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## UK: Let's not rest on our laurels

IFN UK Forum 2023 in London this past week was a resounding success, welcoming over 400 delegates from all over the world. While the general sentiment is that the UK is still deserving of its Islamic finance champion of the west title, industry experts raised genuine concerns. In this two-part series, VINEETA TAN brings you on-the-ground insights from the first half of the day.

The UK's Islamic finance leadership in Europe is undisputed. As a hub, the UK ticks all the boxes: welcoming regulatory environment and tax framework, deep structuring expertise, first-mover advantage and geographically strategic. It has more Islamic banks than any of its European peers, was the first in the region to issue a sovereign Sukuk facility in 2014 and its London Stock Exchange lists some 70 Sukuk.

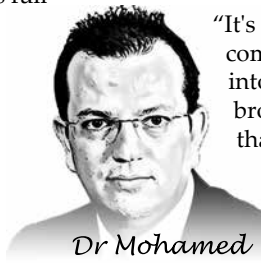
But has it capitalized on its full potential?

"If you look at the development versus the prospects, it hasn't been that significant, in that today, Islamic banks in the UK still represent less than 1% of the total

assets of the banking system compared with the original expectation," observed Dr Mohamed Damak, a senior director and the global head of Islamic finance at S&P Global Ratings. "The demand has not been as strong as initially expected, so there's still some way to continue to develop the activity."

In fact, according to the latest figures from the IFSB, Islamic banking only accounted for 0.1% of total banking assets in the UK in 2021.

Macroeconomic conditions over the last two years such as the closing of borders due to COVID-19, government instability and policy fallouts (ie former prime minister Liz Truss's 'Trussonomics') can explain the declining interest from foreign investors in the UK.

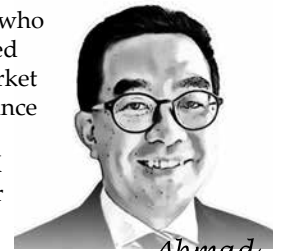


"It's not just a Shariah compliant issue looking at into the UK. It's also the broader market issues that we are dealing with within the UK, that are applicable to conventional finances,

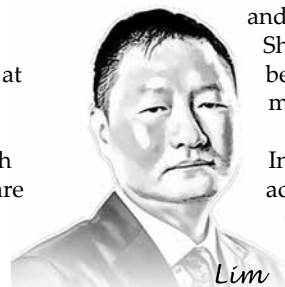


investors coming from the GCC, what have you. It's just a difficult time," observed Mike Tirman, a partner at Ice Miller.

"I don't think that the appeal of the UK as a destination for Islamic finance has improved over the last 18 months," concurred Ahmad Shahizam Mohd Shariff,



a general partner at Mekar Capital, who further explained that the UK market has an overreliance on its banking sector. "The UK has a lot to offer in terms of a world-class hub for financial services, professional services, numerous law firms, accounting firms and has built experience within the Shariah space. But that has not been fully leveraged to develop more innovative solutions."



Innovation is indeed crucial, according to Lim Say Cheong, CEO of Saudi Venture Capital Investment Company.

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2<sup>nd</sup> October 2023, EQ Kuala Lumpur

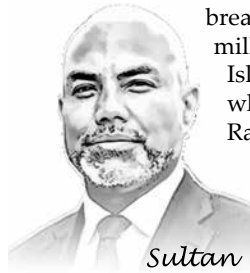
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## UK: Let's not rest on our laurels

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"The UK Export Finance-backed Emirates Airlines's Sukuk in 2015 which totaled almost US\$1 billion was a novelty and the kind of positive differentiation much needed in the industry. But it has been eight years and we have not seen a second one. So that begs the question: What happened?" asked Lim. "The problem with Islamic finance is that it has a long gestation period and people tend to forget after a while because there is no momentum and no build-up."



Sultan

break GBP2 million (US\$2.49 million). Compare that to Islamic charities, especially what they spend during Ramadan, they generate high awareness among the Muslim community. This gives you an indication that you still need a certain amount of resource to build awareness," according to Sultan Choudhury, an advisory board member at the Islamic Finance Council UK.

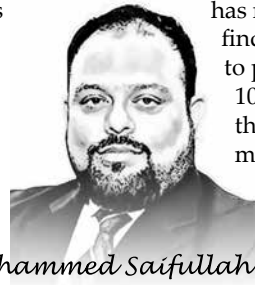
### Complex challenges

There is not one simple answer as to why the UK is seemingly losing its luster. As experts will tell you: it is complex.

As things go, awareness, within both the retail and institutional segments, is still an issue.

"If you took the total marketing spend above the line of any Islamic financial institution, it probably wouldn't even

Mohammed Saifullah Khan, CEO of Dar Al Sharia, echoed the sentiments: "We need to create awareness on why certain products are structured the way they are, what options are available in product development based on different Shariah contracts. Once these are addressed, then we can face the macroeconomic challenges."



Mohammed Saifullah

The current high-interest rate environment is not helping. "Although the desire to invest in the UK remains strong, identifying projects that will create an appropriate balance of risk in return is increasingly difficult," according to Dr Scott Levy, the founder of Al Waseelah, who further added: "I don't think necessarily the perception of the UK from an external investor perspective has changed — it's just that the market has narrowed, and new issuers are finding that they are going to have to price things between eight to 10% as an expected return and that just does not work in their models."

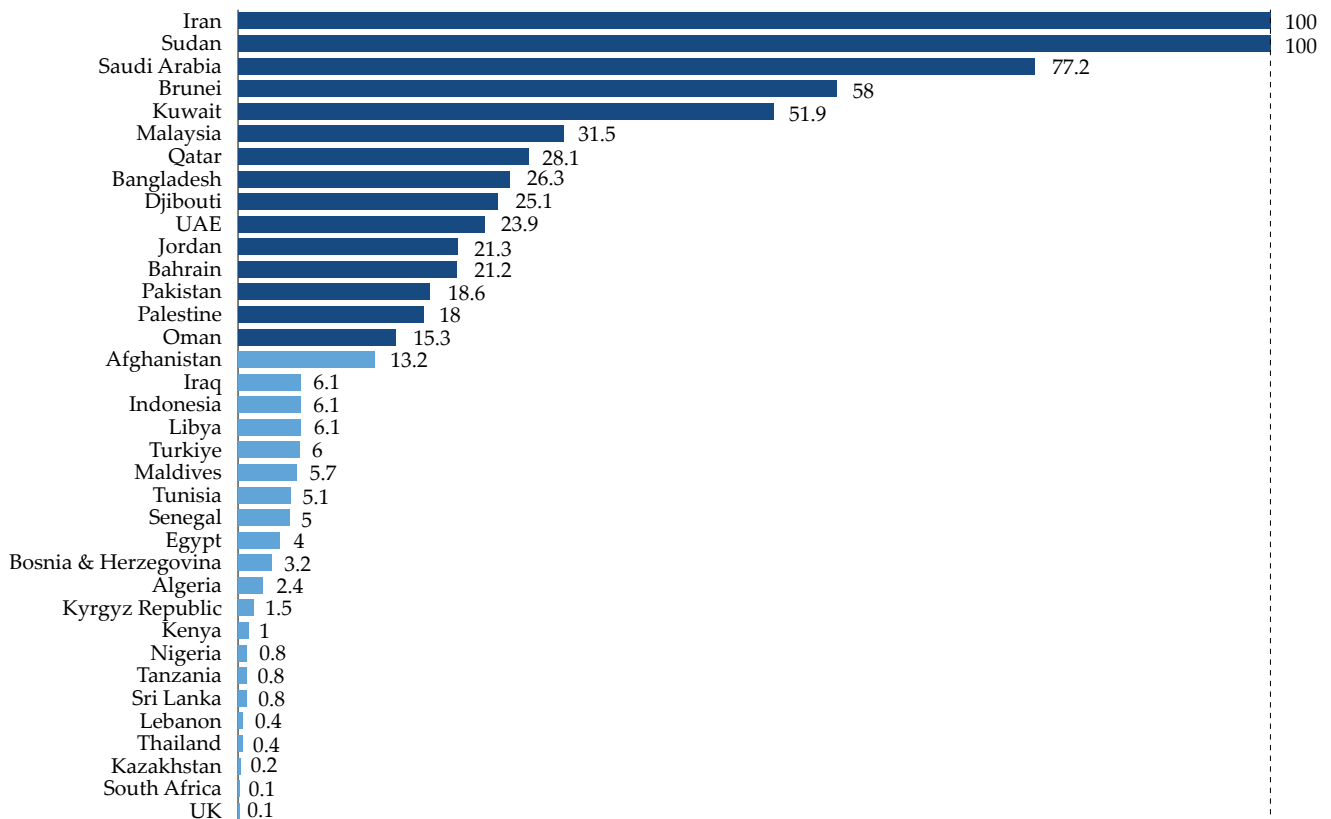


Dr Scott

Apart from consumers perceiving Islamic financial

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Chart 1: Islamic banking share in total banking assets by jurisdiction (%) in 2021



Source: IFSB's Islamic Financial Stability Report 2022

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products as more expensive than conventional instruments and that service delivery is not on par to conventional, the Islamic finance industry in the UK simply does not have the range of products to meet demand and has not exploited other verticals such as asset finance to their fullest potential.

Then there is the issue of Islamic financial institutions not operating on a level playing field. The UK authorities have been diligent and open to engaging the Islamic finance community. The Bank of England (BoE)'s Alternative Liquidity Facility (ALF) launched last December is the most recent landmark initiative to support the industry and has been lauded by the sector.

However, Islamic financial institutions are at a disadvantage because pricing for ALF is lagging. Conventional banks, according to Dr Usman Chaudry, the chief risk officer and an executive director at Gatehouse Bank, derive a significant amount of income by placing funds at the BoE, at rates not available to the ALF.



*Dr Usman*

"We totally understand the operational limitations given that this is a fairly nascent facility, but there's more to be done there," shared Dr Usman. "There is good news on capital gains tax and other things. There are discussions going on, but we need to see a conclusion on huge impediments or any material concern. We would like to see a level playing field for our customers, certainly in the residential space."

Indeed, the residential space is a recurrent highlight among panel experts who have seen its potential heightening. Gatehouse Bank, for example, crossed the GBP1 billion (US\$1.25 billion) residential property finance assets threshold last year, demonstrating robust growth prospects.

### Appealing asset classes

This Islamic finance opportunity in the residential space rides on

the back of the commercial real estate business — which has been a traditional favorite — dwindling down.

"The shift toward social or low-cost housing is one that the institutions are experiencing here in the UK. At Trowers, we have seen our not-for-profit client base looking at this sector now and this is moving into the institutional space. If the institutional market is moving in that direction, then it is logical that the Shariah compliant investors would also move in that direction," opined Nick Edmondson, a partner at Trowers & Hamblins. "But there has to be education and willingness within the UK government to support initiatives aimed at encouraging people to look at such sectors."



*Nick*

Shakeel Adli, the founder and CEO of Zunikh, agreed that sectors such as residential built-to-rent, care homes, student accommodation and co-living spaces are looking lucrative. "Ten, 12 years ago, UK Islamic real estate finance had been very London-centric but now it is generally nationwide as you have got transactions across England, Wales, Scotland and Northern Ireland. So, there's an opportunity to create products such as regionally focused funds focused on student accommodation in the North West which would then allow for high rates of return and therefore attract investors into the market."

Another interesting shift to note is in the debt space.

Historically, Middle Eastern investors look to raise money in the Middle East and then invest that into outbound real estate, whether it is by way of direct investment or through funds, according to Asal Saghari, a counsel at King & Spalding. But in the current climate of rising cost of funding due to increasing interest rates, the assets which Middle Eastern investors have historically focused on, such as logistics, are becoming

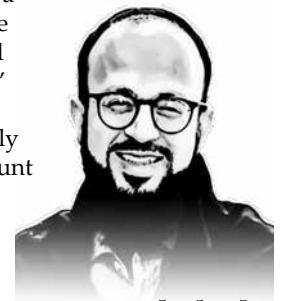


*Asal*

costlier and there is a clear decrease and a slowdown in the amount of outbound commercial real estate. But here is where we are seeing innovation.

"What we have seen is the liquidity gap where the banks are not lending to certain borrowers and certain sectors, and those borrowers are typically borrowers in the commercial real estate sector, where since 2008 there are regulatory restrictions on banks and also certain banks are just not in a position at the refinancing," explained Asal. "So, what we have seen over the past year is our clients, typically capital arms of banks, coming to us to look to lend to the UK market, the market where historically they used to invest directly in real estate. We are seeing lending by way of Shariah compliant financing structures into the same sector. And for me that interest rate increase has led to a direct innovation in debt funds, which again is in line with the global phenomenon where we are seeing non-bank lenders. And I think that's definitely a welcome change and a continued area of growth."

"There is actually not a huge amount of Shariah compliant debt available in the UK," noted



*Shakeel*

Shakeel. While there are Islamic offerings in the commercial real estate space and several providers of bride funding, these are small baskets of capital. "There's not a single mezzanine funder in the UK that operates on a Shariah compliant basis and there's probably about 100, maybe 200 conventional — so there is a huge opportunity there."

### International focus

For many, the UK has an international card to play.

"I see the UK as an international hub for Islamic finance, rather than a domestic play — it has already built up a substantial infrastructure over

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the years to support cross-border transactions," opined Ahsan Ali, the managing director and head of Islamic origination at Standard Chartered Saadiq.



Ahsan



Nasser

Nasser Al-Thekair, the general manager of trade and business development at the International Islamic Trade Finance Corporation,

agreed: "London, specifically the UK, as a whole can build on its global trade hub competitive advantage because there are numerous opportunities in trade such as supply chain finance, Islamic insurance, commodity — these are linked and revolve around trade, which is something that the UK is well known for."

But to encourage inward Shariah compliant investments into the UK, Nick believes that a "much greater push from the establishment as was the case in the past and much more demonstrable encouragement is needed, whether it is another Sukuk issuance by the government or whether it is more direct involvement in Islamic finance, thought leadership opportunities or looking at new sectors of interests such as energy or renewables".

The IsDB Group, which was instrumental in assisting the UK government tap the sovereign Sukuk market, has reaffirmed its continued support to the UK.

"The IsDB stands ready to work with the relevant stakeholders to create more success stories in the UK," assured Zaki Bantan, the head of funding at the IsDB, who added: "To see an advanced economy issuing twice and hopefully more



Zaki



down the road is something that we are hoping."

### Regulatory support

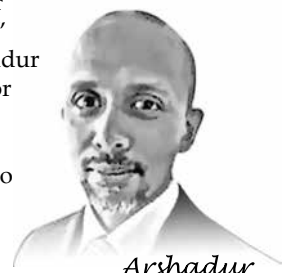
While there is no question of the robustness of the UK's legal infrastructure, it is also clear that the industry desires, and needs, more support, not only the banks, but also Islamic non-bank financial institutions including fintech companies.

"Non-bank financial institutions will be impacted by stamp duty because they are using equity-based structures. If you are not a bank, you may not get additional capital gains tax impact. For diminishing Musharakah, the structure that most banks use, [it] is affected by that on rent. The Consumer Credit Act has stifled the development of personal finance products, car finance and some smaller SME products. And whilst I state them as problems, they are obviously opportunities for us to fix," noted Sultan.

While there are still gaps, industry players do acknowledge the good work that has been done thus far, and the BoE is still committed to the cause, although it is constrained to a certain extent.

"From a regulatory standpoint, the position we articulated way back in 2007 is that we try to offer no obstacles but no special favors. I know this does contrast with authorities in other parts of the world where they take an active promotional role but given the level of financial diversity within the UK, it would be difficult for the BoE and the Financial Conduct Authority to take a specifically promotional position with regards to Islamic finance

versus any other form of finance," explained Arshadur Rahman, a senior manager at the BoE. That being said, we do remain open to dialogue and discussions for any areas where there is a clear gap that needs to be plugged or bridged."



Arshadur

### Part II

Panels in the first half of IFN UK Forum 2023 also identified two major growth drivers for Islamic finance in the UK, sustainable finance and fintech, which we will explore in greater detail next week. ☺