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Jonathan Lawrence of K&L Gates LLP reviews a recent financial title


Consulting Editor: Rahail Ali, Hogan Lovells LLP

ISBN: 9781905783984

Price: £120

Publisher: Globe Law and Business

INTRODUCTION
This is the second edition of the Guide, which was first published in March 2008. In the intervening period, the Islamic finance industry has endured the global financial crisis in the same way as its conventional counterpart. Some global banks have retreated from offering Islamic financial products, while standalone Islamic banks have started up and developed in Islamic and non-Islamic majority countries. The past six years have also seen the growth of transactions which combine conventional and Islamic facilities in one deal. In the UK, the Islamic financial institutions have used the retreat of traditional real estate lending banks to take up market share and assist their Middle Eastern customer base in gaining a foothold in the London commercial and residential property market.

However, Islamic-compliant financing is on a growth trajectory based on demographic trends, rising investible income levels and progress towards harmonisation of global regulation. While the economies of developed economies are under strain, real estate market participants are looking to funding alternatives such as Islamic debt. Islamic banks originating in the countries of the Gulf Cooperation Council (GCC) could emerge as forces to be reckoned with in the new global order of finance.

On current estimates, 26.4% of the global population will likely be Muslim by 2030 against 23% in 2012. The proportion of Muslims in Europe is around 5% of the population. This creates a large market and investor base to consider. The level of harmonisation is increasing between conventional and Islamic banking regulation, thus eroding barriers to entry. Islamic banking services are available in 39 countries on four continents. There are also significant growth opportunities, given that the global penetration of Islamic banking is currently below 2% in real estate finance and the Islamic debt market or sukuk accounts for only approximately 1% of global debt issuance.

The UK has enjoyed an in-built advantage in its attempt to become the hub of Islamic finance in Europe. This is due to English law often being the governing law of international Islamic finance transactions. An Islamic finance transaction might involve a Swiss bank and a Middle Eastern counterparty, but they may choose to use English law to structure their documentation to give flexibility and certainty to both sides.

The UK government issued a £200m government sukuk on 25 June 2014. A sukuk is a bond-type instrument that is compliant with Islamic principles and is therefore attractive to investors that wish to invest in accordance with their religious beliefs. This is the first sukuk to be issued by the national government of a G8 member country.

The announcement of the UK Islamic government sukuk ultimately provides for three key outcomes relevant to other governments:

- encouraging investment in the domestic economy from Islamic-compliant investors through cementing knowledge and acceptability of the sector;

- stimulating regulatory reform in finance, tax and other areas by national governments competing to attract Islamic investors; and

- persuading major corporate institutions into further private sukuk issuances, given the normalising effect of national governments being seen to use Islamic finance as a means of raising funds.

With Islamic finance growing 50% faster than conventional finance and with global Islamic investments set to reach $2.1tn in 2014, the sukuk is symbolic of wider efforts by the UK government to foster growth in the Islamic finance sector in the country. This move could lead to more national governments outside the Islamic world looking to tap the sukuk market.

THE REVIEW
The second edition of this book is fortuitously timed given the UK government sukuk. This follows London’s hosting the World Islamic Economic Forum at the end of 2013.

The Guide itself is divided into six parts: an Islamic finance overview; equity and funds; finance; capital markets; insurance; and regulation. This helps to give the book an overall structure and allows the authors, who comprise both legal practitioners and business people, the opportunity to focus on matters in a detailed way.

The editor of the Guide, Rahail Ali, writes the introductory chapters regarding the markets, the principles and legal issues and standards in addition to later chapters. By providing an historical context to the Islamic finance industry and discussing the sources and principles of Islamic finance, the author sets the scene for the more detailed explanations to come. In particular, the sanctity of contracts is stressed. The object or subject matter of the contract must comply with key requirements. An overriding objective is to ensure fairness to, and the welfare of, all parties. The author also gives a brief introduction to the growth of Islamic finance in non-Islamic majority states such as the UK, France, Singapore, Hong Kong and Japan. Early on, the author hints at the longstanding debate in the Islamic finance market as to whether it is merely aping the conventional finance market's products, or whether it is genuinely new financial engineering. This is an important debate which continues. The second chapter provides a helpful contrasting appraisal of conventional debt and Islamic finance and also considers governing law issues. Parties are free to choose whichever law applies to a particular transaction and which courts can enforce it. The chapter makes the point that English law tends to be the usual choice for large cross-border transactions. This has helped the growth of UK origin law firms' practice in this area. Another ongoing debate in the Islamic finance industry is the perceived need for standards and standardisation of documents. Market practice, legal documentation and even national legal systems may need to move towards harmonisation to help the growth of the industry.

With regard to equity and funds, the Islamic asset management sector and the shariah screening and Islamic equity indexes are considered. These chapters are written by a legal practitioner and a former Islamic banker respectively. The chapter on Islamic asset management contains a section on shariah-compliant leverage which introduces the key contractual structures which underpin Islamic finance -- ijara, musharaka, mudaraba, murabaha and istisna. This is a useful way to introduce these concepts and each is accompanied by helpful diagrams. There is an interesting focus on private equity/venture capital funds as these are ideally suited to the risk-taking nature that should be a characteristic of any Islamic finance transaction. The shariah screening of company shares has been a particularly active area of development and international companies such as Dow Jones, Standard & Poor's and FTSE each have Islamic market indexes to allow compliant investors to put their money into equity investments in the knowledge that the underlying companies have been screened against various criteria. The chapter also considers the application of these screening criteria: whether it is the purification of dividends and other impermissible income or the on-going monitoring of selected companies.

The next part of the Guide looks at Islamic finance in the syndicated bank markets and Islamic project finance. In particular, the growth of multi-sourced financing is considered. Conventional banks often do participate in Islamic syndicated deals. Borrowers are seeking the advantages of pricing and funding diversity. The use of such structures in the UK real estate finance market is now well entrenched. The chapter on Islamic project finance is particularly interesting as it gives detailed diagrams and step by step guides to putting together the variations of Islamic contracts to put together a funding package for a project. Again, the underlying nature of Islamic finance lends itself to project finance in that there is an actual tangible goal in mind of providing projects which benefit large numbers of people and meet a need for infrastructure and other services. This chapter also considers project sukuk and their potential for rapid growth. Although there have only been a small number of project bonds issued as part of greenfield multi-source project financings to date, the market sentiment is that this situation will soon change.

The part of the book concerning capital markets is rightly one of the longer sections. The sukuk market has grown through the global financial crisis and demand for the product often exceeds supply. After an
introductory chapter by the editor, there are more detailed considerations of the global sukuq market and legal structuring considerations. There is consideration of some recent high profile sukuq issues and the Guide considers a couple of them in detail: the nakheel sukuq which was a US$3.5bn pre-initial public offering convertible sukuq based on real estate assets; and the Saudi Arabia’s first sovereign sukuq issued by the General Authority for Civil Aviation. At the time it was, at US$4bn, the largest single-tranche sukuq ever issued. The final chapter in this part is written by the CEO of a financial advisory boutique and looks at the growth of the sukuq market and the life cycle of an issue of such an instrument.

The penultimate part concerns insurance based on Islamic principles (takaful). This is the concept of mutual risk sharing based on the Islamic foundations of social solidarity, co-operation and joint indemnification of losses. The part starts with a useful comparative overview between takaful and conventional insurance. The growth of takaful has been slow in the UK because of the in-built advantage of the economies of scale of the conventional insurance industry. This prompts the issue of whether there is actually public demand for Islamic finance products if they are, or appear to be, more expensive than conventional counterparts. This is a subject with which the industry needs to grapple if it is to grow further in non-Islamic majority countries. The second chapter in this part concerns a case study of takaful and a suggested next cycle for takaful development, including the establishment of an international association to share best practice and a campaign to build public awareness.

The final part of the Guide considers regulation of the Islamic finance industry. A comparison is drawn between the Malaysian and GCC approach to regulation. There is a fundamental theoretical difference between the two centres which is rooted in Islamic jurisprudence or fiqh. There is a discussion of how the different schools of thought within Islam affect regional approaches to Islamic finance. The Malaysian approach to regulation is characterised as comprehensive and centralised, whereas many GCC regulators are said to have taken a passive or minimalist approach to Islamic finance regulation. The book concludes with a chapter discussing the future of regulation of Islamic finance. It recognises that each jurisdiction will have its own structure for the regulation of the financial services industry. Islamic finance needs to be regulated from a capital perspective as well as a systems perspective; therefore, account needs to be taken of the Basel framework. The chapter concludes with a summary Q&A regarding Islamic finance regulations.

The Guide would benefit from an index and glossary to assist less experienced readers. However, the book is an excellent addition to any Islamic finance library. The Islamic finance industry itself is developing a wider platform which will assist in the growth of business and infrastructure across the world.