice Group:

Islamic Finance and Investment

Recent Issues in UK Islamic Finance

By Jonathan Lawrence

This insight will draw together four themes: the current state of UK Islamic banks; the possibility of a UK Sovereign Sukuk; UK real estate and its growing importance for Islamic Finance in the country; and the UK's battle to be the hub for Islamic Finance in Europe.

We are pleased to announce the addition of two new partners to our Islamic Finance & Investment Group - Amjad Hussain who joins our Doha office from Eversheds and Sean Crosky who joins our London office from Norton Rose. Having recently been ranked for our Islamic finance practice in Legal 500 UK and Chambers UK, we look forward to continuing to work with you on your Islamic compliant structures and products.

Key Points:

- The past year or so has seen the growth of Islamic funds and Islamic banks providing mezzanine finance – with the mezzanine finance tranche being slotted into the structure in an Islamic compliant way.
- Many commentators say that the European debt crisis has made a Sovereign Sukuk in Europe a more remote possibility.
- With other jurisdictions seeking to attract Islamic Finance transactions, the UK will need to support and develop its Islamic banking infrastructure further if the UK is to maintain its competitive advantage in Europe.

UK Islamic Banks

All the UK Islamic Banks are relatively recently established in comparison with conventional banks.

First to be established was Islamic Bank of Britain (IBB) in 2004. Although we refer to it as a UK bank, in fact it has been owned by Qatar International Islamic Bank since 1 June 2011. Its Chairman is Chief Operating Officer of the Qatar Investment Authority. IBB is the only wholly Islamic compliant UK retail bank. It serves individual customers and small businesses. It has about seven branches throughout the country and is headquartered in Birmingham. It recently opened a new branch in West Yorkshire, with further openings planned in 2012. It runs a branch agency model, for example sharing office space with local estate agents. IBB's products include a Home Purchase Plan and a 'Buy to Let' Purchase Plan. In the latter, the customer puts down a 25% deposit for the property and the Bank acquires the rest. The customer then pays a rental rate of 5.49% and an arrangement fee of 1%. It follows a joint ownership and rent model.

The European Islamic Investment Bank (EIIB) was formed in 2005. EIIB now looks primarily to the Gulf Cooperation Council countries for its investments and clients.

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In its annual report of 2010, its chairman said "EIIB's funding strategy has shown itself to be over-optimistic and incompatible with the dramatically changed business environment resulting from the global recession". It had previously advised in several areas, including investment management, private equity and banking. EIIB underwent a restructuring in November 2011 and then on 6 January 2012, EIIB made a major investment in Rasmala Holdings. Rasmala is a leading investment bank in the GCC and Egypt and is licensed by the Dubai Financial Services Authority. Rasmala has about 140 people in the region. There will be a leading management role for EIIB and its stake was paid for by the closure of one of its existing equities funds.

The Bank of London and the Middle East (BLME) was established in 2006. It is an Islamic compliant wholesale bank. Its activities include leasing deals in the transport and equipment sectors based on Ijara structures. BLME lends in the real estate and real estate construction areas. In May 2011, it established a Light Industrial Building Fund. The first purchase for the Fund was a 40,000 square foot light industrial unit in Bournemouth. The Fund has an expected 5 year life cycle and a target final value of £200m. The Fund is expected to make annual cash distributions.

Gatehouse Bank was formed in 2007. It is ultimately under Kuwaiti ownership. Gatehouse has a reputation and specialisation in the real estate sector. It has made approximately £300m of real estate investments in the past two years. The asset classes include office space, UK student accommodation, industrial facilities and US properties. Gatehouse has also partnered with others in new ventures: GNL Insurance, the world's first Islamic compliant insurance broker; and GSH Kuwait, a real estate advisory firm. Recent real estate transactions by Gatehouse include, in January 2012, the sale of a Californian medical facility, which it had held for 18 months and, in the same month, the purchase of a data centre in the south of England.

UK Sovereign Sukuk/Alternative Financial Investment Bond

The most recent public statement on this issue came from Lord Sassoon, the Commercial Secretary to the Treasury in January 2012. At an Islamic Finance event he said that a UK Sovereign Sukuk "does not currently offer value for money, at a time when Treasury gilts are giving their lowest yield. The priority [for the Treasury] is to raise the cheapest debt in relation to fiscal discipline".

In shorthand terms, a Sukuk is an Islamic bond or investment certificate. The structure involves a company or government identifying tangible assets on its balance sheet to back the Sukuk. Assets are placed into a special purpose vehicle company that issues the Sukuk to Sukuk holders who place their funds with the SPV company for a return on their investment. The issuer then leases back the assets to the original company or government. Lease payments to the special purpose vehicle from the company or government are distributed to Sukuk holders as income flows. Corporates must have unencumbered assets to do this. However, in theory, it should be relatively easy for governments to enter into this structure if they have the desire given the number of assets they own.

The original plan for a UK Sovereign Sukuk had been for an issue of approximately £2bn with a £100m-200m initial issue. The UK government would have used its own assets to support this via a lease structure. As no interest can flow under Islamic law, only rental payments could be made. The government would lease the right to use assets, such as bridges or roads, to a special purpose vehicle company which would then lease the right to use the assets back to the government for a rental stream.

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Such an issue would be important for UK Islamic banks as they would be assets in which such banks could invest without the danger of contamination by interest. The Basel III regime due to come into force will mean that the only commercial paper on which UK Islamic banks could currently rely would be that issued by the Islamic Development Bank. Therefore there is a real need for a government Sukuk here or in Europe in order for UK Islamic banks to continue to develop. In the meantime, there has been a call for UK Islamic banks to be able to keep deposits at the Bank of England as a safe haven.

At the same event at which Lord Sassoon spoke, Lord Sheikh, the Chairman of the Conservative Muslim Forum, said that the UK has more than £18bn of Islamic assets, more than any other Western centre. Many commentators say that the European debt crisis has, in fact, made a Sovereign Sukuk in Europe a more remote possibility.

UK Real Estate

Real estate has been an increasingly important asset class for Islamic Finance transactions and banks. It has proved to be an alternative source of funds going into the UK real estate market as witnessed by such high profile real estate deals as the Chelsea Barracks and the Shard of Glass.

Islamic finance in the UK has used real estate as an investible, tangible asset class on which to base its financial structures. For non-UK investors, the focus has tended to be on prime or trophy assets: for example, hotels or large office headquarter buildings. However, the past year or so has seen the growth of Islamic funds and Islamic banks providing mezzanine finance. In such structures, a conventional senior bank lends the majority of the debt on an interest payment basis, the investors inject their equity and the mezzanine finance tranche is put into the structure in an Islamic compliant way. This is a feasible way of ensuring that deals get done. The senior conventional bank and the Islamic compliant mezzanine lender enter into an intercreditor agreement which governs the way each loan is treated and takes account of the Islamic sensibilities of the mezzanine lender.

Student accommodation in the UK has been a major target for Islamic funds given the existence of rental guarantees, steady demand and upward only rental payments. We may see further developments in this sector due to a broadening view of social infrastructure to include healthcare, education and social housing sectors. Prime residential properties are still a focus, with an Islamic compliant fund launching in September 2011 to offer Islamic investors exposure to this market.

The UK's battle for Europe

The UK has enjoyed an in-built advantage in its attempt to become the hub of Islamic Finance in Europe. This is due to English law often being the governing law of international Islamic Finance transactions. There may be a Swiss bank and a Middle Eastern counterparty wanting to enter into an Islamic Finance transaction. However, they may well chose to use English law to structure their documentation in order to give flexibility and certainty to both sides.

Nonetheless other jurisdictions have sought to attract Islamic Finance transactions. For example, in 2010, Ireland introduced a tax neutrality regime for Islamic Finance. Ireland has signed over 60 double tax treaties ensuring there is no double taxation for such structures (for example, treaties with Malaysia, Saudi Arabia and the United Arab Emirates). The Irish government has called an Irish government Sukuk 'an option'. Dublin is already well developed as a financial centre.

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The Irish Stock Exchange listed its first corporate Sukuk in 2005. The Goldman Sachs Sukuk secured Irish listing approval in 2011. However, Ireland only has a Muslim population of approximately 30,000 and this may hamper the development of the industry. Nonetheless in 2008, the Irish Financial Regulator introduced a dedicated team to help Shariah compliant funds set up in Ireland. In January 2012, a Malaysia-based international equity funds platform was set up in Dublin.

Luxembourg ruled out a government Sukuk in 2011. However, the country has attracted over 40 Islamic funds. If Luxembourg could be the first European country to issue a government Sukuk then it would certainly put it on the map.

France has a Muslim population of over 3.5million. However the political climate has not been conducive to the development of the industry over the past few years. The UK has had a first-mover advantage over France and the UK property market attraction for Middle Eastern investors has also put the UK ahead.

Turkey is a country to watch. Straddling Europe and Asia its 70m plus population is 99% Muslim. Companies are allowed to issue Islamic compliant debt and the first corporate Sukuk has been undertaken by a leading Turkish bank.

Conclusion

The issues mentioned in this insight intermingle. The UK banking infrastructure is there but needs development; the UK government attitude has been ebbing and flowing; the real estate market has been an aid to development; however the UK competitive advantage in Europe will need to be maintained.

Authors:

Jonathan Lawrence

jonathan.lawrence@klgates.com

+44.(0)20.7360.8242

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