CHAPTER 21

Legal & Regulatory Issues in Islamic Finance from a UK Perspective

21.1. Introduction

As the global economy teeters on the brink of recovery or possible lapse into continued recession, the way in which the Islamic financial industry has been affected by, and how it has responded to, the financial crisis is a topic that fascinates economists, practitioners and regulators alike. The Islamic financial industry, although rooted in ancient Quranic law and tradition, is in reality a tender plant that is being tested in the present economic climate. When the credit crunch first reared its head, there was a voluble expression of opinion (predominantly from the Middle East) that the ethical principles and theories that underpinned a Shari'a-compliant approach to finance and investment had steered the industry between the Scylla and Charybidis of sub-prime lending and securitisation. As the crisis deepened, it soon became apparent how intertwined the Islamic system and the conventional approach to finance actually were. In a globalised world, Islamic and conventional finance breathe the same air and swim in the same water. As global real estate and private equity values plunged, so did the portfolios of many IFIs. As debt maturities approached, the reliance placed by IFIs on inter-bank funding provided via the conventional markets also became apparent and the former confidence of many IFIs started to wane.

More recent defaults in the sukuk markets, the consequences of which remain the subject matter of ongoing restructuring attempts, or court action (and therefore unclear as the end of 2009 approached), together with a growing sense that certain parts of the Islamic financial industry has not been as true to its principles as it perhaps should have been, means that the future shape of the Islamic financial market is unclear. With the conventional banking system also coming under scrutiny by politicians and regulators, questions are being asked about whether the regulatory framework did enough to prevent the worst excesses of the sub-prime crisis and the credit crunch. They also wonder whether there are any 'alternative' ways in which a global financial system can operate that might have avoided the excesses and mistakes of the current system. Whilst some commentators might be willing to include Islamic finance in such an analysis, the reality is that Islamic finance is still questioning its own legal and regulatory framework in many of the markets in which it operates and is not yet sufficiently developed as a system to step into the breach.

Aside from the well known issues of scale, volume and a lack of experienced personnel, the major challenge faced by the Islamic financial community is how to find a way of presenting itself as a more joined-up 'system' that makes both legal and regulatory sense. The task is complex because any such system has to be capable of being understood and implemented in a wide variety of jurisdictions, both Muslim and secular. Various concurrent efforts have been undertaken, and continue to be made, to mark out the guidelines needed. The efforts of organisations like AAOIFI and the IFSB have to be lauded but there continues to be ambiguity about whether and how to apply the principles enunciated by both organisations in national legal systems. There also continue to be examples of the industry creating its own negative headlines by announcements that create internal friction when they appear confused and contradict market practices that have become 'standardised' with the approval of many recognised scholars. In such circumstances, the challenges faced by the industry are twofold: first, how to respond to the immediate crisis and secondly, how to develop legal and regulatory frameworks that balance the demands of Shari'a compliance with secular legal and regulatory systems, at a time when the current approach to global financial regulation is itself coming under intense scrutiny.

One of the most interesting phenomena of recent years and something that looks likely to continue in other countries, has been how the United Kingdom (a secular country with a relatively small Muslim population) and the English legal system have responded to this industry. The financial markets of the United Kingdom have been involved with Islamic finance since the earliest days of its modern renaissance through the provision of intermediation and advisory services together with various liquidity support products. However, it was not until a 1995 speech by the former Governor of the Bank of England, Lord Edward George, that the Bank of England intimated a willingness to understand the specific regulatory and supervisory issues surrounding the industry. From a public policy perspective, the early 2000s witnessed the government of the United Kingdom identify the Muslim minority in the country as a group whose access to the financial market-place should be facilitated on terms that accorded with their faith. Faced by the combined pressure of practitioners, community groups and various interested financial institutions, an alignment between politicians and regulators was eventually forged and 2003 proved to be the seminal year. The Finance Act 2003 introduced the first of an eventual series of tax reliefs that removed the double payment of stamp duty land tax (SDLT) on real estate transactions entered into by individuals. This was designed to facilitate the start of a more broadly based Shari'a-compliant home finance industry in the United Kingdom. Prior to this the (largely) murabaha-based products that had existed were only really being taken-up by high net worth individuals who could afford to pay the double stamp duty (as SDLT was formerly called) on both the original 'cost price' and also the marked-up 'deferred sale price', assuming no ad hoc exemptions were forthcoming from Customs & Excise. In the following sections of this chapter, we will examine how the relevant authorities in the United Kingdom have approached the Islamic financial industry from a regulatory perspective. The significant and embracing changes to those parts of the taxation system which impinge upon Islamic finance are mentioned only in passing since they are increasingly well known. Instead we will provide a description of how the English legal system has responded to contracts that are, or purport to be, Shari'a-compliant and have proven to be a flexible and capable tool, that have supported the global development and application of Islamic finance in numerous sophisticated cross-border transactions. Where appropriate we will look briefly at other systems and see how they have resolved similar issues in their own regulatory and legal frameworks.

21.2. The regulatory challenge

21.2.1 Fundamental differences

The regulatory challenge demonstrates some of the fundamental philosophical differences that exist between conventional and Islamic modes of finance. At the moment, there are two generic approaches to regulating Islamic finance. One is to create a parallel regulatory framework that is intended to apply specifically to Islamic financial products. Such a system may, in reality, be based on a conventional framework that has been specifically tailored to the demands of Islamic finance and evolved over time. This is a model that has effectively been followed in several Muslim-majority states such as Bahrain and Malaysia where the financial regulatory authorities in both States responded to the growth of Islamic finance by introducing frameworks to sit alongside their pre-existing conventional systems.

As an alternative to the 'evolutionary' process of creating a parallel regime, there is the formal creation of a regime, written on a bespoke basis that seeks to regulate the conduct of both conventional financial activity as well as Islamic financial activity. Such an approach is not really a 'parallel' system and has been called a 'formal two-tier system' but even that is perhaps an inaccurate description. Such a system seeks to create a prudential regulatory framework that caters for both conventional and Islamic activities by intertwining the features of both. This is achieved by having interpretation and application rule books that provide definitions and rules for both sectors. This approach tends to be the way in which the newly established financial centres (such as Dubai Financial Services Authority (DFSA) and the Qatar Financial Centre Regulatory Authority (QFCRA)) have gone about authorising such activities.

What is interesting about these regimes (however they are described) is that within many Muslim / Muslim-majority states, you find a bifurcated regulatory framework that still recognises conventional finance (indeed, in many such states, conventional modes of finance still predominate in terms of overall activity) but that has created a very specific space in which Islamic financial institutions are enabled to operate. If conventional banks want to offer Islamic financial products they are required to follow the rules and regulations set out in the parallel regime and seek the appropriate authorisations. In definitional terms, an 'authorised firm' for Islamic finance purposes will typically conduct 'Islamic Financial Business' and either take the form of an 'Islamic financial institution' or an 'Islamic window'. The distinction between an Islamic financial institution and an Islamic window usually being that the former conducts its entire business in accordance with Shari'a whilst the latter only conducts a part of its business in accordance with Shari'a. Of course, a further 'check' on whether and how conventional banks can provide such services in some Muslim-majority countries will also be the fact that they may not be allowed to offer onshore banking services and products (whether conventional or Islamic) in the first place because of restrictions that prevent the operation of foreign controlled financial institutions in the jurisdictions concerned.

Under such regulatory frameworks, there will always be concerns about whether and how the two regimes are applied. Will there be parity of treatment by the regulator towards both authorised firms and their customers whether they are Islamic or conventional? From an administrative perspective, it is crucial for the regulators to ensure that the regulatory framework of both systems is applied consistently and fairly to the firms subject to the regulations. However, perhaps one of the most important considerations is how the customers of the regulated firms will fare as a consequence of the regulatory approach on those issues of critical distinction between the Islamic financial system and the conventional financial system? As will be explained in the next section, the single regime approach, as applied in the United Kingdom, requires a compromise on the part of the IFI, in order to ensure the customer has the opportunity to avail him-

self of the protections available in the United Kingdom (i.e. under the conventional system). Of course, it is arguable that the issue does not need to be addressed by a parallel Islamic regulatory system because different parameters can and should apply if the Islamic approach to finance is to maintain its distinctiveness. However, there will be other relevant considerations that should be given appropriate weight; namely the issue of transparency and full disclosure. One potential criticism of the Islamic financial system at the present time is that much of its client-facing documentation fails to be as transparent as it could be about the nature of the business activities and the risks involved for customers when they entrust funds to an IFI. If the Islamic financial system is not to offer any 'protection' to customers, it must be scrupulous about disclosure. Although various regulatory regimes have disclosure requirements, it is not always clear how fully these requirements are complied with.

21.2.2. A single regulatory framework

The alternative to the parallel approach is to maintain a single regulatory framework and seek to fit Islamic modes of finance within that. The latter approach is the one that has been followed in the United Kingdom over the past five or six years as the City of London has sought to position itself as the leading centre for Islamic finance in the Western world. The types of changes required to financial and legal infrastructures to facilitate Islamic modes of finance may seem relatively simple but in reality they are often complex and have to be undertaken with sensitivity and awareness of political and commercial issues. The experience of the United Kingdom is one that may offer insights and guidance to other countries contemplating how to go making the sort of legal, fiscal and regulatory changes necessary to facilitate Islamic finance. In certain respects, the case can now be made that Islamic modes of finance are often more feasible in the United Kingdom than they are in many Muslim majority states because of the advances that have been implemented. In the remainder of this chapter we shall look at certain aspects of this development in the United Kingdom, since they may well shed light on the types of changes that could usefully be made in other countries (whether they are secular or Muslim-majority).

21.2.3. Segregation

The issue of segregation is an interesting one. So far as pure IFI's are concerned, the question of whether they need to segregate their business lines and the sources of funds they deploy to conduct Islamic financial activity should not be a factor from a constitutional or regulatory perspective. In reality, the fact that some IFI's have partially funded their activities by entering into Shari'a-compliant inter-bank arrangements with conventional banking syndicates is something that they may have to address in the longer term. In the recent past such activity has been and in the medium term, will continue to be a feature of IFI funding. Clearly, an IFI that funds itself in this manner, together with its independent Shari'a Supervisory Board, has to be satisfied that such activity is permissible. Their approach to this may simply be that the form of contract generally used to raise the funding involved (i.e. commodity murahaba on a tawarruq basis) is an acceptable activity and / or the funding requirement, combined with the purpose to which the cash raised will be deployed, are sufficiently important for the Muslim community and the parties involved that they should be considered permissible.

So far as Islamic Windows are concerned, the issue is one that potentially has to be treated more sensitively. At the moment, conventional firms participate in Islamic financial activities under a variety of different legal models. Some have established separate legal entities through which they conduct or 'book' most of their Islamic financial activity. Others simply conduct their business through existing legal entities but may have a brand name under which their Islamic products are marketed. As indicated by the previous paragraph, even IFI's may not have sufficient resources, whether through deposits or equity to fund their activities from Islamic sources, or they may wish to secure a source of funding that is less expensive than equity. The majority of Islamic Windows will similarly have insufficient (if any) Islamic resources to support their activities and invariably funding will be provided from the bank's general treasury.

At the present time, there is no universal requirement that suggests Islamic financial products can only be provided by IFI's (as opposed to by Islamic Windows) or that Islamic Windows must take the form of fully segregated businesses. Similarly, it is not generally a legal or regulatory stipulation that the resources used to fund such activities should be Shari'a-compliant. Such limited guidance as is available can be found in AAOIFI Financial Accounting Standard No 18 (Islamic Financial Services Offered by Conventional Financial Institutions). This Standard does state that the Islamic Window should appoint a Shari'a Supervisory Board and also encourages greater disclosure about how the Islamic Window treats funds, rather than setting any prescriptive rules, but these recommendations are not mandatory.

It is the case that where Islamic Windows receive deposits from Muslim retail clients, the Shari'a Supervisory Board will usually impose an obligation upon the Islamic Window that the funds received should not be deployed in haram activities. In the United Kingdom this has resulted in efforts to ring-fence the cash that cannot be deployed in conventional treasury activities, with a view to it only being deployed in Shari'a-compliant short term money market or investment products. This treatment must be distinguished from the well developed short term deposit business conducted through commodity murahaba where IFIs will sell commodities to conventional banks on deferred payment terms. When the conventional bank sells the commodities it has bought in the market, it is not under any obligation to deploy the purchase price it receives in a Shari'a-compliant manner. Similarly, the funds used by the conventional bank to settle the deferred sale price obligation are not required to come from halal sources. In this context, scholars accept the fungible quality of cash and what is being paid is the purchase price for commodities.

It is also worth mentioning that the segregation of funds on the liability side of a transaction is different to the treatment of funds receivable by the IFI on the asset side. Where an IFI receives income (or profit) from sources that are not wholly halal, it will be required to put such funds through a purification process. From a United Kingdom regulatory perspective, there is no requirement to do this but the Shari'a Supervisory Board will impose the conditions that it expects the IFI and/or Islamic Window to adhere to in this regard.

21.3. The regulatory story in the United Kingdom

21.3.1. Role of the Financial Services Authority

The FSA is currently the key regulatory authority of the United Kingdom. It acts under the authority of the Financial Services and Markets Act 2000 (FSMA) which sets four statutory objectives for the FSA. They are: protecting consumers, maintaining market confidence, preventing financial crime and increasing public understanding of financial services. Under FSMA, only "authorised" or "exempt persons" (as those terms are defined in FSMA) are permitted to carry out a "regulated activity" in the United Kingdom unless there is an available exclusion or exemption. Since approximately 2002, the general approach of the FSA towards Islamic finance has been one of broad support for a developing area of innovation. This has been reiterated in several FSA publications.[211]

21.3.2. Regulated activities

The business of banking itself is not a defined regulated activity. In order for an activity to be regulated under FSMA, it must be carried out by way of business and be specified in an order made under section 22 of FSMA, the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO). It is important to emphasise that the UK policy approach, as set out in FSMA, is to regulate activities rather than products. This means that a firm will not only need to consider the regulatory profile of the Islamic finance products it offers, but also whether the way in which it deploys those products would constitute carrying out a regulated activity within the meaning of FSMA, and whether it will require any permissions from the FSA to carry on these activities (up permissions). This would for example, be the case if a credit institution also carries out investment product related activities such as dealing in or advising on investments

21.3.3. Deposits

The core regulated banking activity is 'accepting deposits', so any institution wishing to conduct such activity must be authorised. Other examples include effecting or carrying out contracts of insurance and advising on investments. It is the definition of products being offered by Islamic firms (or by conventional firms wishing to open an 'Islamic Window') that is critical to the authorisation process. Although the economic effect of certain products is substantially the same as conventional products, the method used to achieve that may be significantly different from a contractual and legal perspective. This means that it is important to analyse each product carefully to determine whether or not it falls within the RAO.

• Definition

In many respects, the central regulatory issue that differentiates Islamic firms from conventional firms is most clearly illustrated by examining the different treatment that is accorded by the conventional banking system and the Islamic banking system to deposits.[212] In the United Kingdom, for RAO purposes a deposit is defined as:
"a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties"

• Debtor-creditor relationship

The definition connotes the requirement for capital certainty and in the UK conventional bank context, a deposit by a customer of cash with a regulated deposit-taking institution results in a debtor-creditor relationship. The bank is contractually obliged to return the sum deposited on demand or on such other specific date as may have been agreed (i.e. for a time deposit) and this applies to current accounts and savings accounts. The sum deposited should be returned with or without interest (again, as determined under the terms of the deposit arrangement). In any event, the principal amount deposited has to be returned in whole and the customer is only supposed to be exposed to the insolvency of the bank. This philosophy is further supported by the statutorily established Financial Services Compensation Scheme, which provides certain levels of protection for the depositor in the event of the bank's insolvency.

21.3.4. Islamic deposit accounts

The approach described in the preceding paragraph is fundamentally different to the Islamic treatment of a deposit. Islamic financial institutions may typically offer three types of deposit account: the current account, the savings account and the investment account. Only in the case of the current account, where the IFI acts as a fiduciary, is the bank obliged to repay the sum deposited in full. However, the simple current account does not entitle the depositor to any increment on the amount deposited, so this is really a method for the safe storage of money, as opposed to saving or investing for a profit. In the cases of the savings account and the investment account, because Islam proscribes the existence of riba in financial transactions and does not permit profits to be derived solely based on the time value of money, an interest bearing deposit is not feasible. A different approach is required. If a depositor expects to receive an increment on the cash he deposits with an IFI, he has to allow the IFI to use those funds in the course of its business and accept the commensurate risk that the IFI may lose all or part of the funds deposited. It is only by the assuming the risk of loss that the Islamic depositor is entitled to an increment (usually called a profit) when the funds deposited are returned.

21.3.5. Non regulated activities

Having said this, many of the other financial activities, transactions and operations entered into or undertaken by IFI's are functionally equivalent to their conventional counterparts and may not even be regulated activities for the purposes of the RAO. For example, the activities of leasing and money transmission are not regulated activities in the UK although they are in certain European jurisdictions (and the impending payment services directive may change this for money transmission).

• No discrimination

The approach of the FSA to the growth of Islamic finance in the United Kingdom has been to create a regulatory framework which recognises the special features of Islamic finance and finds appropriate regulatory responses to them rather than simply applying solutions that have been devised for traditional Western

[211] For example, the Briefing Note BNO16/06 of 9 March 2006 (Financial Services Authority).

[212] Described by Callum McCarthy, Chairman of the FSA in a speech to the Muslim Council of Britain Islamic Finance and Trade Conference on 13 June 2006, as being the 'most problematic' of a number of regulatory issues to be resolved.

non-Islamic banks or insurance companies. Wrapped up within this however is the idea that the users of Islamic financial products must have the "same degree of protection"[213] as the users of non-Islamic products. The FSA considers that it offers a 'level playing field' when dealing with applications from both conventional and Islamic firms. Whilst the FSA has stated it is happy to see the growth of Islamic firms in the United Kingdom, it has also stated that it would not be appropriate, or legally possible, to adjust its standard for one class of institutions. The approach of the FSA was summed up by Sir Howard Davies (when he was Chairman of the FSA) during a speech he made in Bahrain in September 2003 as 'no obstacles, but no special favours'.

• Depositor protection

At its simplest, the notion of a 'depositor protection scheme' is therefore anathema to the Islamic banking system. This is an interesting area and one where more work on the part of Islamic firms may be required as the industry develops. Some writers have suggested that it would be feasible to create Shari'a-compliant depositor protection schemes based on principles of mutual risk-sharing similar to takaful. The conventional philosophy behind a depositor protection scheme is the desire to assure depositors that their funds are 'safe' (up to certain agreed limits) should the bank become insolvent. From an historical perspective, this is a rational component of the fractional reserve banking system and consistent with the concept of a lender of last resort. The relatively low levels of depositor protection afforded demonstrate that it is primarily designed to protect the 'small depositor' or 'consumer', a person who is the focal point of much of the United Kingdom's financial regulatory system and consumer protection legislation. There is an interesting parallel in this ideology with various aspects of Islamic jurisprudential thinking. In particular, the requirement for certainty and transparency (full disclosure) under such legislation is, in many respects, similar to the Islamic prohibition against gharar (uncertainty) that also requires full disclosure of all terms and contractual certainty in commercial dealings. From an Islamic perspective however, the absolute prohibition against riba does mean that notions of caveat emptor (i.e. buyer beware) still prevail in the banking system, so the consumer is less 'protected' than his conventional equivalent. There is probably an argument that more work should be undertaken in this regard. Recent global events have demonstrated (in the Western world at least) that the general level of confidence in the banking system can evaporate overnight and it was only through a huge concerted effort of many governmental 'lenders of last resort' that the crisis appears to have been prevented from deepening even further. Although the Islamic banking system does not encourage the behaviour that triggered the crisis in Western economies, it would be foolhardy to consider itself insulated or immune from the sort of potential collapse in confidence that can arise in a financial crisis. At some point in its development, particularly as the industry increases in scale, pressure may arise for the Islamic financial system to devise a scheme for the protection of depositors. In theory, this could be established on a mutual (or takaful) basis with contributions to a central fund being made by all of the participants in the system: namely, the Islamic financial institutions themselves, their customers or depositors and the State or regulator.

[213] Ibid footnote 1.

[214] Renamed upon authorisation as the Islamic Bank of Britain Plc.

21.3.6. Threshold conditions

The FSA's regulatory analysis starts when it is asked to authorise the establishment of a new IFI in the United Kingdom. In this process it still applies the five threshold conditions that would also be considered when looking at the establishment of a new conventional bank, as follows:

First - adequate resources - the firm must have adequate resources, both financial (capital and liquidity) and non-financial for the activities it wishes to carry on;

Second - management - for a firm incorporated in the United Kingdom, its head office and 'mind and management' must also be in the United Kingdom;

Third - legal status - the firm must have the correct legal status for the activities it wishes to undertake. This reflects the requirement of the European directive that places certain limits on the legal form that firms accepting deposits or conducting insurance business must take;

Fourth - close links - the FSA must be satisfied that any 'close links' a firm has to another firm or person will not prevent the effective supervision of the firm; and

Fifth - fit and proper - this assessment takes into account its connections with other persons, including shareholders and employees, and the nature of the activities it wishes to undertake to consider if it will operate in a sound and prudent manner.

A flexible approach

The application of the threshold conditions is intended to be flexible so that they can be applied to a firm whatever sector it is working in. For example, the capital resources required by a bank are likely to be different to those of an insurance company, whilst those of an Islamic bank and a conventional bank are likely to be similar and would therefore be examined and applied on a similar basis.

21.3.7. Islamic Bank of Britain

So how has the UK gone about solving some of the issues identified above? The FSA first had to look at the definitional problems of a deposit during 2003 and 2004 when it was asked to authorise the establishment of the Islamic House of Britain[214]. The solution at the time was a pragmatic one: the Islamic Bank of Britain resolved this problem by offering full repayment of the deposit but informing the customer how much should be repayable to comply with the risk-sharing formulation required by Shari'a principles. This approach allows customers to choose not to accept full repayment if their religious convictions dictate otherwise. Sitting behind the terms and conditions relating to deposits in which this principle was set out, was the further fact that the Articles of Association of the bank were amended to make it clear that the bank's depositors were to be paid our before shareholders. Also established was a profit stabilisation reserve account and that would also be deployed for the benefit of the depositors. This multi-limbed solution was devised, with the approval of the FSA, for the deposit accounts established by the Islamic Bank of Bahrain. The Islamic Bank of Britain was the first and remains the only retail finance bank established in the UK and operated upon wholly Islamic principles.

21.3.8. Regulatory capital

Under the regulatory capital regime in the UK (and the rest of Europe), there is a requirement for firms to hold capital against their "risk weighted" assets to reflect the risks which they may be exposed to against counterparties. For these purposes, there is a complex regime to determine the calculation of the value of the assets against which capital must be held and one of the aspects of the regime is the extent to which sums owing between a bank and its counterparties may be netted against each other before calculating the value of the assets. This netting creates significant benefits for the bank if it can be achieved as it lowers the regulatory capital requirement. There are a number of requirements in order for the netting to be effective, including the key one of reciprocity between the parties under which they must both be acting in a principal capacity. In the light of this, the requirements are couched in terms of netting of mutual debits and credits and some of them refer specifically in this context to loans and deposits[215]. The application of this analysis is an example of the difficulties of the single framework approach adopted in the UK under which Islamic products are treated under existing concepts although their application is in certain ways strained. A great deal of work has been done in this area and the FSA has, for example, accepted that obligations under a murahaba can be treated as meeting the relevant capital requirements for on balance sheet netting even it is necessary to take a purposive construction of the rules in certain respects in order to reach this conclusion. In principle, the same analysis should be applicable in relation to mudaraba-based deposit-like products but the position is much less clear in relation to a wakala-based product. This is because in certain respects a wakala-based product has aspects of an agency type relationship built into it and it is unclear that for English law purposes it would meet the mutuality test. This is a good example of the tensions between conventional and Islamic categorisation as a number of Middle Eastern jurisdictions permit wakala-based products to be treated as on balance sheet for banks in spite of these categorisation issues.

21.3.9. Consumer Credit Act

Lending to individuals is subject to separate regulation as set out in the Consumer Credit Act 1974, as amended by the Consumer Credit Act 2006 (CCA). This regime will apply in relation to such Islamic finance products as murahaba or tawarruq facilities, when they are provided to individuals and not secured by way of a first charge over land. The regime also captures finance facilities that are secured over land by way of a second legal charge. The key element for the application of this regime is the deferral of repayment and the absence of interest is not material. The CCA regime is highly formalistic. The regulatory authority responsible for overseeing the regime is the Office of Fair Trading. Most businesses that lend money to consumers are required to be licensed by the Office of Fair Trading. The CCA applies to personal credit agreements between a creditor and an individual (which now excludes all bodies corporate and partnerships of four (4) or more persons, but continues to apply to sole traders and small partnerships). There are certain exceptions to the CCA regime (most notably, FSA-regulated first charge mortgages) and before 6 April 2008 it did not apply to loans of more than GBP 25,000. However, as of 6 April 2008, the GBP 25,000 limit was removed with the effect that all credit agreements with individuals (which includes partnerships with two (2) - three (3) partners or unincorporated bodies) will be regulated by the CCA unless subject to an exception.

There is a tension between the formulaic approach of the CCA regime (that is designed to protect consumers) and an Islamic philosophy of risk acceptance (although on a basis that should be certain and transparent). In this regard, the higher levels of disclosure required for consumer products would seem to fit well with Islamic notions of fairness in contracts. Where difficulties can arise is in an area such as the early payment of a consumer financing product. The CCA requires early repayments to be made in accordance with a specified formula inherent in which is the calculation of an interest component over a period of time. This does not match well with Islamic requirements where riba is proscribed. In international commercial contracts the approach of the scholars has been to allow the debtor the right to request early settlement but his obligation is to repay the amount outstanding in full and rely upon the discretion of the financier to provide a rebate for early settlement. The scholars have consistently refused to allow any attempts to describe the amount to be rebated by the use of formulas. It is difficult to imagine them changing their minds about this approach even in the context of consumer products.

21.4. Shari'a-compliant or not?

Shari'a Supervisory Board

Another aspect of Islamic finance that financial regulators around the world have to get to grips with is the fundamental question of whether they should have a role in deciding if a financial product is or is not Shari'a-compliant? The same issue has to be responded to in both Muslim-majority and non Muslim jurisdictions, so it is not unique. An individual who is an expert in financial regulation (whether he is a Muslim or not) may not necessarily also be an expert in Shari'a and fiqh al muamalat, so it is questionable whether a financial regulator should ever assume the ability to determine matters of Shari'a compliance. In the UK, the FSA has repeatedly stated that it recognises the special position of the Shari'a Supervisory Board within an Islamic bank but it does not seek to regulate the composition, competencies or operation of that board or the people who comprise it. The FSA's principal concern is whether Shari'a scholars have an executive role or an advisory role. This matters for the following reasons:

any person acting as a director of an authorised firm must be registered under the FSA Approved Persons regime. This regime requires any director of an authorised firm to have the relevant experience. If the Shari'a scholars are seen to have a directorship role, some of them may not meet the competency and capability requirements; and

on the assumption that the Shari'a scholars are direc-

[215] section 5.3 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms

tors, their role is likely to be that of an executive director, as it will involve active participation in the activities of the organisation concerned.

From the FSA's perspective, each Islamic financial institution needs to demonstrate that the role of its Shari'a Supervisory Board is purely advisory and does not interfere with the management of the institution. Those firms that have been authorised by the FSA thus far have been able to demonstrate this. In examining Shari'a Supervisory Boards, the FSA focuses on the governance structure, reporting lines, fee structure and the terms and conditions of the contract establishing the Shari'a Supervisory Board. The FSA has reiterated on several occasions that it does not wish to be a 'religious' regulator of, or have to supervise, Shari'a scholars and this approach in many respects correlates with the philosophy adopted by the English judiciary. Of course, the question of whether or not an individual is appropriately qualified to provide Shari'a advice to Islamic financial institutions is another topic that the industry has to deal with but provided Shari'a scholars perform their advisory functions in an independent manner and do not cross the rubicon and start assuming executive functions they are not required to be Approved Persons[216].

Roles of Shari'a scholars

As the Islamic financial system continues to develop (in both volume of business and complexity of product), it will inevitably be the case that the demands and expectation placed on the currently limited pool of scholars will evolve. Eventually, the roles and functions that Shari'a scholars undertake will need to be better demarcated as the demand for greater levels of transparency increases (for example, so as to distinguish between the advisory function and the audit function and each of these have both an 'internal' and 'independent external' aspect to be considered). From a regulatory perspective, the question that arises is: who should determine these issues? Even in Muslim-majority countries it is not clear that leaving this to Allah will be a satisfactory answer as pressure for more transparency, certainty and standardisation continues to grow.

The Malaysian approach

The country that has the most developed approach to this issue is Malaysia, where Bank Negara Malaysia (BNM) and the Securities Commission (SC) have both established a Shari'ah Advisory Council. The Shari'a Advisory Council of BNM is generally responsible for advising on matters in relation to Islamic banking and takaful businesses or any other Islamic finance area that is supervised and regulated by BNM; whereas the Shari'a Advisory Council of the SC is generally responsible for advising on matters pertaining to the Islamic capital markets in Malaysia. The Shari'a Advisory Council of BNM has attempted to define and rationalise the relationship and working arrangements between itself and the Shari'a Committee of each Islamic financial institution, by the introduction of the "Guidelines on the Governance of Shari'a Committee for the Islamic Financial Institutions (BNM/GPS 1)" (Guidelines).

Both Shari'a Advisory Councils are independent bodies within BNM and SC, respectively and consist of prominent Shari'a scholars, jurists and market practitioners. The members of the two Councils are qualified individuals who can present Shari'a opinions and have appropriate experience in banking, finance, economics, law and application of Shari'a, particularly in the areas of Islamic economics and finance. The Shari'a Advisory Council of BNM generally plays a 'higher level' role in advising on, monitoring and supervising the implementation of Shari'a in Islamic finance at the national level. Under the Guidelines, the Shari'a Advisory Council of BNM operates as an independent body within BNM and focuses on Shari'a related matters. The Shari'a Advisory Council is the authority for the ascertainment of Shari'a for the purposes of Islamic financial business[217] and its functions include ascertaining the Shari'a on any financial matter and issuing a ruling upon reference made to it; advising BNM on any Shari'a issue relating to Islamic financial business, the activities or transactions of BNM; providing advice to any Islamic financial institution or any other person as may be provided under any written law; and such other functions as determined by BNM.[218] BNM consults the Shari'a Advisory Council on matters relating to Islamic financial business and for the purpose of carrying out its functions or conducting its business or affairs, in accordance with the Shari'a.[219] Although it is not specifically provided for, the role of the Shari'a Advisory Council is fairly separate from BNM's financial regulatory function.

In a secular country such as the United Kingdom, it is extremely unlikely that it would be feasible (or appropriate) to establish any sort of similar function which, although 'independent', would operate under the auspices of the FSA. For the time being, it must be the case that the financial regulator cannot assume responsibility for Shari'a compliance, all it can do is help facilitate the framework in which IFI's can operate and leave Shari'a compliance to those more suitably qualified.

21.5. Legal systems

Within the Islamic financial industry there is a growing concern about the interplay between secular legal systems, the codified laws of Muslim states and Shari'a itself. This is focused by the question: what law should be the governing law of a contract that purports to be Shari'a-compliant? For very understandable reasons, many Shari'a scholars would argue that a reference to Shari'a alone should suffice. From the perspective of an investor, financier or businessman however, invariably this answer is not satisfactory, even where he is a devout Muslim, because there is a great deal of uncertainty about precisely what 'Shari'a law' actually is, or might be, and how reliably it will be enforced, on any particular issue. A statement of this nature may sound critical but it is not intended to be. In many respects, it reflects two factors that have been mentioned earlier; the relative youth of the industry at the present time and the fact that consistency and certainty only develop with the passage of time. As scholars, practitioners and other participants in the industry gain more experience so consensus will increase.

The adoption of English law as the preferred governing law in many international contracts (even between parties where there may be no physical or contractual nexus to the United Kingdom other than the choice of law clause) occurs because the corpus of English law and the judicial framework that surrounds it has developed steadily over many hundreds of years. Such a remark may sound trite but the critical point is that many commercial issues have been the subject of detailed judicial scrutiny over the years and recorded in detail through the common law system of precedent. By specifying English law as the governing law of a contract, the businessman is engaging with a reliable legal framework and a set of procedural rules for resolving disputes. The United Kingdom has a judiciary that is experienced, highly respected and generally considered unlikely to act in a capricious manner. For financiers and their customers entering into sophisticated commercial contracts, perhaps the most important legal objective is the ability to predict outcomes.

When it comes to applying these considerations to Islamic financial contracts, there is an additional stratum of complexity to take into account; what needs to be done to ensure the contract is Shari'a-compliant as well as legally enforceable? In many respects, this exercise should not be as difficult as first thought. The vast majority of provisions in an Islamic financial contract will also often appear in many so-called 'conventional' instruments. The lawyer's role is to understand how financial contracts need to be re-organised to achieve the different requirements of Shari'a. The re-organisation will likely involve subtle shifts in the risk profiles and the obligations imposed on the parties. The extent of these adjustments will depend upon the precise character of each financial instrument, as well as the relevant economic effect that the product designer is trying to achieve. In many cases, efforts have been made to convert conventional financial instruments into Shari'a-compliant formats that achieve the same economic outcome as the conventional product. Inevitably, this sort of approach has been criticised by many commentators as not being the 'proper' way to conduct Islamic finance but this should not be construed as being a criticism of the legal framework under which these effects are achieved. If an Islamic financial institution wants to offer, or an investor wishes to invest in, an asset class that is well known in the conventional investment universe, it may be perfectly possible to re-design the product so as to be able to offer a permissible Islamic version. Whether such a product is 'Shari'a-compliant' (a term sometimes used with negative connotations to suggest an instrument that has only achieved the status of being 'compliant' by virtue of rigidly following individual rules at various stages of its creation and operation but which might in aggregate be considered an artifice (or 'hiyal') by its critics) or 'Shari'a-based' (in contrast, a product whose ethos is grounded in principle and so, better follows the Islamic tradition) may simply be a question of degree and emphasis. Critics often forget that certain types of financial activity can be conducted without adaptation and are capable of being halal or haram simply by virtue of the asset that is the subject matter of the investment. For example, an un-leveraged purchase of a minority interest in a winery business, however structured, should not be something that is permissible; whilst buying a minority interest in a ceramics manufacturer using the same contractual arrangements would not raise any objections.

Whilst a 'Shari'a-based' approach to product design and development might suggest a certain risk profile or economic outcome (one that may be just as familiar to conventional investors) and hold out the prospect of being more genuinely Islamic: the issue is whether, in reality, the Islamic financers designing these products and the customers wishing to utilise them, actually desire the risk profiles and the economic effects this would deliver, or are they really seeking something different? Despite the Islamic requirement that the capital provider assumes 'commercial risk' in a transaction, most Islamic financiers remain as risk adverse as their conventional counterparts. This is compounded by the fact that trying to balance the Islamic 'attitude' towards risk against the practical realities inherent in many risk profiles, is often harder for the Islamic firm to manage because of the shortage of tools available for managing their short term liquidity positions.

Secular judicial and regulatory systems in many Western countries are invariably adept enough to be able achieve a variety of economic outcomes with careful structuring. At the end of the day, most product development is customer driven; there are very few examples of Islamic financial institutions or Islamic Windows designing products in a vacuum. It is possible that over time existing global economic and fiscal frameworks will adjust and evolve in such a way that financial instruments adopt a characterisation that is more 'Islamic' than conventional. In all of this activity, regardless of the direction in which it moves, it is not the legal 'system' per se that dictates whether or not the product or activity is going to be Shari'a-compliant: it is the subject matter of the investment, the risk profile, the transaction economics and the way contracts are combined that dictate whether or not a particular financial product or activity complies with Shari'a principles. All that the legal framework does is permit or, in some cases, prohibit certain types of activity (and here we are usually talking about criminal activity rather than actions proscribed by religious sensitivities) whilst also determining if the contracts under which the financial obligations are to be performed are capable of being enforced in the jurisdictions in which the parties to the contracts are conducting their affairs. If this distinction can be made and understood, it ought to be possible to divorce emotional concerns about whether a contract should be governed by English law or Shari'a, from an objective analysis of what is required to ensure the legal efficacy of the product or transaction in (very often) a global market. In many non-Muslim states, it is possible to say that the legal system is (or should be) 'neutral' when it comes to the import of Shari'a and matters of religious orthodoxy on financial transactions. Of course, the same cannot be said for those Muslim states where Shari'a ultimately prevails and so there is another important realisation (which we shall come back to), that the right answer in one country will not necessarily be the same in another.

It is interesting to note that over the past twelve months or so the author has detected a certain shift in emphasis in the approach of prominent scholars to these issues. It is likely that the prevailing global economic situation from which neither the Middle East nor the Islamic finance sector have been immune, has been a factor in this. It is at times of stress, that the strengths and weaknesses of financial products are discovered. It is arguable that a proper weighting of the component parts of any Islamic financial product has been missing for some time and that a shift is starting to happen. From a pragmatic perspective, there are three critical components that should be in equilibrium when designing any Islamic financial product. They are as follows:

First - the economic rationale. There should be a good business proposal and / or socially compelling reason

[216] NB: Inset reference to Regulations defining Approved Persons

[217] Section 51, Central Bank of Malaysia Act 2009

[218] Section 52, Central Bank of Malaysia Act 2009

[219] Section 55, Central Bank of Malaysia Act 2009

(maqasid al Shari'a) for undertaking the investment or designing the product. This is primarily for governments, financiers, economists, analysts, investors and consumers to think about.

Secondly - the design and operation of the product should be based on sound Shari'a principles and capable of attracting a fatwa from Shari'a scholars. This is a matter for the scholars to determine. In most cases, the views of individual scholars or ad hoc committees brought together to form Shari'a Supervisory Boards will prevail. There continues to be a debate as to whether or not this is the right way to develop anything approaching an 'Islamic financial system' but for the time being a credible alternative methodology does not exist, save for several attempts to control the promulgation of financial fatwa centrally in countries like Malaysia and Sudan.

Thirdly - the financial product or transaction must be legally binding upon the parties to the arrangement, and capable of being enforced between them in a default scenario. The Quran holds contracts in high regard and describes man's relationship with God in contractual terms in several verses. Unfortunately, in the modern commercial world, it is also necessary to have effective legal sanctions that will ensure contractual obligations are performed. This is where the lawyer has a role to play.

For understandable reasons, a great deal of emphasis is placed on what is required to satisfy Shari'a concerns. In the vast majority of cases, there is no reason why a robust secular legal approach should detract from or prevent an equally clear approach towards Shari'a requirements. It is the commercial and economic factors mentioned earlier that are likely to cut across the legal and Shari'a treatments. In trying to determine what is an appropriate governing law for any contract there is no 'one size fits all' solution and this is something that has perhaps not been stressed enough in previous discourses on the question. There is a lot of emotion attached to the topic but an objective analysis of some typical scenarios where Islamic products are deployed will illustrate the case for a variety of approaches. It is possible to conclude that the appropriate governing law for each scenario is different. The following examples seek to demonstrate this:

Local / commercial - this situation envisages the financial institution offering commercial products to business customers being domiciled in (or nationals of) the same jurisdiction. Under these circumstances, it is difficult envisaging the governing law being anything other than the local law. The complexity of the documents might vary depending upon the type of product and the quantum of the financing involved. The way in which Shari'a is addressed in the product or transaction documents will depend upon whether the country concerned is non-Muslim or Muslim (and even in the latter case, the treatment will vary from country to country depending on the legal and regulatory framework in place).

Local / retail - this is the same scenario as the previous example but where the financial product is being provided to retail customers instead of business customers. In most countries the local laws and regulations are likely to be more prescriptive about the form and content of the documents presented to retail customers by financial institutions. In this case, it may often be difficult to work within the local legal framework to re-design or re-characterise products in order to make them Shari'a-compliant (a good example is the difficulty avoiding having to state APR's in many consumer lending situations). This remains an issue in both Muslim and non-Muslim states. Once again the laws of the local jurisdiction will invariably prevail as the appropriate governing law.

Local / international (whether business or retail) - in this scenario, it is envisaged that an international financial institution is seeking to provide financial services onshore in a foreign country through locally established branches, subsidiaries or joint ventures to nationals of the country concerned (whether business or consumer). The international institutions will be seeking to bring their global brands, systems and products onshore. They will invariably have to adapt familiar products in their home territories to new legal systems abroad. In certain transaction types, it may be possible to select a governing law other than that of the new jurisdiction but in many cases it will not be feasible to do this. Whether that is an appropriate decision might depend, for example, on the nature of the asset being financed. The classic asset classes referred to when discussing this dilemma are ships and aircraft versus real estate. From the financier's perspective, the former moveable assets might be better financed under arrangements where the governing law is not that of the state of the customer on the grounds that it may be feasible to take enforcement action against the assets when they are offshore. When it comes to real estate this level of flexibility does not exist and it will be important to ensure that any security works at the local level.

International (whether business or retail) - in this category, we are contemplating international financial institutions that are seeking to provide Islamic financial products and services from offshore locations into other jurisdictions. Products and transactions in this category may be entered into on a bilateral or a syndicated basis. For present purposes, the only material difference between a bilateral and a syndicated facility would be the ability of the financier under a bilateral facility who was planning to keep the transaction on his own books and not sell down in the future, to 'take a view' on which governing law should prevail. Where a deal is being syndicated, the Facility Agent or Investment Agent, will have to ensure that an often disparate group financial institutions and participants are happy with the law selected to govern the transaction documents and it is on these occasions that English law is invariably the preferred choice.

In all of the categories described above, the question of how to handle the Shari'a characterisation and efficacy of the product or transaction can be resolved in subtly different ways. However, it is the international category which contemplates major cross-border transactions that tends to attract the most attention. It is here also that some of the most interesting (and in some cases counter intuitive) situations arise. For example, it would not be uncommon for an Islamic financial institution based in the GCC, providing finance to a corporate customer in another Muslim majority country outside the GCC not to want the laws of the customer's country to apply. Similarly, the customer may insist that the laws of the financier's country should not apply. When this happens, the neutral selection is most often English law. Although it almost goes without saying, the starting point for the vast majority of international financial institutions providing finance and non-financial corporations investing abroad (and this as true regardless of whether the target jurisdiction is in the Muslim world or not) is a preference for the laws of their own country or those of a neutral state.

It is for all the reasons described above that the position of English law and how it responds to contracts that purport to be entered into on a basis that complies with Shari'a principles is of fundamental importance. It is also why attempts to set aside a judicial tradition and body of common law that has developed over several hundred years have to be scrutinised carefully. Any financial institution contemplating such a course of action needs to consider whether it has made after a credible assessment of the likely impact this will have on its own ability to develop international business. Is access to the English legal system being removed merely because it does not 'feel right' (i.e. that an Islamic contract is describing itself as being governed by English law) or because there is a genuine and fundamental incompatibility between English law and the Shari'a? If for the latter reason, what evidence of such incompatibility exists? Another reason sometimes cited by its critics as to why there is reluctance to have these contracts governed by English law, is the notion that the English courts will not treat Shari'a with the respect it deserves. This is another topic where opinions are subjective and emotions can run high. However, the objective response to this concern is simply to examine how the English courts have actually responded when they have been faced with these difficult questions?

The United Kingdom and the City of London in particular, has been involved with what might appropriately be called 'modern' Islamic finance since its earliest days in the nineteen seventies. The story has developed ever since then with the most rapid growth having occurred since 2001. So far as the judicial consideration of Islamic financial products is concerned, a series of cases have been heard, of which the leading judgement is the Court of Appeal decision in Shamil v Beximco[220]. The Shamil v Beximco case was concerned with the construction and effect of a governing law clause that was written in a form that had developed in the Middle East during the late eighties and early nineties. It read as follows:

"Subject to the principles of the glorious Shari'a, this Agreement shall be governed by and construed in accordance with the laws of England"

This hybrid form of governing law clause had developed as a compromise to satisfy, on the one hand, financiers who wanted the certainty of English law governing their international contracts and on the other hand, scholars who were concerned that without an express reference to the Shari'a, the contract might not be treated as being Islamic. During the period when this clause was in regular use, the task of the lawyer predicting how such a clause might be construed by the courts was not an easy one. The final decision handed down by LJ Potter in the Court of Appeal in January 2004 produced a pragmatic and practical solution, which in many respects has reinforced the sensible approach the English courts are renowned for adopting in difficult cases.

In view of the discussion so far in this chapter, one of the most interesting passages in the decision is as follows:

"English law is a law commonly adopted internationally as the governing law for banking and commercial contracts, having a well-known and well developed jurisprudence in that respect which is not open to doubt or disputation on the basis of religious or philosophical principle."

Although the implications of a powerful sentence like this are profound, they are not negative or adverse towards Islam or Islamic finance. In many respects, when read in conjunction with other passages in the judgement they are respectful of all religions because the court is saying it will not be persuaded by arguments based solely on religious grounds. The Court of Appeal understood that there were still "areas of considerable controversy and difficulty … because of the existence of a variety of schools of thought" in Shari'a. In such circumstances, LJ Potter formed the view that a mere reference to the principles of Shari'a was not sufficiently certain to allow the Court to determine whether or not the various agreements were actually Shari'a-compliant. Critics of this decision have argued that the Court of Appeal avoided the hard issue of determining whether or not the murahaba agreement originally entered into between the parties was Shari'a-compliant. It is difficult to accept such criticism for several reasons.

First, the author would argue that the original murahaba transaction was structured in a manner that was generally considered to be an acceptable modus operandi (evidenced not least through general custom and usage that prevailed several years before the contract was entered into and which continues to this day). Over the years, procedural adjustments may have been made to the implementation procedures of murahaba, each Islamic financial institution tends to favour its own has its own documentation and scholars may have become more rigorous in the way they conduct audits of back-office procedures, but the basic technique remains the same.

Secondly, although not probably realised by the Court of Appeal at the time, the notion that the words were "intended simply to reflect the Islamic religious principles according to which the Bank holds itself out as doing business…" implied that the bank must itself determine what those principles are. This approach aligns itself with the corporate governance procedures that have been promulgated by both AAOIFI and the IFSB. For example, in its Governance Standards 1 to 6, AAOIFI describes a methodology for the establishment of an independent Shari'a Supervisory Board and emphasises that this is the key governance characteristic that differentiates an Islamic financial institution from a conventional firm. In view of this, one can argue that there is nothing unusual or irregular in having the Shari'a Supervisory Board determine the Shari'a character of the financial institution's business and the Court of Appeal's approach supports this. There is a completely separate debate to be had regarding whether or not, in the longer term, it should be independent Shari'a Supervisory Boards, as opposed to other bodies (whether national or international), that continue to determine what is, or is not, considered Shari'a-compliant in the financial markets. In the Western world, this is relatively easy to resolve since financial regulators make it clear that they are not qualified to determine whether any particular product is Shari'a-compliant or not. In the Muslim-majority world, the approach varies from coun-

[220] Shamil Bank of Bahrain E.C. v Beximco Pharmaceuticals [2004] EWCA Civ 19

try to country at the present time and raises fascinating questions about whether or not Islamic finance has emerged, or more likely, is emerging as a legal system in its own right?[221] The potential for developing a joined up system of Islamic financial jurisprudence is unclear and beyond the scope of this chapter. However, in various jurisdictions attempts to regularise Shari'a contracts and principles are being progressed and in some cases financial regulators are writing rule books that are becoming more prescriptive. What is less clear is how joined up this activity is across jurisdictions and so the debate is likely to continue running for a long time. Even in the most recent public discussions regarding this topic, commentators can be found describing the perceived almost insurmountable difficulties in standardising Shari'a parameters: "Quite frankly the Muslim world today is not governed by a structure - like the Vatican where you have a Pope structure - so you will always have conflicting views"[222].

The Shamil v Beximco judgment clearly dismissed the idea that the reference to Shari'a in the governing law clause was sufficient to introduce the whole body of Shari'a into the contract. The Court was also unwilling to accept a narrower construction (argued by counsel for the Appellants) that the rules relating to the prohibition of riba and the nature of murahaba and ijara contracts should be incorporated. Whether it would be feasible at some point in the future development of Islamic jurisprudence to incorporate sufficiently specific 'black letter' provisions akin to specific provisions of a foreign law or international code remains to be seen. For the time being, it is believed that the hurdles to this sort of approach are too high. It has been suggested that AAOIFI's rules could perhaps form a framework for this purpose but they still remain sufficiently ambiguous and largely un-adopted, so this does not seem feasible yet. So where does this discussion leave English law in its relationship with contracts that purport to be compatible with Shari'a, and what considerations are relevant when framing contracts under English law that are intended to work from a Shari'a perspective? In many respects, it leaves English law in the position where it can carry on doing what it does best: enforcing international financial and commercial contacts in accordance with their terms.

From a practical perspective, there are some basic steps that the parties to an international Islamic financial contract can take to try and secure an appropriate legal interpretation of the contract in the event of any dispute between them. Their ability to enforce that interpretation will then be decided by the network of international conventions and treaties dealing with the enforcement of judgements or arbitral awards. There are certain areas where Islamic jurisprudence and the English common law of contracts have similarities. As has been mentioned, the Quran holds the honouring of contractual obligations in high regard[223] and this is also a cornerstone of English commercial law. The Arabic word for contract is 'Aqd' and is derived from the root verb 'aqada' meaning to tie or bind[224]. Once a contract has come into existence, it should be performed in accordance with its terms. If it is not, then the non-performing party will be at risk of being sued for breach of contract and various consequences flow from that. Where financial obligations are not being performed there may be a claim in debt for payment of the sums owed; in other cases the breach of contract may result in claims for damages, specific performance or injunctive relief. Islamic jurisprudence does not (arguably) have a general system of contract law but instead has witnessed the development by jurists (fuqaha) of a variety of nominate contracts (bay (sale); hiba (gift); ijara (Hire) and ariya (loan)). One therefore has to look at this evolution to understand the basis upon which certain different types of contract can come into existence. As in English law, there is in Islamic jurisprudence a general notion of freedom to contract, save that it is transcribed by the injunction that no contract may transgress the Shari'a[225]. So the norms of behaviour which an English court would be cognisant of (i.e. contracts purporting to sanction criminal behaviour, conflict with mandatory legislative provisions or breach public policy etc.) will be expanded to include the prohibitions recognised by Shari'a. The three cornerstones or pillars (arkan) of the nominate contract have been listed as follows[226]:

(a) parties to the contract (buyer and seller);
(b) object of contract (price and what is priced);
(c) the language of the contract (offer and acceptance).

All of these criteria have their parallel concepts in the English law of contract, and the exchange of an offer and an acceptance to bring the contract into effect is critical to both. The above commentary is only a brief indication of some of the reasons why English law can offer a sympathetic framework in which to devise Shari'a-compliant contracts. If the reader has accepted the premise this chapter is supporting then the concluding advice should be easy to follow.

When designing Islamic financial contracts, financiers and lawyers, must realise that the substance of an Islamic transaction is as important as its form. In the current economic climate where 'synthetic' contracts have been entered into at distances far removed from the assets to which they purported to relate, and were found wanting, this is a timely reminder that there should be a genuine economic rationale for all financial contracts. In many respects, the most fundamental consideration for any Islamic financial transaction should be the nexus between the finance being provided and the use or purpose to which it will be put. If the purpose is genuine and the three pillars are satisfied, there is no reason why a commercial contract cannot be written to reflect this. In that case, what else can be done to improve the characterisation of the contract as 'Islamic' or Shari'a-compliant? As a consequence of the decision of Shamil Bank v Beximco, there is an approach to agreements dealing with Islamic financial contracts that has been designed to remove (to the extent possible) any uncertainty about the parties' intentions regarding the Shari'a basis of the transaction.

The final paragraphs of this chapter describe a generic approach to a financing transaction. It will need to be adjusted from contract to contract depending primarily upon (a) the nature of the financial instrument and (b) the approach the relevant financial institution is taking to reputational risk. The approach adopted for a working capital facility or a project financing may differ slightly from a wealth management product. Similarly, the precise wording and emphasis of the risk factors found in private placement memoranda and other types of offering document can be tailored as required. For a typical Islamic financing contract, the following approach is suggested:

[221] For a detailed and thought provoking discussion on this topic, see 'Islamic Finance as an Emergent System' Nicolas HD Foster (2006).

[222] Omar Sheikh, Executive Board Member at the Islamic Financial Council, UK quoted in Emirates Business 24/7 on Sunday 25th October 2009.

[223] For example, Quran "it is righteousness … to fulfil the contracts which ye have made" (Quran II:177); "Fulfil their covenant up to (the end of) its period; Allah loves those who show piety" (Quran IX:4).

[224] The Theory of Contracts in Islamic Law, S.E. Rayner, Graham & Trotman (1991) see Chapter 4, The Islamic Principles of Contract.

[225] See Ibn Taymiyya's statement: 'The following rule shall be applied: men shall be permitted to make all transactions they need, unless these transactions are for bidden by the Book or by the Sunna.' H Laoust, Le Traité de Droit Public d'I billion Taimiyya Annotée de La Siyassa Shar'iya (Beirut, 1948) p167.

[226] Financial Transactions in Islamic Jurisprudence, W. Al-Zuhayli, trans. M.A. El-Gamal (2003), Chapter 1, Constituents of Sale. Although there is also some discussion whether these are early four cornerstones if the buyer and seller are treated separately.

Recitals - The agreement should contain a recital making it clear that it is intended (by the Parties) to be entered into in conformity with Shari'a principles. In essence, what this implies is that each party must read the document and satisfy itself that every provision is one that it is comfortable agreeing to as a matter of that party's own Shari'a observance. An example of such provision is provided below:

"The Parties agree that this Agreement shall be in conformity with the principles of Shari'a as shall be determined by the [Shari'a Supervisory Board of the financial institution]."

Representations and warranties - The parties should make representations and warranties to each other that they are satisfied the agreement does comply with Shari'a principles. An example of such provision is provided below:

"The parties have entered into this Agreement after having reviewed this Agreement for the purposes of compliance with Shari'a principles and with, to the extent it has considered this necessary, independent advice from advisors specialising in matters of Shari'a and they are satisfied that the provisions of this Agreement do not contravene Shari'a principles."

Whether the representations and warranties are mutual, or are only made by the customer in favour of the financial institution will vary depending upon the product, the transaction or the financial institution. For example, some Islamic financial institutions will say that they need not make the representation because everything they do is, by definition, Shari'a-compliant. Some Islamic Windows will feel nervous about making such a statement for reputational risk reasons but provided they are acting upon the advice of their Shari'a Supervisory Board, such concerns are not convincing; simply by offering the product the inference exists.

Undertaking and estoppel - We also try to incorporate a provision whereby the customer agrees that it will not seek to challenge the enforceability of the agreement in the future for reasons of non-compliance with Shari'a principles. This provision is intended to create what is known as an "estoppel" as matter of English law. It has to be emphasised that the enforceability of such a provision has not been tested in the courts yet. An example of such provision is provided below:

"The [Customer] has entered into this Agreement after having reviewed this Agreement for the purposes of compliance with Shari'a principles and with, to the extent it has considered this necessary, independent advice from advisors specialising in matters of Shari'a and confirms that it does not have any objection, nor will it raise any objections in the future, as to matters of Shari'a compliance in respect of or otherwise in relation to any of the provisions of this Agreement."

The language is designed to be similar to language that typically warns investors to seek professional advice from their financial adviser, lawyer or account.

Single governing law selection - It is recommended that the governing law clause provides for the contract to be governed only by English law. An example of such a provision is provided below:

"This Agreement shall be governed and construed in accordance with English law."

Interest repugnant - Notwithstanding the recommendations above, we still believe it is permissible for the parties to recognise and agree that the payment of interest is repugnant to Shari'a and they may accordingly waive their entitlement to interest from the other. An example of such provision is provided below:

"The Parties recognise and agree that the principle of the payment of interest is repugnant to the Shari'a and accordingly, to the extent that any legal system would (but for the provisions of this clause) impose (whether by contract or by statute) any obligation to pay interest, the Parties hereto hereby irrevocably and unconditionally expressly waive and reject any entitlement to recover interest from each other."

This type of clause is an expression of intent but also raises an interesting issue as to whether or not it is permissible to contract out of statutory or judicial rights to award interest on debts. Under English law there are several ways in which interest may be awarded on the late payment of a debt even if there is no express right to claim interest in the underlying contract. The Late Payment of Commercial Debts (Interest) Act 1998 provides for interest to be payable on the late payment of debts arising under business-to-business contracts for the supply of goods and services. The right to interest is limited and does not need to be explained further in this chapter but it is possible to contract out of the right provided the contract offers an alternative 'substantial contractual remedy'. Market practice at the moment (which admittedly does vary amongst Islamic financial institutions) seems to permit the charging of a liquidated sum (generally described as a 'late payment charge') from which actual costs and expenses can be deducted before the balance is paid to charity. In most cases this remedy would produce a lesser amount than a corresponding claim for delay interest. Since it is also important that any amount claimed under such 'late payment charge' clauses does not amount to a penalty under English law, this is no bad thing. The author is not aware of this type of provision ever being tested in the English courts but in reality the issue should not arise as the plaintiff Islamic financial institution should never make a claim for interest under the relevant legislation. The other area where interest could theoretically be awarded is by the exercise of judicial discretion. Again, it would be difficult to imagine an Islamic financial institution particularising such a claim in pleadings, so the existence of a promissory estoppel in the form quoted above should give comfort that such a situation would never arise in the first place.

As an interesting aside, in April 2009 the European Commission published its intention to revise European law[227] on combating late payment in commercial transactions. The European Commission is contemplating a directive that would permit businesses to claim both late payment interest and reimbursement of any recovery costs. The proposed directive and any revisions are not expected to come into effect until 2010[228]. In theory, such a directive would offer a remedy to Islamic financial institutions that provide funding by entering into contracts for the supply of goods and services. However, as in the case explained above, we would not expect an Islamic financial institution to plead such

[227] (Directive 2000/35/EC).

[228] See www.practicallaw.com/5-379-8248.

a claim as it would mean the creditor was not acting in Shari'a-compliant manner.

21.6. Concluding remarks

The focus of this chapter has been an examination of the regulatory and legal responses to the development and expansion of Islamic finance in the United Kingdom. It is reasonably well known in the global Islamic financial community how the UK Treasury has gone about creating a 'level playing field' for tax purposes. Whilst industry participants may argue that these changes should have been introduced more quickly, the reality is that such changes can only be achieved with a methodical and consistent approach. With the best will in the world, the complexity of the UK tax regime is such that it is extremely difficult to ensure that each adjustment to the regime covers every potential issue or does not create problems (of which opportunities for tax avoidance is the biggest concern) elsewhere. However, since the tax system is largely a creation of statute, it is possible to keep making adjustments and fine-tuning it which is something the Government has made clear it is committed to doing.

The recent public and international focus on tax development in the United Kingdom have perhaps hidden other changes and benefits that have been running concurrently with the tax changes. The recent authorisation by the FSA of at least six banks, one takaful provider and an asset manager all intended to be run fully in accordance with Islamic principles; along with the City of London's status as a provider of global financial services has been a great driver of change. The regulatory framework may not be considered perfect and there will always be concerns that the proper risk profile of an Islamic deposit has been compromised but the irony is that this has occurred largely because of a desire to protect the consumer. So far as the legal system is concerned, English law continues to demonstrate an almost infinite flexibility to allow parties to contract together and enter into arrangements that can be modelled to reflect their precise requirements in an Islamic context. Shari'a may not be specified as the governing law but so long as each financial institution satisfies itself that the terms of its contract reflect its institutional view on what is Shari'a-compliant behaviour and if (ideally) the customer acknowledges this too, there is a framework in place that will endeavour to enforce the agreement reached between the parties to the contract without taking into account matters extraneous to that relationship.

CHAPTER 22

Regulation of Islamic Finance in North America: Canada, Caymans and USA[229]

22.1. Introduction

North America, Canada and the United States in particular, have some of the world's most heavily regulated financial systems. Turmoil in United States markets with spill over effects into the rest of the world, has accentuated the need for re-thinking regulation. This puts a spotlight on the role that Islamic investment may play in filling gaps resulting from defunct institutions and reviving stagnant capital. While further integration and inflow into the North American economy is required, significant progress has already been made in the structuring and selling of Shari'a-compliant investment products within the existing framework of North American legal systems. The proliferation of Islamic banking and finance in highly regulated markets may usher in a better understanding of Islamic precepts and the role they can play in the world economy.

22.2. Major hurdles

There are major hurdles to the full-scale development of Islamic finance in the North American and world economy. For example, European lawyers like Paul Wouters observe that:

"There are ongoing compliants on the lack of PLS partnership funding at commercial/retail Islamic banks. Islamic banks indeed mostly stick to equity-based finance contracts, such murahaba and ijara. These compliants are without merit, since this kind of equity venturing simply is not (and will never be) their line of business."[230]

Other Europe-based commentators, like A.L.M. Abdul Gafoor, have made the case for equity-based financing in works like Participatory Financing through Investment Banks and Commercial Banks. In the opening remarks of his book, Gafoor states:

"Islamic bankers have introduced the concepts of investment accounts and profit-and-loss sharing into commercial banking. In practice, depositor's funds in the investment accounts are used by the Islamic banks to finance projects by entrepreneurs. The profits (and losses) are shared by the three participating parties – depositor, bank and the entrepreneur – in a pre-arranged ratio. They have, however, run into serious difficulties in implementing it, mainly because it is applied to situations where it is inappropriate."[231]

One of the situations where PLS arrangements are inappropriate is within commercial banks in Canada, the United States and most other Western countries. For these countries, many of which are grappling with the issue of how to integrate Islamic finance into their conventional systems, the main hurdle is regulatory.

22.3. The problem of bank deposit guarantees

The core issue with regard to commercial banking is guarantee of bank deposits, mandated and regulated by financial regulators. This will always be an issue for banks as long as Basel II remains the bedrock of international banking law.[232]

Some North American banks, like University Islamic Bank, have tried to develop Shari'a-compliant products that also comply with United States financial law. University Islamic Bank launched limited musharaka deposit accounts. These limited musharaka products were structured closer to investment vehicles than to bank deposits. This follows the lead by pioneer European institutions like the Islamic Bank of Britain (IBB). IBB gives

[229] Excerpts from this part of the Global Islamic Finance Report are drawn from Shahzad Siddiqui & Imran Ahmad, Cross-Border Regulation of Islamic Finance and Foreign Investments in North America (London, Euromoney, 2010).

[230] Paul Wouters, "Islamic Private Equity Fund," Islamic Finance News in conjunction with British Swiss Capital Partners and Bener Law Office, Istanbul: http://sukuk.net/library/education/2008_oct_17_ifn_Islamic_Private_Equity_Fund_IPEF.pdf <Last accessed May 13, 2009>, p. 13.

[231] A.L.M. Abdul Gafoor, Participatory Financing through Investment Banks and Commercial Banks (Groningen, The Netherlands: Apptec Publications, 1996), p. 5.

[232] For a detailed exposition on Basel II, see Carolyn V. Currie, "The Test of the Strategic Effect of Basel II Operational Risk Requirements on Banks," Working Paper No. 143, September 2005, University of Technology Sydney, (School of Finance and Economics).

For a more theoretical discussion, see Pierre Hugues-Verdier, "Transnational Regulatory Networks and their Limits," The Yale Journal of International Law, 34: 113.