CHAPTER 22
The UK model

22.1 Introduction

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 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).

22.2 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 SSB, 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 murabaha 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 murabaha 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.

22.3 Role of the FSA

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 on 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[1].

22.4 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 on 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 on a regulated activity within the meaning of FSMA, and whether it will require any permissions from the FSA to carry on these activities. This would for example, be the case if a credit institution also carries on investment product related activities such as dealing in or advising on investments.

22.4.1 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[2]. 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"

22.4.2 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.

22.4.3 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

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

[2] 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.

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 case 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.

22.5 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).

22.6 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 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"[3] 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'.

22.7 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.

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

[3] For example, the Briefing Note BNO 16/06 of 9 March 2006 (FSA)

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.

22.8 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[4]. 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 Britain. 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.

22.9 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[5]. 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 murabaha 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.

22.10 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 murabaha 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)

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

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

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.

22.11 Shari'a-compliant or not?

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 be 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 directors, 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 SSBs, 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[6].

22.11.1 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.

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.

[6] See Part V: s59 Financial Services and Markets Act (2000).

CHAPTER 23
The Pakistan model

23.1 Introduction

Islamic finance has witnessed rapid expansion over the years and can now truly be considered a global industry both in terms geographical spread and assets class coverage. The IFSB, estimates assets of the Islamic financial industry to reach USD 1,600 billion along with revenues of approximately USD 120 billion by 2012. Currently the Middle East and Asia are the largest Islamic financial markets while the United Kingdom, Australia, China, France, Germany, Hong Kong, Italy, Korea, Luxembourg, and Singapore are among the list of non-Muslim countries providing Islamic finance services. Islamic financial institutions have gone through major transformation, while proactively responding to market demands. Given that 22 % of the world population is Muslim, even a 1 % contribution by IFIs towards global financial assets and deposits depicts a significantly untapped market.

Pakistan remains at the forefront in promoting Islamic finance. Efforts in this regard can be traced back to the mid 60s, when the Banking Companies Ordinance (BCO, 1962) was amended to allow non-interest based transactions. Following this, in 1973, Article 38(F) of the constitution of Pakistan directed the elimination of riba from the country's economic system. However, initial attempts of establishing Islamic finance as an alternative to the conventional system did not meet success. A landmark event in the evolution of Islamic finance in the country was achieved in 1980's when banks were directed not to accept interest bearing deposits and the Modaraba Companies & Modaraba (Floatation & Control) Ordinance 1980, and Modaraba Companies and Modaraba Rules (1981) were promulgated. Financial institutions were instructed to conduct their business in line with Shari'a principles. Despite being way ahead of other countries introducing Islamic finance reforms at that time, this model could not meet its objectives. This was primarily due to lack of planning for smooth transition, limitations of the proposed system to adjust to market dynamics, and apprehensions in its implementation on part of majority of the stakeholders.

In the beginning of the 1990s, the Federal Shari'a Court classified banking transactions non-Islamic and an appeal was filed before the Shari'a Appellate Bench (SAB) of Supreme Court of Pakistan (SCP). The SAB, in response to this appeal, not only directed to transform the whole system to a purely Islamic system by 30th June 2002,[1] but also prescribed detailed guidelines for the transformation. This time round, there was a greater sense of maturity on part of all the stakeholders. The government and the central bank, the State Bank of Pakistan (SBP), have remained committed ever since the court's decision to introduce Islamic finance reforms based on strong Shari'a and market fundamentals. This process has also been supported by the progress made in Islamic finance internationally, providing local stakeholders an opportunity to learn from global experiences and ensuring a dynamic regulatory framework that facilitates market development.

At present, the Islamic finance industry consists of banking and non banking institutions. The banking sector contains full-fledged Islamic banks, stand alone Islamic branches of conventional banks; while non banking institutions include mudaraba companies, mutual funds and takaful companies etc. The (SBP) regulates the banking sector, while the non banking sector is regulated by the Security & Exchange Commission of Pakistan (SECP).

23.2 Banking institutions

In line with the SAB of the Supreme Court of Pakistan's instructions to transform the banking system into an

[1] First deadline was June 2001 that got extended to June 2002.