Sizing up London Sukuk

By Benjamin Macfarlane

Sukuk, often referred to as "Islamic bonds", are akin to Islamic "investment certificates". Unlike bonds, which are debt-based instruments that pay interest, Sukuk are asset-based and represent the ownership (actual or beneficial) by the Sukuk holders in the underlying asset.

Returns are paid to investors in line with their proportional ownership in that asset. These certificates are designed to comply with Shariah law, the divine law of Islam that is based on the Quran and other sources.

The UK government has rolled out its plans to become one of the first European governments to issue Sukuk in 2008.It has already taken a lead in establishing the first secondary market in Islamic bonds, although with small volumes, and has also undertaken the first attempt at creating Shariah compliant hedge funds.

Experts agree that the UK is currently the strongest European center for the industry and that as a major international financial center, with strong ties to Asia and the Middle East, London has developed as a gateway for Islamic financial activity, particularly structuring and listing, with 13 Sukuk currently listed out in the UK.

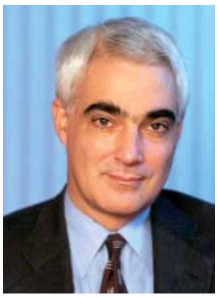
Government's aims

Issuing Sukuk has been on the agenda of the UK government for quite some time and the introduction of new measures for Sukuk in the 2007 budget confirmed its commitment. The budget enabled Sukuk to be issued, held and traded in the same way as corporate bonds. Sukuk are already listed on the London Stock Exchange and London's secondary Sukuk market is experiencing tremendous growth.

In April 2007, the Economic Secretary to the Treasury announced that HM Treasury and the Debt Management Office would carry out a feasibility study into the potential for the government to become an issuer of Islamic financial instruments in the wholesale sterling market, consulting with the Islamic Finance Experts Group and reporting on progress at the time of the 2007 Pre-Budget Report ("PBR").

The government's stated aims for Islamic finance are:

- To establish London's position as a global gateway for Islamic finance as part of the city competitiveness agenda being pursued by the Chancellor of the Exchequer's High Level Group; and
- To create a level playing field for alternative finance and investments, such as Islamic finance, in the retail market.



The UK took another step toward the eventual issuance of its debut sovereign Sukuk, when the Chancellor of the Exchequer Alistair Darling (*pic*) announced in his PBR that progress has been made in this regard.

The government reported that it had identified a number of potential benefits of Sukuk issuance flowing to the City of London and to the wider community. It had also identified a number of potential costs, including the costs of both structuring and launching Sukuk, as well as other costs that are dependent on the size and nature of the issuance.

The government envisages that if it issues Sukuk, there may be benefits for the financial and wider community, particularly:

- In demonstrating it has a commitment to Islamic finance products and so giving impetus to London developing as a center for Islamic finance.
- In facilitating the development by banks of a greater range of Shariah compliant retail financial products.

In November 2007, HM Treasury finally published the long-awaited consultation document on "Government Sterling Sukuk Issuance". According to the ministry, it is seeking views on the advantages, disadvantages and risks flowing from any Sukuk issuance.

The consultation, which closed on the 21st February 2008, focuses on the feasibility of the government issuing Sukuk denominated in sterling in the wholesale market either in "bond-like" form (having a maturity of greater than one year) or "bill-like" form (a maturity of less than one year).

The government's aim is to minimize differences between Sukuk issuance and bonds and bills. It is particularly concerned about differences that could make a Sukuk issuance, either by its office or by corporate issuers using the same structure, a less attractive investment. Issues on which views are sought include structure, taxation, regulatory, listing, registration and liquidity management.

The publication of the consultation paper by the government was good news for the Islamic capital and debt markets, as there were reports that the government had abandoned its plans to issue Islamic bonds and this was not received warmly by finance lawyers.

'War' on UK Sukuk

There were also some doubts in the past as to whether the UK government was indeed committed to seeing through a Sukuk issuance debut, initially for benchmark purposes, following the departure of Ed Balls, the then Economic Secretary to the Treasury. However, all these doubts were removed by the publication of the consultation paper as a step toward issuance of the first sovereign Sukuk.

There were reports that suggested that UK politicians were committed to the issuance of Islamic debt instruments in the wholesale sterling market. However, there was a "turf war" between pro- and anti-Sukuk issuance factions among the Treasury civil servants.

The anti-Sukuk civil servants apparently believe that the Sukuk structures are too complex and far removed from current UK legislation and government debt management objectives, which, inter alia, prioritize low transaction costs and the cost of issuance of Treasury bills and bonds.

The supporters of Sukuk issuance believe that it is possible to launch a Sukuk at a competitive price with attractive yields at little or no cost to the UK taxpayer. They also believe that such a move would enhance

continued...

Sizing up London Sukuk (continued...)

the City's Islamic finance credentials as well as New Labour's social and financial inclusion policies.

According to the Financial Services Authority, the lack of Islamic scholars and global standards for Islamic finance still remains one the major issues that could hamper the UK's efforts to become a hub for Islamic finance.

Undoubtedly, there are as many political as financial reasons behind the proposal to borrow in accordance with Islamic finance law. However, issuing sovereign Sukuk would create the momentum for other western governments with an interest in Islamic finance and would help create a benchmark for UK private sector Islamic bond issues.

If private sector companies in Europe begin to fund themselves according to Islamic finance law principles, this will present a great opportunity for Shariah compliant investors from the Middle East to spread their risk.

The UK government has underlined its commitment to the Islamic finance sector in the recent March 2008 Budget, promising to examine the possibility of a sovereign Sukuk and also to take legal powers in the Finance Bill 2008 to facilitate any potential future issuance of Sukuk.

Darling, the Chancellor of the Exchequer, promised to provide an update on the Sukuk program, including the response to the public consultation on the issuance of a Sukuk in the wholesale sterling market.

Decisive action needed

It is understandable that in the post-credit crunch era, the government is cautious of financial instruments. However, it must recognize that London's position as the leading western center for Islamic finance is by no means assured.

Ireland and Luxembourg are already vying for a portion of the market. If their legislators are quick, they could grab some of London's share.

It is high time the UK government took some decisive action. Competition is heating up globally with Dubai, Bahrain, Malaysia, Qatar and even Saudi Arabia all competing to be the major global center of Islamic finance.

Furthermore, issuing a UK government Sukuk would help raise the profile of the European Islamic Investment Bank and Islamic Bank of Britain.

And last but not least, this first Sukuk from a western government would show that Islamic finance has secured a place in the world financial system, beyond the Gulf and Far East.

B.J. MACFARLANE & CO.

Benjamin Macfarlane is a partner at B J Macfarlane & Co, a law firm specializing in insurance, reinsurance, shipping and trade matters. He can be contacted at +44 20 7190 2988 or via email at b.macfarlane@bjm-co.com