CHAPTER 10

THE UK GOVERNMENT SUKUK

An Historic Moment for Islamic Finance

The issue by Her Majesty's Treasury (hereafter to be referred as HMT) through its wholly owned subsidiary, HM Treasury UK Sovereign Sukuk PLC, of a £200 million Shari'a-compliant trust certificate using a sukuk al ijara structure on 2 July 2014 (hereafter to be referred as the Issue) constituted a seminal moment in the development of the Islamic financial services industry, not just in the UK but also, potentially, across a wider European footprint. This chapter takes a closer look at the transaction and explores what the UK Sukuk might mean for the further development of Islamic finance in a wider European context.

It is important to understand that the Issue arguably represented the completion of a process that had commenced over 10 years earlier when the first tentative steps were made in the UK to create a level playing field for the tax treatment of Islamic financial instruments. The UK's enabling environment for Shari'a-compliant finance and investment products is based on the premise that where a Shari'a-compliant product seeks to deliver a substantially similar financial effect to its conventional product equivalent, it should receive the same tax and regulatory treatment.

If the development of Islamic financial instruments can be compared to building a house, the deployment of murabaha-based products represents the foundations and basic building blocks upon which many other products are dependent. Other instruments such as istisna'a (manufacturing or construction finance), ijara (leasing in various forms), mudaraba (asset and investment management), and musharaka (joint venturing and equity participation) together with many other ancillary contracts and arrangements form the walls, windows and doors. Sitting on top of all this and keeping everything watertight is the roof or sukuk. In many respects, sukuk represents the culmination of Islamic financing techniques since it depends upon, and is intimately connected to, the various forms of contract that are deployed beneath it to provide connectivity to the real world and thereby support the sukuk roof of the Islamic finance house. The UK's enabling environment has evolved to facilitate sukuk issuance by first ensuring the viability of those other Shari'a-compliant financial instruments that underpin each sukuk issue.

SOME HISTORY

To better understand why the UK government even wanted to consider issuing a sukuk, it is helpful to place the activity of 2014 into some historical context. As the world's leading financial centre, the City of London has been providing financial intermediation and support to the Islamic financial services industry since its emergence in the mid 1970s. London was a centre for much of the petrodollar investment flowing from the Middle Eastern countries of the GCC[1] during the 1980s and 1990s. Towards the end of that period, advisors started to witness a desire on the part of certain investors to structure their UK investments in a more Shari'a-compliant manner. Much of this investment concerned real property and it rapidly became apparent that adopting Shari'a-compliant modes of finance was not tax efficient because of the exposure to double stamp duty (amongst other things). At the time, the second stamp duty charge either had to be borne by the purchaser or reliance placed on ad hoc, informal agreements with HM Customs & Excise to gain relief or exemption from the second charge on a transaction by transaction basis. If an ijara-based product was being used, the transaction faced the possibility of three different stamp duty charges being applicable during its lifetime. What relevance does this have to the sukuk of 2014?

The situation described above was not particularly satisfactory and represented a stumbling block to the wider deployment of Shari'a-compliant modes of financing in the UK, particularly retail mortgages for home purchase. In the early 2000s all of this was to change when a number of parallel activities converged, including the following:

- **i.** The Labour government of the day sought to broaden access to financial products and independence, particularly for minority groups, including Muslims;
- **ii.** Several GCC banks (and the investors they represented) wanted to increase their investment activities in the UK but do so in a Shari'a-compliant way;
- **iii.** Several GCC investor groups were starting to consider the feasibility of launching Shari'a-compliant financial institutions in the UK;
- **iv.** HSBC launched its Amanah brand and the operation was originally based in London;
- **v.** The Bank of England became aware of the tax impediments to the deployment of Shari'a-compliant techniques for residential home finance and evinced a willingness to help resolve them by forming a Working Party to explore the issues involved;
- **vi.** Several law firms active in the Islamic financial industry through their offices in the Middle East, started to see an uptick in activity in London and were willing to support the development of the industry; and
- **vii.** Several community groups active at the time, such as the Muslim Council of Britain, were invited to join the Bank of England Working Party, which helped build momentum.

The eventual outcome of this activity was a period of sustained cooperation between the UK government, the Bank of England, financial regulators (the Financial Services Authority or FSA at that time), industry practitioners and community groups, which resulted in the Finance Act 2003. This first piece of legislation introduced tax changes and laid the ground-work for Islamic finance to be undertaken on a cost-effective and more efficient basis in the UK. This process also facilitated the launch in 2004 of the IBB, the first FSA-authorised financial institution established with the intention that it would be managed on a wholly Shari'a-compliant basis. In the four years following the launch of IBB a further four wholesale banks together with an investment manager and a Takaful enterprise were also approved and launched.

The sustained development of the Islamic financial services industry in the UK, encouraged by the Labour administration during this period, culminated in an announcement that the government would issue a sukuk. There followed a series of consultations, commencing in November 2007 that continued though much of 2008. HMT also appointed lawyers to advise on the structure of a treasury bill style of sukuk issuance programme and good progress was made towards structuring such an issue. Unfortunately, even as this exercise progressed, reservations started to arise as to whether or not the instrument would achieve the relevant "value for money" targets set by government. Perhaps the final death knell in the likelihood of such an issue ever happening was the increasingly negative impact of the global financial crisis on the UK economy, which forced a complete re-focusing of government energies and priorities away from any potential sukuk issue. Despite the frustration engendered within the broader Islamic finance community by the government's eventual decision not to proceed with a Sukuk in the summer of 2009, it should be realised that considerable work was

1. Bahrain, Kuwait, Oman, Qatar, Kingdom of Saudi Arabia and the United Arab Emirates

completed towards creating the legal regime under which a Sukuk would eventually be feasible. For example, section 157 of the Finance Act 2008 authorised HMT "by regulations [to] make provision for raising money through alternative finance arrangements" and to specify a purpose under the National Loans Act 1968, thereby bringing sukuk into the box of monetary instruments available to HMT and its executive arm the Debt Management Office DMO. More generally, this work culminated in the Finance Act 2009 where Schedule 61 implemented the architecture that would ensure that from a tax perspective, sukuk could be issued by the UK companies using real estate as the underlying asset.

Unsurprisingly, the new Conservative/Liberal Democrat coalition government that took power in May 2010 had little time to think about Islamic finance, still a niche industry in the UK. However, three years later by the summer of 2013, as the economy was showing signs of recovery from the worst effects of the global financial crisis, a Ministerial-led 'Task Force' was mandated to re-engage with the Islamic financial services community. Later on that year, at the 9th World Islamic Economic Forum held in London and for the first time outside a Muslim majority country, Prime Minister David Cameron announced on 29 October 2013 that the government was reconsidering the possibility of issuing a sukuk.

At the end of January 2014, HM Treasury publicly, and arguably slightly unusually, announced the appointment of HSBC Bank Plc (as sole financial advisor) and Linklaters LLP (as sole legal advisor) for the Issue. Much started to be made of these announcements in the Islamic financial industry press as to whether and when the UK government would issue sukuk, and in particular, if it would manage to do so earlier than several other non-Muslim countries which were similarly rumoured to be contemplating sukuk issuances during the course of the year.

WHAT DID THE ISSUE INVOLVE AND WHY WAS IT DONE?

A key factor in the decision of the UK government to issue the sukuk was securing the continuity of the City of London's position as the leading hub for Shari'a-compliant financial and investment activity outside the Muslim world and more specifically in Europe. Thus, building on the City's role of providing intermediation and supporting services to the Islamic financial services industry since its inception in the 1970s. It was also considered important that the Issue should demonstrate to the market the feasibility of issuing sukuk under the UK's existing legislative, fiscal and regulatory frameworks, as it was hoped this would encourage future sukuk issuances by other UK-based market participants. The government's approach to the Issue was that it did not want to be doing something that was feasible for government (perhaps because of special legislative provision) but could not then be replicated by non-governmental potential issuers.

The government chose to issue by way of a sukuk al ijara because this method is generally considered to be a vanilla structure and has historically been the preferred approach of most first-time sovereign issuers. One of the interesting features of the legislative approach adopted by the UK towards enabling Islamic finance has been the embedding of the ability to allow for future adjustments by way of Statutory Instrument (or other forms of guidance) without necessarily requiring primary legislation. This approach means that when HMT demonstrates its willingness to make any adjustments to facilitate other types of issuance, should that prove necessary, it has both the legislative authority and the tools available to do so.

The following paragraphs discuss the various requirements of HM Treasury and explain how they impacted the development and structuring of the Issue under the Finance Act 2009.

A Gilt-like Character

HMT wanted the Issue to be structured such that it would be as "gilt-like" as possible. The Issue was a modest £200 million issuance to demonstrate the feasibility of a Shari'a-compliant instrument issued under the DMO's gilt framework. UK government gilts have traditionally been issued in a very simple format using short-form documentation with no disclosure and few risk factors - very different to a typical sovereign sukuk. The holders of gilts rely upon the Crown Proceedings Act 1947 to secure their recourse against HMT. In order to replicate that aspect of gilts in a sukuk-style of transaction, some interesting structural arrangements would have to be introduced.

UNDERLYING ASSET CONSIDERATIONS

One of the critical components of any sukuk is the availability of genuine assets that are sufficiently Shari'a-compliant to underpin the issuance. HMT identified UK government owned and occupied buildings in London (referred to as the Properties) that could be used to support the Issue. The Properties were valued (to ensure that they would match or exceed the value being raised by the Issue), assessed by the financial advisor's Shari'a Supervisory Board (to ensure that no objectionable activities were being carried out) and subjected to a title due diligence exercise (to ensure there were no encumbrances or other adverse interests). Unlike many sukuk in the Middle East, the underlying qualifying interests[2] in the Properties were transferred by way of a registered and perfected lease granted by the Department of Communities and Local Government ("DCLG")) to HMT UK Sovereign Sukuk PLC (the wholly owned special purpose company established by HMT for the purposes of the Issue (the "Trustee")) to hold the Properties as trustee on behalf of the sukuk holders.

A long leasehold interest of 99 years was granted by DCLG in favour of the Trustee in exchange for the payment of a premium. The structure had to balance the requirements of Finance Act 2009 (which required that where the underlying assets consisted of land the "qualifying interest" should be a freehold interest or a leasehold interest longer than 21 years) against the concerns of government (to ensure a continuing reversionary interest in the Property) and the concerns of Shari'a scholars (that a genuine right in property should underpin the Issue). To generate the necessary cashflows that would allow the Trustee to make periodic distributions to holders of the Certificates, the Trustee would grant a short sub-lease (five years) in favour of DCLG with periodic payments of rental due thereunder. The arrangements under which DCLG allows various governmental departments to occupy the Properties would be able to continue after the structure had been implemented as the Shari'a scholars satisfied themselves there were no pre-existing lease concerns to be addressed.

ROLE OF HM TREASURY

HMT is the UK government department responsible for developing and executing the British government's public finance policy and economic policy. Throughout the process of designing the issuance it was important to HMT that it should remain the primary obliger and the representative body of the UK facing the eventual holders of Certificates. Achieving that objective proved harder than it might seem due to several aspects of UK constitutional law impacting upon HMT and the various departments of the Crown. Even though HMT is one of the departments of the UK government, various legal and technical considerations prevail against it holding direct interests in real property. In the context of a sukuk al ijara transaction, where the obliger party is also the originator of the underlying asset and will eventually be obliged to re-purchase the asset at maturity, this constitutional consideration meant that HMT would not be able to act in the traditional capacities of a sukuk originator.

Fortunately, other departments of state are better suited to own real property and since, as a matter of constitutional law, they exist alongside HMT as constituent parts of the Crown body as a whole, it was decided that an appropriate department of state needed to be identified that could collaborate with HMT. In view of this, DCLG was introduced into the structure since the department already owned some of the land and buildings that had been identified as potential Properties to be included in the Issue. It was determined that additional Properties would be conveyed to DCLG to minimise the number of departments involved. A new document in a sukuk transaction – the Procurement Undertaking - was developed and introduced pursuant to which HMT unconditionally undertakes in favour of the sukuk holders that it shall perform, or shall procure that DCLG performs, the various obligations required to be performed under the suite of transaction documents. By virtue of the Procurement Undertaking and the Crown Proceedings Act 1947, the sukuk holders acquired direct rights against HMT instead of the traditional sukuk rights of action for non-payment against the Trustee, or against the Obliger through the Trustee. Since the UK government has not failed to repay government debt in over 650 years, it is unlikely such rights will ever need to be exercised.

2. An expression that is defined in Paragraph (1) (a), Part 1 (Introductory), Schedule 61 (Alternative Finance Investment Bonds) Finance Act 2009 (see following commentary).

No Delegate

A characteristic of most sukuk transactions is the existence, and appointment by the Trustee, of a third party to act as the delegate, whose role is to provide an independent representative function for the benefit of the sukuk holders, similar to the role of a bond trustee. As the structure of the UK sukuk developed it became apparent that the role and most of the functions of the delegate were redundant, as an analogous bond trustee does not feature in the government's gilt documentation. The traditional role of a delegate was therefore largely removed from the documents, making this (to the author's knowledge) the first international sukuk to be issued without the usual delegate function. There was an additional, important reason for this approach. HMT was concerned that nothing in the structure should inhibit its ability to perform the payment obligations it was assuming, which might be the case if a third party outside of its control, was involved in the process of making or directing payments to the sukuk holders, whether periodically during the tenor of the sukuk or at maturity.

Tax Aspects

A major work stream throughout the transaction concerned the tax treatment of the overall arrangements. Often when Islamic financial products and services are removed from their source of origin in the Middle East (in this context, the GCC States in particular) and used in different jurisdictions they start to encounter adverse fiscal effects as a result of the tax treatments that are imposed upon the underlying transactions in other countries. At its simplest, Islamic finance achieves credit effects that are often similar to conventional lending arrangements by the debtor and creditor parties entering into various trading (i.e. commercial) transactions involving the sale and purchase, or the sale and leasing, of tangible assets. This differs markedly from conventional debt or capital markets financing which are based on banks or investors lending money and charging interest to the borrower/issuer without getting involved in the actual supply of assets to the borrower/issuer. Consequently, most jurisdictions around the world have designed taxation systems that charge income, corporation, capital gains, sales taxes and VAT etc. on commercial transactions or the final profits and gains of commercial activity and also charge registration or other taxes on the transfer of real property (land or buildings being the most common form of tangible assets used in sukuk al ijara structures). Under this model, the interest costs involved in borrowing to fund business activity are often deductible as an expense of the business when a company calculates its tax return and so the system favours conventional borrowing as a way of financing business activity. Unless adjustments are made to the domestic tax framework to create a level playing field when Islamic financiers utilise transactions that otherwise look like commercial arrangements to achieve a financing effect, they cannot compete effectively with conventional modes of finance.

As mentioned in the historical introduction, the UK has progressively passed legislation to ensure a level playing field for the tax treatment of Islamic financial products and services; a process that commenced with Finance Act 2003 which cleared the way for murabaha contracts to be used in the financing of residential properties. As mentioned earlier, Finance Act 2009 is the statute which sets out the conditions to secure the relief available under alternative finance investment bonds when dealing with real estate (see in particular Schedule 61). The statutory requirements are prescriptive and the arrangements not only have to be entered into in accordance with their terms at the outset but complied with at maturity of the sukuk (or earlier if an event triggering an early termination occurs), when they have to be exited as prescribed by statute in order to obtain relief. The provisions are designed as anti-avoidance measures to ensure sukuk are not used to circumvent taxes that would otherwise be applicable on the underlying arrangements.

Her Majesty's Revenue and Customs (HMRC) were engaged throughout the structuring of the Issue to advise on all tax aspects of the transaction, including compliance with the Finance Act 2009 conditions for tax relief, and specific income tax, corporation tax, VAT, SDLT and inheritance tax issues.

Statutory Instrument

As mentioned earlier, the other piece of important enabling legislation for HMT to raise public debt by way of sukuk was section 157 of Finance Act 2008. The final piece of the legislative jigsaw puzzle that needed to be completed for the Issue was the production of the regulation referred to in section 157. HMT's internal legal service, Treasury Legal Advisors, in consultation with Linklaters LLP, drafted a new Statutory Instrument (Government Alternative Finance Regulations 2014 (S.I. 2014/1327) (the "SI")) under the Finance Act 2008, which came into effect on 16 June 2014, confirming the necessary powers and aligning the sukuk fundraising with certain requirements of the National Loans Act 1968. Since the SI would have been one of the tools that could have been used to legislate for any otherwise insurmountable tax issues, it was critical to the timing of the transaction that the tax analysis was completed and HMRC approval obtained, so that the SI drafting could be settled and the instrument laid before Parliament early enough to facilitate the pre-Ramadan issuance timetable being targeted by the government.

WHAT CAN OTHER EUROPEAN COUNTRIES LEARN FROM THE UK EXPERIENCE?

Denominated in Pounds Sterling, the UK sukuk was more than 10 times oversubscribed and demonstrated continuing investor appetite for sukuk even when issued in a currency other than US dollars or Malaysian Ringgit (the two traditional sukuk currencies). The fact that the Issue was below benchmark size probably means that true demand was not apparent as some potential investors may not have submitted bids knowing they would have been scaled back. The pricing at 2.036% was the same as would have been expected for equivalent tenor gilt and so achieved the government's objectives of maintaining parity with similar conventional instruments.

The London Stock Exchange has provided a platform for the listing of more than 40 sukuk, including this Issue, and leads the non-Muslim world for such activity. The UK sukuk has now demonstrated that sukuk outside the Muslim-majority world can also be structured, issued and will be acquired by investors. Following on from the success of the UK issuance, the Duchy of Luxembourg became the second sovereign European State to issue sukuk when it launched its Euro-denominated issue in October 2014. This was the first sukuk issued in Euro since the State of Saxony-Anhalt Sukuk some 10 years earlier, in 2004.

Other European countries, most notably, France and Germany, have explored Islamic finance with varying degrees of seriousness and intent in the past (the State of Saxony-Anhalt Sukuk has just been mentioned). However, notwithstanding the legislative changes that have occurred in France, no other European country has to-date invested as much political capital as the UK, to push forward the sort of comprehensive changes required to their tax frameworks in order to establish a level playing field across the spectrum of Islamic financial services and products. Luxembourg has also made an investment in the industry by its founding membership of the International Islamic Liquidity Management Corporation (IILM) and has subsequently benefited from the use of Luxembourg securitisation vehicles for IILM's issuance structure. Luxembourg has also made progress in other areas of Islamic financial product and service development. If the earlier metaphor of sukuk forming the roof of a house is pursued, it becomes clear that sukuk cannot exist in a vacuum because they need to be supported by the remainder of the Islamic financial product universe. What this suggests is that a more holistic approach is needed by governments and legislators in Europe (and elsewhere in the non-Muslim world) if they wish to encourage and enable Shari'a-compliant finance and investment to flow into their countries. It remains to be seen how many European governments are willing and able to facilitate such activity.

Prospects for the further growth and expansion of Islamic financial techniques in other European countries is a regular topic of conversation within the Islamic financial services industry but the reality is that material developments have been few and far between. Ad hoc investments, particularly in real estate, have taken place over the years in a number of European countries but structuring such deals has often been complex, based on legal interpretation and occasionally finding a work-around solution, rather than being able to rely upon clear statutory frameworks. In the period since the commencement of the global financial crisis the general economic malaise in many European states has also been a factor inhibiting further investment in the Eurozone. More recently, several initiatives to establish new Islamic banking operations in France and Germany, respectively, are underway but they have been a long time coming and subject to much regulatory scrutiny. Without pro-active political pressure to continue the initiatives required to level the playing field (since legislative steps are usually required to implement necessary changes), it is difficult to see other

European countries creating the broader enabling environment that now exists in the UK. Having said that, it might only take a few more European sukuk issues to encourage other governments in a larger number of European countries to look more seriously at Islamic finance, with a view to enabling the industry and unlocking the potential benefits that encouraging Shari'a-compliant investment activity may offer their jurisdictions.