Seizing the Initiative:
the UK's Islamic Finance Opportunity

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Executive Summary:

"The empire of the Caliphs seems to have been the first state under which the world enjoyed that degree of tranquility which the cultivation of the sciences requires. It was under the protection of those generous and magnificent princes, that the ancient philosophy and astronomy of the Greeks were restored and established in the East; that tranquility, which their mild, just and religious government diffused over their vast empire, revived the curiosity of mankind, to inquire into the connecting principles of nature."

- Adam Smith, History of Astronomy[1]

Due to specific proscriptions within Sharia, such as the prohibition on interest, many Muslims are unable to make full use of traditional financial institutions. Since the emergence of modern Islamic finance in the 20th century, new instruments have emerged to deliver financial services to the world's 1.9 billion Muslims.

With worldwide Islamic finance assets set to exceed $6.7 trillion in total value by 2027, Islamic finance is quickly becoming an integral part of the global financial system. The UK is widely recognised as the Islamic finance hub of the Western world - in 2014, it became the first country outside of the Islamic world to offer sovereign sukuk.

As Britain's global orientation changes in a post-Brexit world, policymakers have an opportunity to build on this existing reputation in order to cement London's place as the go-to Western hub for Islamic finance. Forging closer trading relationships with partners in the Islamic world, particularly in the Gulf, aligns with key UK economic and strategic goals.

Leveraging London's reputation as a stable, reliable place to do business, the UK's extensive financial and legal services expertise, and a favourable regulatory regime, the UK should seek to establish itself as a key exporter of Islamic finance.

In order to seize this opportunity, policymakers should consider taking the following steps:

1. The Bank of England's Alternative Liquidity Fund should continually operate during the working week, and include an online portal for interaction by depositors.
2. The Alternative Liquidity Fund should be further digitised, moving away from encrypted email and phone banking, and move towards an online portal for depositors.
3. The Government should implement the recommendations of its 'Tax Simplification for Alternative Finance' report.
4. The Government should align its Capital Gains Tax rules for alternative finance

1 History of Astronomy, Adam Smith, The Essays of Adam Smith, 1869, Pg. 353,

with mainstream applications of the tax.

5. The Lord Mayor of London and HMT should further engage with foreign Islamic Banks, and review current structures in the City to create more effective environments for Sharia-compliant foreign direct investment.

Introduction

“We have all the tools. What we have to do is convert short-term money into long-term finance and investments.”

So said Sheikh Saleh Abdullah Kamel, widely regarded as one of the pioneers of the contemporary global Islamic finance movement. Alongside scholars such as Anwar Qureshi and Muhammad Hamidullah, Sheikh Saleh Kamel played a pivotal role in the global emergence of Islamic finance, at a time when the compatibility of Islam and modern financial instruments was a matter of intense debate. Over the past decade, governments and regulators alike have continued to strengthen Islamic finance regulations, expanding provision of Sharia-compliant services and applying Islamic finance principles to emergent financial technologies. Fast forward to today, and projections from the London Stock Exchange indicate that worldwide Islamic finance assets are set to exceed $6.7 trillion in total value by 2027.[2]

Clearly, Islamic finance represents a significant part of our global financial ecosystem - but what does that have to do with the UK? The UK is already globally recognised as the Islamic finance hub of the Western world - according to 2023 analysis from Fitch Ratings, strengths include *“the London Stock Exchange (LSE) as a key international sukuk listing venue, its sizeable Islamic funds segment, and its capable human capital – including its professional and legal services, which cater to Islamic finance globally.”*[3]

In a post-Brexit world, policymakers must seize on the growth opportunities presented by increased services trade with markets in Asia and Africa. Islamic finance is a key piece in that puzzle. Get it right, and the global growth of Islamic finance has the potential to deliver enormous benefits for the UK, powering growth in the financial services sector and helping the City of London to retain its place as a centre of global finance.

Making the most of this opportunity will mean crafting a regulatory framework that enables Islamic finance institutions to start and grow in the UK. It will also mean ensuring that London builds and maintains a credible pool of human capital. For the foreseeable future, demand for Islamic finance in the UK will be largely driven by international consumers. As such, any regulatory reform in this area should aim to maximise potential export upside, carrying on in the proud British tradition of exporting high-quality financial services around the world. With about 1.9 billion Muslims in the world today, the demand for Islamic finance is plain to see - it stands to reason that London should step up, and deliver the supply.

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2 *Navigating uncertainty: Global Islamic finance assets expected to exceed $6.7 trillion by 2027,* Shaima Hasan and Shereen Mohamed, London Stock Exchange Group, February 26th 2024

3 *UK maintains Islamic finance Western hub status, despite domestic niche,* FitchRatings Dubai, June 20th 2023

What is Islamic Finance?

Despite its importance to the global economy, mainstream Western knowledge of Islamic finance is weak.

'Islamic finance', sometimes known as 'Islamic banking' or '*Sharia*-compliant finance', simply describes financial services activity deliberately designed to comply with Sharia law.

The most well-known difference between Islamic finance and traditional Western models of finance regards the payment of interest. Sharia prohibits riba, or usury, generally defined as interest paid on all loans of money. Much of the literature on the theory of Islamic banking has grown out of a concern as to how the monetary and banking system would function if interest were abolished. In general, Islamic financial institutions deal with this prohibition through some form of 'Profit and Loss Sharing' mechanism, most often *mudabarah* (profit-sharing and loss-bearing) or *musharaka* (joint venture). The Institute of Islamic Banking and Insurance provides an illustrative example of the practical function of such a mechanism:

"Another Islamic principle is that there should be no reward without risk-bearing. This principle is applicable to both labour and capital. As no payment is allowed to labour unless it is applied to work, so no reward for capital should be allowed unless it is exposed to business risks...

[Under mudabarah], The two persons co-operate with each other on the basis of partnership, where the capital-owner provides the capital and the other party puts his management skills into the business. The capital-owner is not involved in the actual day-to-day operation of the business, but is free to stipulate certain conditions that he may deem necessary to ensure the best use of his funds. After the expiry of the period, which may be the termination of the contract or such time that returns are obtained from the business, the capital-owner gets back his principal amount together with a pre-agreed share of the profit.

The ratio in which the total profits of the enterprise are distributed between the capital-owner and the manager of the enterprise is determined and mutually agreed at the time of entering the contract, before the beginning of the project. In the event of loss, the capital-owner bears all the loss and the principal is reduced by the amount of the loss. It is the risk of loss that entitles the capital-owner to a share in the profits. The manager bears no financial loss, because he has lost his time and his work has been wasted. This is, in essence, the principle of mudarabah."[4]

The relationship in *mudabarah* is not considered to be equivalent to that of creditor

4 *Basis of Islamic Banking, Islamic Banking Principles,* Institute of Islamic Banking and Insurance, accessed 2024

and debtor, due to the fact that both parties agree on the ratio in which profits will be shared between them, and because both parties suffer in the event of a loss.

Mudabarah is not the only consequence of the Islamic prohibition on riba. Loans are also governed by different principles in Islamic finance; all loans in Islam are interest-free. Qard al-hasan (translated roughly to 'benevolent lending') is the standard form of loan in Islamic finance; borrowers need only pay back the amount borrowed and are not subject to additional interest payments.

However, nor is the prohibition on *riba* the only principle of Islamic finance. Investment in businesses that provide goods or services considered haram, such as pork or alcohol, is also forbidden. Investments are also forbidden in the case of excessive uncertainty (gharar) and all forms of gambling (maysir). These latter prohibitions tend to rule out investments in derivatives, options, and futures. Instead, many Islamic finance institutions offer *sukuk*, or Sharia-compliant bonds. *Sukuk* holders are given nominal part-ownership of an asset from which they receive income, either from profits generated by that asset or from rental payments made by the issuer. Unlike traditional forms of investment, *sukuk* is regarded as permissible for Muslims - *sukuk* bonds are structured to comply with *Sharia* by paying profit, rather than interest.

Islamic jurisprudence also traditionally makes prescriptions about the proper functioning of markets - *"hoarding, speculation and collusion among producers and traders against the interest of consumers, and such monopolies that are injurious to the socio-economic health of society are all ruled out."* [5] According to the Islamic Research and Training Institute of the Jeddah-based Islamic Development Bank:

"The most important feature of Islamic banking is that it promotes risk sharing between the provider of funds (investor) on the one hand and both the financial intermediary (the bank) and the user of funds (the entrepreneur) on the other hand ... In conventional banking, all this risk is borne in principle by the entrepreneur."[6]

Many Islamic banks also help Muslims with management of zakat, a religious obligation for all Muslims who meet the necessary wealth criteria. Zakat is a mandatory charitable contribution, customarily calculated as 2.5% of a Muslim's savings and wealth above a minimum amount (known as nisab) each lunar year. The collected amount should be paid to:

"The poor, the needy and those who work on [administering] it, and to those whose hearts are to be reconciled, and to [free] those in bondage, and to the debt-ridden, and for the cause of God, and to the wayfarer."[7]

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5 *The Islamic Financial System*, Institute of Islamic Banking and Insurance, accessed 2024

6 *Challenges Facing Islamic Banking*, Munawar Iqbal, Ausaf Ahmad, Tariqullah Khan, Islamic Development Bank, 1998, Pp 15-16,

7 *Who receives Zakat?*, National Zakat Foundation, citing Qur'an, 9:60, 2024

In most Muslim-majority countries, zakat is paid on a voluntary basis.

Islamic financial institutions take many different forms, ranging from fully-fledged Islamic financial institutions (such as Gatehouse Bank, or Al Rayan Bank) to Sharia-compliant units within traditional financial institutions (such as HSBC's HSBC Amanah service). Most of these institutions are overseen by an internal Sharia Supervisory Board (SSB), composed of jurists specialising in Islamic financial jurisprudence. The scope and powers of SSBs has largely been standardised, through guidance issued by institutions such as the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions, the Organisation of Islamic Cooperation's Fiq Academy, and the Islamic Financial Services Board. However, SSBs and Islamic financial institutions more broadly are still beholden to regulators in the states in which they operate.

This is a non-exhaustive overview; Islamic financial institutions now provide hundreds of different types of financial services to the world's 1.9 billion Muslims. Though many of the underlying principles of Islamic finance are unfamiliar to Westerners, the principle of meeting demand for Islamic finance with a supply of financial services is not. The prescriptions outlined above have an influence on the day-to-day financial decisions of the world's Muslims. It stands to reason that institutions would emerge to enable Muslims to store and grow their wealth in line with these principles.

Provision of *Sharia*-compliant financial services is at once relatively young and very old. According to some historians, the elimination of interest in early Islam culminated in a "*fully fledged Islamic economic system*" under Umar ibn al-Khattab, the second Rashidun caliph (634-644 AD).[8] An early form of market economy emerged under the early Islamic caliphates, with millions of people across vast swathes of territory tied together by a single legal system (*Sharia*) and a single, widely circulated currency, the gold *dinar*. Muslim traders are known to have used cheques (*sakk*) since the time of the Abbasid Caliphate.[9]

In the 19th century, Islamic Modernists attempted to reconcile Islam with modern developments in financial services. This included a reconsideration of the prohibition on interest, in light of economic orthodoxy which held that interest rates and insurance were among the "*preconditions for productive investment*" needed to stimulate growth in a modern economy.[10] Sir Syed Ahmad Khan, one of the leading lights of the 19th century Aligarh Movement amongst Muslims in British India, argued for a distinction between riba and legitimate non-riba interest, such as in cases of commercial lending.

8 The Foundations of Islamic Political Economy, M.A. Choudhury and U.A. Malike, MacMillan Press, 1992, p104.

9 A Short History of the Arab Peoples, Sir John Bagot Glubb, Dorset Press, 1988, p105.

10 Jihad: on the trail of Political Islam, Giles Kepel, Harvard University Press, 2003, p77.

However, this nascent attempt at reconciling Islam with modern financial instruments was superseded by a new academic and jurisprudential consensus in the 20th century, which instead chose to define all interest as *riba*. From the late 1940s and early 1950s, scholars and jurists such as Muhammad Hamidullah came to argue for a bespoke system of commercial banks, based on concepts such as *mudarabah*, which used novel mechanisms to enable commercial banks to remain *Sharia*-compliant. At the First International Conference on Islamic Economics, several hundred jurists, scholars, and economists from across the Islamic world "*unequivocally declared that all forms of interest are riba*."[11]

In 1975, the Jeddah-based Islamic Development Bank was established, with a mission to support bankable projects in OIC Member Countries. The first modern commercial Islamic bank, the Dubai Islamic Bank, was established in 1979. The first Islamic insurance company, the Islamic Insurance Company of Sudan, was established in 1979.

These early forays into Islamic finance infrastructure were complemented by a regulatory infrastructure which emerged in the following decades, The aforementioned Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was founded in 1993, with a mandate to publish norms and standards for the Islamic finance industry. Its standards are mandatory for Islamic financial institutions in Bahrain, Sudan, Jordan and Saudi Arabia, and are heavily relied upon elsewhere.[12]

11 Ibid.

12 *What Is Wrong with Islamic Economics?: Analysing the Present State and Future Agenda*, Muhammad Akram Khan, Edward Elgar Publishing, 2013

The Global Shape of Islamic Finance Today

Today, Islamic finance is an integral part of the global financial ecosystem; the global Islamic finance industry is expected to maintain high single-digit growth in 2024-25, after a growth of 8% in 2023.[13] Islamic finance is one of the fastest growing segments of the global financial system, with an estimated compound annual growth rate of 17% since 2009.[14] The assets of the world's Islamic banks expanded rapidly to reach $3.24 trillion by the end of 2022, up from $1.3 trillion in 2012. The number of fully-fledged Islamic banks was reported by the London Stock Exchange as to be 336 in 2022, while the number of conventional banks offering Islamic banking services was reported as 274.[15]

The strongest growth in Islamic finance over the past decade has been in Saudi Arabia, the United Arab Emirates, and Iran. However, over the past decade, the number of countries engaged in creating enabling infrastructure for Islamic finance has increased. In 2023, Bank Nizwa launched the first *Sharia*-compliant financial offering for retail customers in the Sultanate of Oman. Turkey has offered *sukuk* certificates since 2012, with Islamic finance now regarded as 'strategically important' by the Turkish government - President Erdogan has announced his intention to ensure that Islamic banks reach 15% of financial sector assets by 2025.[16] Similar interest in Islamic finance has emerged in Kazakhstan, Uzbekistan, Nigeria, Uganda, and the Philippines.

However, it ought to be recognised that growth has been concentrated in a few key markets. According to data compiled by the Union of Arab Banks, just 10 countries account for almost 95% of the world's *sharia*-compliant assets:[17]

1. Iran (29%)
2. Saudi Arabia (25%)
3. Malaysia (11%)
4. The United Arab Emirates (8%)
5. Kuwait (6%)
6. Qatar (6%)
7. Turkey (2.6%)
8. Bangladesh (2.1%)

13 *Islamic Finance 2024-25, Resilient Growth Anticipated Despite Missed Opportunities*, Mohamed Damak, S&P Global Ratings, April 29th 2024

14 *Islamic Finance*, David Platt, Pinsent Masons, October 26th 2023

15 *Navigating uncertainty: Global Islamic finance assets expected to exceed $6.7 trillion by 2027*, Shaima Hasan and Shereen Mohamed, London Stock Exchange Group, February 26th 2024

16 *Turkish Islamic Finance Industry Set To Cross USD100 Billion Amid Government Push*, Matthew Pearson, FitchRatings, October 31st 2023

17 *Islamic Finance: Just for Muslim-Majority Nations?*, Chloe Domat, Global Finance, January 1st 2024

9. Indonesia (2%)
10. Bahrain (1.8%)

Unsurprisingly, Islamic finance remains strongest in the Middle East and North Africa (MENA); the region is home to 190 Islamic banks. The member states of the Gulf Cooperation Council (GCC) dominate the world of Islamic finance, with over 90% of the region's *sharia*-compliant assets.

Country	Number of Islamic Banks	Assets (USD)
Saudi Arabia	4	194.7 billion
United Arab Emirates	7	169.2 billion
Kuwait	5	120.5 billion
Qatar	5	113.3 billion
Bahrain	10	57.8 billion
Egypt	214	9.8 billion
Jordan	2	9.6 billion
Sudan	7	9.4 billion
Oman	2	4.5 billion
Algeria	2	3.4 billion
Tunisia	1	1.4 billion
Syria	2	Not available
Yemen	1	Not available

(Analysis conducted by the Union of Arab Banks, 2024)[18]

Traditionally, the practice of Islamic finance has been far stronger in the GCC than in other parts of MENA. In recent years, North African states such as Morocco have taken steps to liberalise laws around *sharia*-compliant financial services - until 2017, such products were illegal in Morocco. In 2018, the Central Bank of Morocco issued its first *sukuk*. Despite significant challenges, Morocco's nascent Islamic finance sector is developing slowly, and reflects a broader, gradual shift in the world of Islamic finance away from absolute GCC dominance.[19]

This trend is perhaps best encapsulated by the fact that Asia-Pacific represents almost 25% of the global Islamic finance market. In Malaysia, sharia-compliant institutions account for close to one-quarter of the financial sector.[20] Kuala Lumpur is one of the main drivers of the global sukuk market and weighs in on international compliance with the Islamic Financial Services Board. Other mature Asian Islamic finance markets include Bangladesh, Brunei, and Pakistan, where *sharia*-compliant assets make up more than 15% of total bank assets.

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18 Analysis from the Union of Arab Banks published as part of *Islamic Finance: Just for Muslim-Majority Nations?*, Chloe Domat, Global Finance, January 1st 2024

19 *Morocco's Islamic Finance Industry Is Nascent; Faces Key Challenges*, Matthew Pearson, FitchRatings, March 15th 2023

20 *Islamic Finance: Just for Muslim-Majority Nations?*, Chloe Domat, Global Finance, January 1st 2024

In short, support for expansion in Islamic finance has grown rapidly in recent years, driven by both increasing consumer demand and increasing support from Governments in a number of major Muslim economies. While growth is still concentrated in the six member states of the GCC, global involvement in Islamic finance continues to diversify.

Holding around 70% of global Islamic financial assets, Islamic banking was the main driver of the overall growth of the industry over the past decade. However, the fastest growing asset class is *sukuk*, driven by an ever-growing need for funding across the Islamic world. Since 2002, when the first sukuk was issued during the modern Islamic finance period, growth has traditionally been centred in traditional Islamic finance markets. The past decade has seen a diversification of issuers - the UK issued its first sovereign *sukuk* in 2014, making it the first country outside of the Islamic world to do so.[21]

With this in mind, it ought to be noted that Islamic finance institutions do not necessarily need to domicile themselves in Muslim-majority countries. As indicated by the fact that many traditional commercial banks now offer *sharia*-compliant services for consumers, the success of Islamic finance does not require wholesale tailoring of the regulatory system around Islamic finance principles. Provided that these services are not actively prohibited in a given jurisdiction, *sharia*-compliant financial institutions can operate from any country.

In this sense, the UK - as a globally-recognised services hub - has an enormous opportunity in Islamic finance. By leveraging the City's traditional position as a services exporter, the UK could attract Islamic finance institutions to London, delivering jobs and investment for the nation's capital while enabling businesses to draw on the UK's financial services expertise, its regulatory stability, and its global prestige in financial services.

So, why is the UK so well-suited to seizing this opportunity, and how can it do so in practice?

21 *UK bolsters Islamic finance offering with second Sukuk*, HM Treasury, March 25th 2021

The UK's Islamic Finance Opportunity

The UK is already globally recognised as the Islamic finance hub of the Western world. According to CityUK's ICD-Refinitiv Islamic Finance Development Indicator (IFDI) report, the UK ranks 27th out of a total 136 countries, and has outperformed all Western countries excluding Turkey.[22]

So why is the UK such an attractive place for Islamic finance compared to our European peers? This is certainly not a feature of outsized domestic demand - not only is France, rather than the UK, home to the largest Muslim population in Western Europe, but most demand for Islamic finance in the UK is found overseas.

For one, the UK enjoys a global reputation as a financial services hub, and maintains close links with many of the economies powering the global Islamic finance industry. English common law's status as a globally-recognised instrument for dispute resolution also plays a part here - sovereign sukuk is "*almost always structured as trust certificates under English law.*"[23]

According to analysis from FitchRatings, the UK has also benefited from active efforts to incubate sharia-compliant financial infrastructure:

"*The government's promotion of the role of the London Stock Exchange (LSE) as a key international sukuk listing venue, its sizeable Islamic funds segment, and its capable human capital – including its professional and legal services, which cater to Islamic finance globally…the LSE lists more than 55 sukuk, with over $50 billion outstanding as of 1Q23. The assets under management of UK-based Islamic funds totalled $280.6 million as of Q1 2023 which recorded a growth of 2.9% compared to the previous quarter.*"[24]

The UK issued its first sovereign *sukuk* in 2014, making it the first country outside the Islamic world to issue sovereign *sukuk*. It offered a second *sukuk*, with a total value of £500 million and a 5-year maturity, in 2021. The second *sukuk* was more than double the size of the first issuance, and attracted global demand, with orders totalling in excess of £625 million.[25]

In 2004, the UK saw the launch of the first Islamic commercial bank outside the Muslim world, in the form of the Islamic Bank of Britain.[26] Today, the UK's Islamic

22 *Islamic Finance: Global Trends and the UK Market,* CityUK, 2022, p5.

23 *Embracing sovereign sukuk: demystifying Sharia-compliant sovereign finance,* Dr. Reza Baqir and Ali Hakim, Alvarez and Marsal, April 15th 2024, p5.

24 *UK maintains Islamic finance Western hub status, despite domestic niche,* FitchRatings Dubai, June 20th 2023

25 *UK bolsters Islamic finance offering with second Sukuk,* HM Treasury, March 25th 2021

26 *Key Sharia Principles and Prohibitions in Islamic Finance,* Faleel Jamaldeen, July 24th 2016 banking sector is dominated by four key players: Bank of London and the Middle East (BLME), Gatehouse Bank, Islamic Bank of Britain (Al Rayan), and the Qatar Islamic Bank UK (QIB UK), a subsidiary of Qatar's QIB. The rise of the UK as a fintech hub has led to a corresponding growth in Islamic fintech startups - prominent examples in recent years include Kestrl and Wahed.

This relatively well-developed Islamic finance infrastructure is complemented by increasingly strong trade relations between the UK and the Islamic world. According to the latest available figures, UK trade with the six GCC nations now totals £61.5 billion in total value,[27] of which 47.9% was in services.[28] Foreign direct investment from the GCC in the UK amounts to at least £8.8 billion.[29] Due consideration of reform to Islamic finance infrastructure has the potential to boost this trading relationship, particularly in light of ongoing negotiations around a UK-GCC Free Trade Agreement.

27 *Trade Update: UK-Gulf Cooperation Council FTA*, Department for Business and Trade, November 22nd 2023

28 *Free Trade Agreement Negotiations with the Gulf Cooperation Council*, House of Commons, April 26th 2023

29 Ibid.

Policy Recommendations

The UK has a head-start in Islamic finance when compared to other Western nations. This market is set to grow in the future, based on trends within the industry and an expansion in the financial power of the six member states of the GCC (Saudi Arabia, Qatar, the United Arab Emirates, Kuwait, Bahrain, and Oman), as well as other majority-Muslim countries such as Bangladesh, Indonesia, and Malaysia.[30]

Likewise, the growth of ethical finance products and providers, provides investment pools and infrastructure for companies who are developing ESG-oriented products, including Islamic finance products. This has been recognised by the current Lord Mayor of London, Professor Michael Mainelli, and has served as a key part of the City's agenda - 'Connect to Prosper' - under his mayoralty.[31] With over £90bn invested in British responsible financial services as of 2021,[32] there is a clear consumer interest in ethical investing which can help to boost the UK's growth potential.

However, the UK cannot rest on its laurels. Increased competition globally should convince regulators and institutional stakeholders to review existing regulations, in order to ensure that Islamic finance can play a key role in the City's future in an increasingly globalised world.

We recommend that policymakers consider the following changes:

Policy Recommendations:

1. **The Bank of England's Alternative Liquidity Fund should continually operate during the working week.**

In 2021, the Bank of England opened its Alternative Liquidity Fund (ALF), the first of its kind to be launched by a Western financial institution.[33] Religious constraints on investments, as noted above, means that Islamic finance organisations cannot participate in interest-bearing investigations. With this in mind, the Bank of England provides liquidity through a separate account. Deposits must be made by a Thursday deadline, with refunds and withdrawals being structured in a similarly analogue manner. As of February 28th 2023, £140 million was deposited into the facility.[34]

Whilst this is welcome news for the industry, further steps should be taken to better

30 *Navigating uncertainty: Global Islamic finance assets expected to exceed $6.7 trillion by 2027,* Shaima Hasan and Shereen Mohamed, London Stock Exchange Group, February 26th 2024

31 *Lord Mayor Calls on London to Use Its Unparallelled Global Connections to Address Global Challenges in Areas like AI and Climate Change,* City of London, November 14th, 2023

32 *UK Fund Market - 2022 Year in Review,* The Investment Association, May 13th 2024

33 *The Bank of England's Alternative Liquidity Facility,* Bank of England, February 2024

34 *Bank of England's Islamic finance facility is hitting the mark*, Mark Lynch, Arabian Gulf Business Insight, October 17th 2023 develop the framework of the Fund to permit greater flexibility and efficiency.

In particular, we recommend that the Bank of England work to extend the operating hours of the ALF to ensure greater flexibility for users. The initial success of the ALF would be bolstered by an agenda that sought to simplify use of the service for consumers - in particular, by recognising that the 9-to-5, Monday to Friday (or, indeed, Monday to Thursday) weekly structure is an increasingly antiquated one, which does not adequately reflect the increasing diversity of operating hours across the sector.

This is particularly true in the case of businesses in the UK which operate as a subsidiary of international businesses - often, London offices of such businesses adapt their working hours to ensure overlap with 'HQ'. This change particularly stands to benefit Gulf businesses planning to invest in the UK through a subsidiary.

2. The Alternative Liquidity Fund should be further digitised, moving away from encrypted email and phone banking, and include an online portal for interaction by depositors.

Alongside an expansion of operating hours, the ALF should also be further digitised as far as possible.

In particular, we recommend that the ALF gradually move away from its current system of encrypted email and phone banking, and instead instate an online portal for interaction by depositors. Digitalisation represents an example of 'low hanging fruit' efficiency savings, helping to increase ease and speed of transaction for users.

In the case of Islamic finance in the UK, digitalisation is also likely to deliver particular upside for investors and operators from major Islamic finance markets, most of which have a high level of digital penetration. In Saudi Arabia, 97.86% of the population has access to the Internet, alongside 89.56% of Malaysians and 100% of people living in the United Arab Emirates.[35] Investors from these countries are more likely to be familiar with digital infrastructure than encrypted email and phone banking, the use of which continues to decline around the world.

3. The Government should implement the recommendations of its 'Tax Simplification for Alternative Finance' report.

Alternative support for Islamic Finance should not just rest in the Bank of England, but also in the Treasury.

The Government recently - January 16th 2024 - published its report on 'Tax

35 *Internet Users By Country 2023,* Wisevoter, accessed March 14th 2024

Simplification for Alternative Finance'.[36] This Treasury-led report makes a number of recommendations for tax simplification around Islamic finance, all of which aim to ensure that the rules for taxation on *Sharia*-compliant financial products are consistent with the rules for taxation on comparable financial products provided by traditional financial institutions.

In particular, the report notes that:

"Capital allowances let taxpayers write off the cost of certain capital assets against taxable income. They take the place of depreciation charged in commercial accounts, which is not normally deductible for tax purposes. Plant and machinery allowances are not available for expenditure on plant or machinery for use in a dwelling-house where the person is carrying on a property business. Similarly, structures and buildings allowances are only available for structures and buildings for nonresidential use. ***However, if a person refinances using an alternative finance arrangement in circumstances where plant and machinery allowances or structures and buildings allowances are available and have been claimed, there may be capital allowances consequences for the person that would not arise for a person using conventional finance.****"*[37]

This uneven application of the rules serves as a disincentive to investors wishing to benefit from capital allowances while also using alternative financial products - while this disadvantage remains in place, such investors are likely to choose to invest in countries where Islamic finance products are treated evenly, or actively favoured.

Fortunately, the report also provides a relatively straightforward amendment to the existing law as a means of correcting this imbalance:

"If changes are required for capital allowances purposes, subject to assessing the evidence requested in the preceding paragraphs, the proposal would be to adopt a capital allowances solution for alternative refinancing arrangements that is similar to the proposal described above for Capital Gains Tax."[38]

Namely, this takes the form of:

"The overall purpose of these changes is to ensure that, where certain conditions are met, the person obtaining the finance (P) is treated as having owned the interest in property throughout the period of the arrangements, and neither P nor the financial institution are treated as having made any disposal or acquisition."[39]

Given the relative ease of these changes, we recommend that the Government fully

36 *Tax Simplification for Alternative Finance*, HM Treasury, January 16th 2024

37 Ibid, p22.

38 Ibid, p23.

39 Ibid, p19.

implement the findings of its Tax Simplification for Alternative Finance report as regards capital allowances.

4. The Government should align its Capital Gains Tax rules for alternative finance with mainstream applications of the tax.

Further to this, one of the most prominent recommendations in the 'Tax Simplification for Alternative Finance' report was the recommendation that Capital Gains Tax (CGT) for Sharia-compliant financial products be aligned with mainstream application of CGT. Currently, those with Sharia Compliant Mortgages, making up around c.£6bn of the mortgage market, can be subject to Capital Gains Tax if they remortgage their property. According to HM Treasury's own research:

"This outcome could deter some people from using alternative finance arrangements when they wish to refinance."[40]

This is simply an oversight in the structure and application of CGT, and has been recommended for reform in the Government's aforementioned 'Tax Simplification for Alternative Finance' report.[41] With a consultation on the matter recently closed, we recommend the government continue to simplify these capital gains rules for domestic Islamic finance customers.[42]

5. The Lord Mayor of London and HM Treasury should further engage with foreign Islamic banks, and review current structures in the City to create more effective environments for Sharia-compliant foreign direct investment.

Beyond changes to existing traditional financial infrastructure, and improvements to infrastructure specifically designed to enable Islamic financial products, key stakeholders should work with foreign Islamic banks and review the City's current investment infrastructure to power greater investment from *sharia*-compliant investment funds.

Such funds typically specialise in asset classes such as real estate, shipping, aviation, private equity, and commodities, while some funds specialise in sharia-compliant mezzanine financing, Islamic index tracking, and Islamic equities.

While the other four recommendations made in this paper aim to improve the UK's competitiveness at exporting Islamic finance products to the wider world, this recommendation is designed to help the UK to reap the benefits of its close financial relationships with partner countries in the Islamic world. This would serve to build on

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40 Ibid, p17.

41 *Bank of England Market Operations Guide*, Bank of England, January 30th 2024

42 Tax Simplification Update, Hansard, *N.Huddleston MP, Volume 743: debated on Tuesday 16 January 2024* the £8.8 billion of GCC FDI stock currently in the UK.[43]

The Lord Mayor of London and HM Treasury should work to establish a regular forum for dialogue with key stakeholders in this space, in order to maximise the potential for investment by sharia-compliant funds in London. Such a forum should include key industry practitioners, and should meet quarterly to discuss policy challenges, as well as facilitating broader dialogue around the UK's investment climate. This ongoing dialogue would help to ensure that future opportunities to maximise the benefits of Islamic finance in the UK are filtered through directly to senior stakeholders, facilitating ease of future policy change.

43 Ibid.

Conclusion

Britain has long benefitted from its embrace of new frontiers in financial services. The earliest known life insurance policy was made at London's Royal Exchange on 18th June 1583; a Mr Richard Martins took out a policy against the life of a Mr William Gybbons, paying 30 pounds. Wherever we have seen an opportunity to provide financial services to consumers willing to pay, the UK has sought to meet that demand with supply.

In an increasingly globalised world, demand for financial services will necessarily be reflective of a wider range of ethical, religious, and economic systems. In order to maintain London's position as a hub for global services export, it is more important than ever before that policymakers in the UK work to shape a regulatory framework that allows the City to provide financial services to the world's 1.9 billion Muslims, many of whom are choosing to engage exclusively or primarily with sharia-compliant financial services.

With increasing consensus around the idea that the 21st century will be characterised by Asia's emergence as a global economic force, re-tooling the City's existing infrastructure, skills, and outlook to respond to this fact would represent a prudent long-term investment in London's durability as a financial centre.

We urge policymakers to give due consideration to the recommendations in this paper, and to consider closely how the UK can leverage its existing status as the West's Islamic finance hub - and its cordial relationships with major players in the world of Islamic finance - to deliver meaningful growth and prosperity for the financial services sector in this country.

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