Islamic Finance & Markets 2021

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LEXOLOGY®
Getting The Deal Through

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Lexology Getting The Deal Through is delighted to publish the eighth edition of *Islamic Finance & Markets*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, John Dewar of Milbank, for his continued assistance with this volume.

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United Kingdom

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OVERVIEW

Policies

1 In general terms, what policy has your jurisdiction adopted towards Islamic finance? Are Islamic finance products regulated differently from conventional instruments? What has been the legislative approach?

Islamic finance has developed rapidly in the United Kingdom during the past decade and the government has been very supportive of its development and promotion. The United Kingdom hosted the first stand-alone Islamic financial institution in the European Union and has the highest value of *shariah*-compliant assets of any non-Muslim country. The United Kingdom has a strong and proud tradition of openness and flexibility, which, combined with London's position as a leading international financial centre and the United Kingdom's significant Muslim population (just above 5 per cent of the UK population, according to the 2011 census), provides a strong foundation for growth. As a result of its standing, London has long been perceived as the Western hub for Islamic finance.

The government established the United Kingdom's first Islamic Finance Task Force in March 2013, and the task force's mandate is to help to build upon London's status as the western hub for Islamic finance by showcasing the United Kingdom as the preferred choice for the Muslim world to invest in and do business with. Its objectives include engaging with the United Kingdom Islamic Finance Secretariat and others to promote and raise the international profile of the industry and to use Islamic finance to facilitate inward investment and strengthen the UK economy. In June 2014, the United Kingdom became the first western country to issue a *sukuk*, attracting orders of more than £2 billion from global investors. London's maiden *sukuk* is structured as a *sukuk al-ijarah* and will pay out profits based on the rental income from three government-owned properties instead of interest (*riba*), which is forbidden by *shariah*. The £200 million sale was heavily oversubscribed by investors in the United Kingdom, the Middle East and Asia, attracting orders of £2.3 billion, 10 times higher than the amount sold. Then, in April 2015, the Secretary of State (acting by the Export Credits Guarantee Department and operating as UK Export Finance) guaranteed a *sukuk* issued by Khadrway Limited (where the proceeds of the issuance were used by the United Arab Emirates to finance the acquisition of four new Airbus A380-800 aircraft). This was the world's first *sukuk* supported by an export credit agency.

Islamic finance products in the United Kingdom are not regulated any differently from conventional instruments and existing legislation and regulations apply. The United Kingdom's approach has been to ensure a level playing field for Islamic finance products and conventional instruments, and so the United Kingdom has proactively monitored and responded to any unequal treatment between the two by introducing remedial legislation and regulations. For example, the government was quick to remedy the adverse tax treatment of *sukuk* to place them on a level playing field with conventional debt instruments. Another example is where the Treasury abolished the double stamp duty land tax (SDLT) charge on *shariah*-compliant mortgages.

The government believes that the growth of Islamic finance in the United Kingdom is beneficial to all UK citizens and that Islamic finance should be available to everybody. On the retail side, all consumers gain from a wider choice of retail financial services, particularly those consumers whose religious beliefs prevent them from accessing conventional finance. On the wholesale side, the entire country benefits from the UK financial services industry's success as the leading western centre for Islamic finance.

Market development

2 How well established is Islamic finance in your jurisdiction? Are Islamic windows permitted in your jurisdiction?

Islamic retail products first appeared in the United Kingdom in the 1990s, and in the past decade, there has been significant growth of Islamic finance products in both the wholesale and the retail sectors. According to a report published by TheCityUK in 2019, the United Kingdom is ranked 17th out of 48 countries in the Islamic banking and finance industry (The Islamic Finance Country Index), with assets of UK-based institutions offering Islamic finance services amounting to a total of £4.7 billion in 2017.

Against the backdrop of global drivers of Islamic finance, the government, the Financial Services Authority (FSA) (replaced in large part by the Financial Conduct Authority (FCA)) and the Bank of England have actively supported the development of Islamic finance in the United Kingdom during the past decade. In 2000, the Bank of England recognised the potential for retail and wholesale Islamic finance in the United Kingdom and, together with the Treasury, established a working group to investigate the obstacles facing the industry. This led to the first of many legislative measures introduced by the Treasury to enable the development of Islamic finance in the United Kingdom. Since 2003, the Treasury, HM Revenue and Customs and the FSA have introduced several changes to the tax and regulatory systems to enable UK companies to offer a range of Islamic financial products including asset finance, mortgages and ISAs. Since 2004, the FSA has authorised several Islamic financial firms and the United Kingdom is the first country in the EU to authorise stand-alone Islamic financial institutions to offer only *shariah*-compliant products. This has been achieved by applying the same authorisation criteria to Islamic and conventional financial institutions. Currently, the United Kingdom has 20 financial institutions, including five fully *shariah*-compliant banks, offering Islamic finance products, more than any other western country. The main financiers in the UK market include stand-alone Islamic financial institutions such as Al Rayan Bank (formerly the Islamic Bank of Britain) and certain conventional institutions that have set up Islamic windows. If a conventional institution establishes a separate branch or subsidiary to operate as an Islamic window, that branch or subsidiary would probably require a separate authorisation from the FCA.

Sovereign wealth funds from Islamic countries are active in the United Kingdom. The mandate of the Islamic Finance Task Force is to facilitate Islamic financial business, including investment in UK infrastructure by Islamic sovereign wealth funds. Islamic funds also operate from the United Kingdom and IFIs offer Islamic finance products in the United Kingdom. A total of four *shariah*-compliant exchange-traded funds and two *shariah*-compliant exchange-trade products are listed on the London Stock Exchange.

There are no explicit restrictions for investments in *haram* activities (ie, non-compliant investments), although investment might be limited to *halal* activities.

There have been many listings of *sukuk* on the London Stock Exchange. The issuers of these listings have principally been corporates and banks based in the Middle East. According to TheCityUK, 72 *sukuk* have been listed on the London Stock Exchange, including a total of three *shariah*-compliant exchange-traded funds.

Legislation

3 | What is the main legislation relevant to Islamic banking, capital markets and insurance?

The United Kingdom has not enacted legislation specifically addressing Islamic finance. Islamic banking, capital markets and insurance are subject to general finance laws (particularly the Financial Services and Markets Act 2000) and regulations in the United Kingdom and are intended to be subject to the same tax treatment that applies to their corresponding conventional instruments. However, certain amendments have been made to existing laws and regulations specifically to facilitate Islamic finance transactions in the United Kingdom.

The most important changes have been to the tax laws (which broadly work based on form over economic substance) to ensure the tax treatment of *shariah*-compliant structures follow the treatment of their conventional finance alternatives. For example, the rules have been amended to provide for certain *shariah*-compliant finance arrangements (including certain *murabahah* and *musharakah* arrangements) to be taxed in the same manner as conventional equivalents under the alternative finance arrangements regime (see Chapter 6, part VI of the Corporation Tax Act 2009).

The alternative finance regime has now also been extended to *sukuk*, which hitherto had been treated differently from conventional bonds for tax purposes because payments on *sukuk* represent profit distributions, although such payments are economically similar to interest. Unlike interest, however, profit distributions are not usually tax-deductible and this would have made *sukuk* a more expensive way to raise finance, especially in comparison with conventional bonds.

To respond to this anomaly, the alternative finance regime (under which certain *shariah*-compliant finance structures are taxed in the same manner as their conventional equivalents) has been extended to provide that *sukuk* be taxed similarly to conventional bonds. This has been achieved by providing that, where the arrangements meet certain conditions (including listing on a recognised stock exchange), amounts paid by issuers to *sukuk* holders (other than those representing the principal amount originally paid by the *sukuk* holder to the issuer) are generally deductible by the issuer under the loan relationships regime, and taxable in the hands of the holder as interest (if the holder is subject to income tax) or under the loan relationships regime (if the holder is subject to corporation tax).

Also, the Finance Act 2009 provides relief from SDLT for *sukuk* (as alternative finance investment bonds), amends the law to classify *sukuk* as tax-exempt loan capital for stamp duty and stamp duty reserve tax purposes, and allows existing corporation tax and income tax rules on Islamic finance arrangements to be amended by regulation.

SUPERVISION

Principal authorities

4 | Which are the principal authorities charged with the oversight of banking, capital markets and insurance products?

Before 1 April 2013, the Financial Services Authority (FSA) was the principal authority charged with the oversight of banking, capital markets and insurance products in the United Kingdom. From 1 April 2013, the FSA was abolished and most of its functions transferred to two new regulators: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The FCA inherited most of the FSA's roles and functions and also adopted the legal corporate identity of the FSA. The FCA is responsible for the conduct of business regulation of all firms, including those regulated for prudential matters by the PRA, is responsible for the prudential regulation of firms not regulated by the PRA, and inherited the FSA's market conduct regulatory functions, except for responsibility for systemically important infrastructure, which was transferred to the Bank of England.

The FCA and the PRA, therefore, now regulate IFIs to the extent they perform regulated activities for the Financial Services and Markets Act 2000 (FSMA). Their approach to the regulation of IFIs is expected to be the same as the FSA, which can be summed up as 'no obstacles, but no special favours'. Unlike certain other regulatory authorities, such as Malaysia's, the FCA does not have *shariah* scholars who review the *shariah*-compliance of a product offered by an IFI. The FCA's approach is to treat IFIs as it would conventional firms, so an IFI would require authorisation to carry on regulated activities and obtain the necessary permissions from the FCA. IFIs may need to provide additional information to the FCA in certain circumstances, such as the role if any, that the IFI's *shariah* board performs concerning operational and financial matters. Further, any financial institution already authorised by the FSA wishing to offer *shariah*-compliant products under its existing FCA permissions must, in practice, notify the FSA of its intention to expand its activities to include Islamic financial business.

Financial transactions entered into with an individual and not otherwise subject to regulation under the FSMA may be subject to regulation under the Consumer Credit Act 1974 (CCA), unless that agreement is entered into wholly or predominantly for business purposes, or one of the other exemptions under the CCA 2006 applies.

Before its replacement by the FCA on 1 April 2013, the FSA stated that it intended to work with international industry bodies, such as the International Organization of Securities Commissions, which have their own Islamic finance initiatives. The FSA also supported moves to develop common *shariah* standards by organisations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). While the FSA did not implement either the IFSB or AAOIFI standards (which have no binding legal effect), these standards are certainly useful in identifying best practice for IFIs and examples of the application of regulatory rules to IFIs.

Guidance

5 | Identify any notable guidance, policy statements or regulations issued by the regulators or other authorities specifically relevant to Islamic finance.

The FSA issued a discussion paper in November 2007, 'Islamic Finance in the UK: Regulation and Challenges', which outlined the regulatory framework for Islamic finance in the United Kingdom and considered the risks and challenges that Islamic firms in the United Kingdom face in the retail and wholesale markets.

The FSA and the Treasury released a joint consultation paper on *sukuk* in December 2008, 'Legislative Framework for the Regulation of Alternative Finance Investment Bonds (Sukuk)'. This paper suggested further legislative reforms to align the regulatory treatment of *sukuk* with conventional debt securities, particularly the creation of a new specified instrument for *sukuk* under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, to exempt those instruments from the definition of collective investment schemes under the FSMA. The Treasury also published a paper in December 2008, 'Development of Islamic Finance in the UK', on the government's approach to promoting and facilitating the development of Islamic finance in the United Kingdom.

In 2019, the Land Registry published 'Practice guide 69: Islamic financing' that focusses on the three forms of contract found in Islamic finance: *ijra wa igtina*, *diminishing musharaka* and *murabaha*. The guide also examines the emergence of the Islamic bond or *sukuk* market.

Central authority

6 Is there a central authority responsible for ensuring that transactions or products are shariah-compliant? Are IFIs required to set up shariah supervisory boards? May third parties, related parties or fund sponsors provide supervisory board services or must the board be internal?

The United Kingdom has no central authority responsible for ensuring that transactions or products are *shariah*-compliant. The United Kingdom does not impose a legal requirement that an IFI has a *shariah* supervisory board. Although, by complying with the relevant AAOIFI guideline for *shariah* supervisory boards, an IFI could arguably demonstrate that it complied with its duties under the FCA's Principles for Businesses to take reasonable care to organise and control its affairs responsibly and with adequate risk management systems. Further, while there is no statutory requirement for IFIs to have *shariah* supervisory boards, most IFIs do, as a matter of course, have *shariah* supervisory boards that sit alongside their boards of directors or employ third parties to act as an external *shariah* supervisory board (either because their constitutive documents so require or because this provides investors, stakeholders and customers with an assurance that the IFI will operate under *shariah* principles).

Board approval

7 Do members of an institution's shariah supervisory board require regulatory approval? Are there any other requirements for supervisory board members?

There is no express requirement for regulatory approval of a *shariah* supervisory board; however, in an application to the FCA or for the PRA to be authorised, the IFI would need to indicate whether the members of the *shariah* supervisory board would perform an executive or an advisory role. To the extent an advisory role is to be performed, the IFI would not need to apply for each member to be an approved person. The competence of the members of the *shariah* supervisory board would still be relevant to determine whether the IFI is fit and proper to be authorised. To the extent that the *shariah* supervisory board would perform an executive role, then the IFI would need to apply and meet the requirements of the FCA for each member to be an approved person, including the requirement as to competence and capability.

Authorisation

8 What are the requirements for Islamic banks to be authorised to carry out business in your jurisdiction?

The primary statute governing banking in the United Kingdom is the FSMA. Under the FSMA, it is an offence for a person to engage in 'regulated activities' unless he or she is authorised or exempt from the authorisation requirement.

As with conventional banks, Islamic banks are dual-regulated by the FCA concerning how they conduct business and by the PRA for prudential requirements (such as capital and liquidity). To become an authorised bank, an application must be made to the PRA, the lead regulator for banks. This is assessed through a collaborative process. The final decision will be made and communicated by the PRA. To authorise the firm, the PRA must have received the FCA's consent.

Foreign involvement

9 May foreign institutions offer Islamic banking and capital markets services in your jurisdiction? Under what conditions?

Foreign institutions may offer Islamic banking and finance products in the United Kingdom, provided that they comply with the applicable United Kingdom laws (including the FSMA).

Takaful and retakaful operators

10 What are the requirements for takaful and retakaful operators to gain admission to do business in your jurisdiction?

The FSMA governs the regulatory regime in the United Kingdom. The FSMA provides that carrying on a regulated activity, or purporting to do so, in respect of a specified investment by way of business in the United Kingdom, requires authorisation from the FSA, unless the person carrying on that activity is exempt. Effecting or carrying out contracts of insurance (which include *takaful* and *retakaful*) is a regulated activity. Therefore, a similar authorisation procedure to that applying to banks would also apply to *takaful* and *retakaful* operators.

Foreign operators

11 How can foreign takaful operators become admitted? Can foreign takaful or retakaful operators carry out business in your jurisdiction as non-admitted insurers? Is fronting a possibility?

Foreign *takaful* operators may be admitted in the United Kingdom to offer *takaful* and *retakaful* products, after complying with the applicable UK laws (including the FSMA).

Disclosure and reporting

12 Are there any specific disclosure or reporting requirements for takaful, sukuk and Islamic funds?

There are no specific disclosure or reporting requirements for either *takaful*, *sukuk* or Islamic funds that differ from conventional products.

Sanctions and remedies

13 What are the sanctions and remedies available when products have been falsely marketed as shariah-compliant?

If financial products have been falsely marketed as *shariah*-compliant, there are three potential remedies available to an investor. The first is a contractual remedy, which, depending on the terms on which the product was purchased, may enable the investor to call an event of default (arising from the misrepresentation by the IFI of a material term of the contract) and then accelerate amounts owed by the IFI to the investor.

The second remedy is to institute a civil claim for misrepresentation. For fraudulent and negligent misrepresentation, the claimant may claim rescission of the contract and damages. For innocent misrepresentation, the court has the discretion to award damages instead of rescission or rescission; the court cannot award both. And this is only if the right to rescind exists. If that is lost, damages under section 2(2) of the Misrepresentation Act 1967 are unavailable.

The third remedy is only applicable if the relevant product is a securities offering that is made through a public offering and where a prospectus is issued that is untrue or misleading as to the *shariah*-compliance of the securities offered. In this circumstance, section 90 of FSMA 2000 establishes that the person responsible for the prospectus is liable for damages to a person who has acquired securities to which the particulars apply and has suffered loss as a result of any untrue or misleading statement in the particulars, or the omission from the particulars of any matter required under section 80 or section 81 of FSMA 2000. Additionally, section 90A of FSMA 2000 extends the issuer's liability to include liability to persons that have suffered loss as a result of a misleading statement or dishonest omission in the prospectus or a dishonest delay in publishing the information. Consequently, not only persons acquiring the *sukuk* direct upon issue but also those trading the *sukuk* on the secondary market would be entitled to bring a claim under these provisions.

Jurisdiction in disputes

14 | Which courts, tribunals or other bodies have jurisdiction to hear Islamic finance disputes?

There are no specific courts or tribunals in the United Kingdom that hear Islamic financing disputes. The matter would be dealt with by the competent court in the United Kingdom, which, at first instance and depending on the complexity and final value of the dispute, is likely to be either the county court or the High Court of Justice.

CONTRACTING CONCEPTS

Accommodation of concepts

15 | Mudarabah – profit sharing partnership separating responsibility for capital investment and management.

The entry into a *mudarabah* arrangement is acceptable for a UK entity or person as it would be treated as akin to a partnership arrangement wherein the investor (*rab-al-mal*) contributes the capital and the recipient (*mudarib*) provides professional or managerial expertise to carry out the venture to earn a profit that is shared between the *rab-al-mal* and the *mudarib* under an agreed ratio.

Where a *mudarabah* is used for deposits with a bank, care must be taken to ensure any deposit complies with the definition of 'deposit' in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended) (RAO). While a traditional *mudarabah* requires that the *rab-al-mal* bears the risk of any loss on the deposit, the RAO requires that to be classified as a deposit under article 5(2) of the RAO, the depositor must be entitled to the right to repayment, whether on-demand or under terms agreed. The Financial Conduct Authority (FCA)'s solution to this and to ensure that Islamic deposits are categorised as protected deposits under FCA rules (and therefore that customers who deposit funds with IFIs receive equivalent deposit protection to conventional depositors under the Financial Services Compensation Scheme) was that depositors under a *mudarabah* would be entitled to full payment of the amount deposited (thereby satisfying the RAO requirement). Because this could be construed as a guarantee of the deposit by the *mudarib* and depart from the principle that the *rab-al-mal* bears the risk of any loss on the deposit, the *rab-al-mal* would, however, have the right to opt-out of the deposit protection subsequently on religious grounds and choose to be repaid under the risk-sharing methodology reflecting a traditional *mudarabah*. In 2017, Dana Gas (an issuer based in the United Arab Emirates) attempted to render its *mudarabahsukuk* unenforceable on several grounds, one of which was that the *sukuk* were not *shariah*-compliant because they featured what appears to be a guarantee from the *mudarib* of the face amount of the *sukuk* contrary to the risk-sharing methodology reflecting a traditional *mudarabah*. While Dana Gas had sought to bring proceedings to adjudicate on this matter in the Sharjah Federal Court of First Instance, several of the *sukuk* documents were governed by English law, and so Dana Gas had also sought and obtained an interim injunction in the English High Court preventing the *sukuk* holders from declaring an event of default or dissolution event concerning the *sukuk*. On 17 November 2017, the English High Court ruled against Dana Gas on all grounds.

16 | Murabahah – cost plus profit agreement.

Murabahah transactions can generally be implemented under English law. As in economic terms, the *murabahah* is akin to a loan, the transactions would be classified as loans for International Financial Reporting Standards (IFRS) purposes.

Concerning the taxation of a *murabahah* transaction, before the introduction of section 57 of the Finance Act 2005 (replaced by section 564C of the Income Tax Act 2007 and sections 503 and 511 of the Corporation Tax Act 2009), the profit paid by the customer to the bank would not have been tax-deductible by the customer. However, since the new legislation came into effect, subject to satisfying the applicable preconditions, the profit would now be treated as interest payable during the period of the loan and hence qualify for a tax deduction.

Where the assets acquired by the bank under the *murabahah* transaction include real property, while SDLT would otherwise have been levied on both the purchase of property by the bank and the subsequent sale to the customer, since the introduction of section 73 of the Finance Act 2003, provided certain conditions are met, no SDLT is payable on the subsequent sale of the property by the bank.

For value added tax purposes, HM Revenue and Customs treats the sale of the asset by the vendor and the onward sale by the bank to the customer under the normal value added tax rules, which will be dependent on the nature and location of the asset.

17 | Musharakah – profit sharing joint venture partnership agreement.

It is permissible for a UK entity or person to enter into a *musharakah* arrangement because it is akin to a joint venture or partnership arrangement. However, care should be taken to determine whether the *musharakah* arrangement could fall within the broad definition of 'collective investment scheme' in the Financial Services and Markets Act 2000 (FSMA). To the extent the *musharakah* arrangement is considered a collective investment scheme, the IFI may need to apply for permission under the FSMA.

A *musharakah* where each partner's share in the capital remains constant would be treated as a partnership and therefore be transparent for tax purposes, which means that the profits of the partners would be taxed.

In the case of a diminishing *musharakah*, following the enactment of section 47A of the Finance Act 2005 (replaced by section 564C of the Income Tax Act 2007 and sections 503 and 511 of the Corporation Tax

Act 2009), and provided that the specified conditions are met, the return paid to the financier is now treated as if it interested payable on a loan and is tax-deductible.

18 | Ijarah – lease to own agreement.

An *ijarah* will generally be classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership to the lessee. If all the risks and rewards incidental to ownership are transferred to the lessee, such an *ijarah* is likely to be categorised like a finance lease. An *ijarahmunthahiyah bi-tamlik* (lease to own) is akin to conventional hire purchase and so would be accounted for in the same way as a finance lease.

19 | Wadiah – safekeeping agreement.

Wadiah agreements are not commonly used in the United Kingdom, but the entry into such an agreement should be possible provided the applicable regulatory requirements are met.

PRODUCTS

Securities structuring

20 | Sukuk – Islamic securities. Have sukuk or other Islamic securities been structured and issued in your jurisdiction to comply with Islamic principles, such as the prohibition of interest?

On its website, the London Stock Exchange (LSE) boasts that more than US$53 billion has been raised through 72 *sukuk* issuances that have been listed on the LSE and those securities can be admitted on either the Main Market, which is a regulated market under the EU Markets in Financial Instruments Directive (2004/39/EC); or the Professional Securities Market, which is a platform reserved for professional investors and is not regulated. Most of the listed *sukuk* have been structured as either *sukuk al-mudarabah* or *sukuk al-ijarah*. To take advantage of certain tax efficiencies, the vehicle most often adopted for the issuer is a limited company incorporated in a tax-efficient jurisdiction. Several *shariah*-compliant institutions are listed on AIM (formerly the Alternative Investment Market), enabling the purchase of *shariah*-compliant shares. Further, there are seven *shariah*-compliant exchange-traded funds based on Islamic indices.

The requirements concerning listings of *sukuk* on the Main Market are governed by the Financial Services and Markets Act 2000 (FSMA) and the UK Listing Authority's Prospectus Rules, the Listing Rules and the Disclosure and Transparency Rules. An application to list a *sukuk* on the Official List must be submitted to the Financial Conduct Authority together with listing particulars, which, under section 80(1) of FSMA 2000, should contain all such information as investors and their advisers would reasonably require, and reasonably expect to find there, to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities, and the rights attaching to the securities.

Legal position

21 | What is the legal position of sukuk holders in an insolvency or a restructuring? Are sukuk instruments viewed as equity or debt instruments? Have there been any court decisions or legislation declaring whether sukuk holders are deemed to own the underlying assets?

Several structures can be adopted for a *sukuk* that may have an impact on how it is classified for insolvency, tax and regulatory purposes. *Sukuk*, are, however, typically structured to have the same economic effect as a conventional bond and are treated as such for IFRS purposes.

On insolvency involving the issuer, the legal position of *sukuk* holders should not be any different from that of conventional bondholders in that the *sukuk* holders would have a debt claim against the issuer for the outstanding face amount of their respective certificates.

Whether a *sukuk* is treated as an equity or debt instrument depends on the structure and the risks and rewards of the *sukuk*. In particular, whether the *sukuk* is asset-based or asset-backed could affect this analysis. Often, it is the case that, from the originator's perspective, the *sukuk* is shown as a financial liability on its balance sheet because it retains control over the issuer entity. From the *sukuk* holders' perspective, the holding would need to be classified into certain categories, such as an instrument held to maturity or a loan and receivable. Legislation now provides that where certain conditions are satisfied, the return paid to *sukuk* holders is tax-deductible by the issuer, consistent with the treatment afforded to conventional bondholders.

There have been no English court decisions, nor has there been legislation declaring whether *sukuk* holders are deemed to own the underlying assets.

Insurance

22 | Takaful – Islamic insurance. Are there any conventional cooperative or mutual insurance vehicles that are, or could be adapted to be, shariah-compliant?

Friendly societies and other mutual insurance companies are potential vehicles that could be adapted to provide *takaful*. Friendly societies in particular have an affinity with *shariah* principles because all contributions to a friendly society are made voluntarily. Friendly societies have evolved in different ways over the years. Since 1992 most have taken advantage of the ability to incorporate, which allows them to undertake a defined range of activities.

There would be significant challenges in establishing a new *shariah*-compliant friendly society since, to be authorised by the Financial Services Authority to carry on regulated activities in the United Kingdom, the friendly society would need significant amounts of regulatory capital. As a mutual institution, a friendly society does not have shareholders that might provide that capital. On the contrary, section 5(2)(b)(i) of the Friendly Societies Act 1992 provides, in effect, that only members (or persons connected with members) can receive benefits from the society and the converse of this is also generally held to be true, namely that a person cannot be a member of a friendly society unless he or she (or a person connected) receives insurance or similar benefits from the society.

23 | Which lines of insurance are currently covered in the takaful market? Is takaful typically ceded to conventional reinsurers or is retakaful common in practice?

The UK *takaful* insurance market is in its infancy. Principle Insurance attempted to provide *takaful* motor insurance but suffered significant financial difficulties in 2009. Cobalt Underwriting launched a *takaful* structure in 2003 that allows syndication of the risks across several insurers, but it remains to be seen how successful this venture will be.

MISCELLANEOUS

Regulatory obstacles

24 What are the principal regulatory obstacles facing the Islamic finance industry in your jurisdiction?

Given the legislation designed to remedy the adverse treatment of Islamic products relative to corresponding conventional products, and the Financial Conduct Authority's and Prudential Regulation Authority's non-discriminatory regime towards ensuring the same authorisation and prudential requirements that apply to conventional firms also apply to IFIs, there appear to be no immediately apparent regulatory hurdles for the Islamic finance industry in the United Kingdom.

In the Treasury's paper 'Development of Islamic Finance in the UK', issued in December 2008, the government identified several areas in which further progress was necessary to develop the Islamic finance industry. These included:

- the need to create a set of robust and accessible term sheets for the main Islamic products through collaboration between industry and international standard-setting bodies;
- the need to raise awareness of, and knowledge about, Islamic finance at the grassroots level; and
- the need to highlight the United Kingdom's strength as a provider of education, training and skills in Islamic finance.

Shariah law

25 In what circumstances may shariah law become the governing law for a contract or a dispute? Have there been any recent notable cases on jurisdictional issues, the applicability of shariah or the conflict of shariah and local law relevant to the finance sector?

Shariah law is not applied in the United Kingdom and English law does not recognise *shariah* as a system of law capable of governing a contract, on the basis that English law does not provide for the choice or application of a system of law other than a system of national law. This is based on the Convention on the Law Applicable to Contractual Obligations 1980 (the Rome Convention), which requires that a governing law of an agreement must belong to a country.

The approach of the English courts, mainly, has been to distinguish between *shariah* and the contractual governing law of an Islamic finance agreement by ruling that *shariah* issues are not justiciable in the English courts. That element of the agreement is deemed as forming part of the commercial agreement (which English courts will rarely interfere with) and not the legal agreement. Instead, the dispute will be dealt with applying the ordinary principles of English law and an English court will avoid ruling or commenting on the compliance of the agreement with *shariah* (see *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2003] 2 All ER (Comm) 84). This approach was reaffirmed in a recent English High Court case, *Dana Gas PJSC v Dana Gas Sukuk Ltd & Ors* [2017] EWHC 2928, where Dana Gas (an issuer based in the United Arab Emirates) was attempting to render its *mudarabah sukuk* unenforceable on several grounds, one of which was that its *sukuk* was not *shariah*-compliant.

Parties may still elect to have a dispute concerning a contract determined and resolved under *shariah* principles by submitting to arbitration. Under section 46 of the Arbitration Act 1996, arbitral tribunals are obliged to decide disputes concerning either the national law chosen by the parties or any other agreed considerations (including *shariah* considerations).

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Institutional takeover

26 Are there any special considerations for the takeover of an Islamic financial institution, outside the requirements of the general merger control regime?

The United Kingdom has no special rules governing the takeover of an IFI.

Other notable features

27 Are there any notable features of the Islamic finance regime and markets for Islamic finance products in your jurisdiction not covered above?

Not applicable.

UPDATES AND TRENDS

Key developments of the past year

28 Are there any proposals for new legislation or regulation, or to revise existing legislation or regulation? If so, please give a reference to any written material, whether official or press reports. Are there any other current developments or trends that should be noted?

The United Kingdom remains and is expected to remain as such in a post-Brexit environment, one of the world's premier financial capitals and its expertise in creating complex structured finance products puts it in a strong position to be at the forefront of the development of Islamic finance globally. While no new Islamic finance-specific legislation is expected in the near-term, the UK government has a track record in reacting to the demands of the market as they arise.

In terms of commercial and transactional development, fintech is one of the main focus areas in finance at present and Islamic finance is not immune to this trend. The UK government has done its part to encourage Islamic finance through the issuance of *sukuk*, which has paved the way for UK corporate issuers to follow suit. There can be no question that the legal system in the United Kingdom has been suitably adapted to facilitate the growth of Islamic finance and so its future development in the United Kingdom looks very positive. Further, a no-deal Brexit could bring more investment to the United Kingdom from the Persian Gulf, thereby solidifying the United Kingdom's commitment towards encouraging the Islamic finance market.

Coronavirus

29 What emergency legislation, relief programmes and other initiatives specific to your practice area has your state implemented to address the pandemic? Have any existing government programmes, laws or regulations been amended to address these concerns? What best practices are advisable for clients?

In response to the coronavirus pandemic, the UK government enacted the Coronavirus Act 2020, which grants the government emergency powers to handle the pandemic. The Act covers areas from changes to the healthcare system to the temporary closure of educational institutions.

Other schemes have also been introduced in response to the pandemic. On 11 March 2020, the Coronavirus Business Interruption Loan Scheme (CBILS) was announced, which is designed to help businesses manage their finances in light of the pandemic. CBILS covers businesses with a turnover of up to £45 million and can be used to support various businesses and types of finance facility, such as asset finance, loans and overdrafts.

In addressing the pandemic, on 8 July 2020 the Islamic Financial Services Board (IFSB) issued two statements discussing the impact of coronavirus on Islamic banking and Islamic capital markets. The IFSB noted the measures taken to preserve the resilience of the financial system, including Islamic finance. These measures include payment moratoriums, *shariah*-compliant government guarantees and recipients of *shariah*-compliant financing.The IFSB also recommended areas for increased regulatory vigilance to mitigate the negative economic impact of the pandemic.

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