

IFN Islamic Finance *news*

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A letter from Amin
2015 – 2025 (and counting...)

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Allow me to introduce myself

By Mohammed Amin

While I have been writing technical articles for publication since early 1997, this is the first time I have been a columnist. The editor has asked me for one piece each month, on anything which is relevant, readable and legal. It should also be interesting, if that is not an oxymoron for the writings of a chartered accountant! To help readers understand how I see the world, I have devoted this first column to how I came into Islamic finance.

“ All religious issues are for the individual Muslim to decide, since each of us is individually accountable to God ”

I have been an accounting, tax and treasury expert for a long time — a chartered accountant since 1977, a chartered tax advisor since 1978 and a corporate treasurer since 1995.

Conversely, I first thought seriously about Islamic finance in 2002 when I went to perform the Hajj. One of those in our group was a biochemist (PhD holder I recall) in middle management in a pharmaceuticals company. He did not own his own home because he had religious objections to a conventional mortgage. We spent many hours inconclusively debating why a fixed interest loan was impermissible but a Murabahah transaction with the customer's payments identical to those of the fixed interest loan was permissible.

I became professionally involved in 2005 when the UK changed its corporation tax and income tax laws with the goal of enabling Islamic banks to operate without the bank or the customer suffering tax costs greater than with conventional banking. Given my background, I have always concentrated on the tax, accounting and regulatory aspects of Islamic finance. From time to time, people approach me seeking a religious opinion, and I always tell them I am not a religious advisor and recommend they

think about the issue for themselves.

Fundamentally, that is because I believe that all religious issues are for the individual Muslim to decide, since each of us is individually accountable to God. Obviously, that does not preclude seeking guidance and advice from those who have studied Islam more deeply than you, but ultimately the religious decisions are yours and nobody else's, since it is you who must answer for them.

I often remind people that, despite many years of strong growth, Islamic finance worldwide still amounts to between 0.5% and 1% of total finance, with the other 99+% being conventional, despite Muslims being about 23% of the world's population. Leaving the reasons to one side, those statistics show that the industry has enormous scope for future growth.

I feel passionate about Islamic finance because it provides financial services to those Muslims whose religious views preclude them from purchasing conventional finance. Every occasion when a Muslim husband dies in Britain, with no life insurance but leaving an impoverished wife and young children, is a reminder of why we need a life Takaful provision in Britain.☺



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Internationalising the language of Islamic finance

By Mohammed Amin

I want Islamic finance to be seen around the world as commonplace and normal, rather than rare, exotic or outlandish and believe all other Islamic finance practitioners also do.

To practice something, we have to be able to talk about it. Language, regardless of whether we use words or mathematical symbols, is the way people share ideas and together create a world none of us could have created by ourselves. It makes us human.

Most Islamic finance is practiced within national borders, in countries such as Malaysia, Bahrain or Pakistan, to name but three, and is conducted in national languages such as Bahasa Malaysia, Arabic and Urdu. However, the language of international business, including international Islamic finance business, is English.

“ For Islamic finance to become commonplace and normal, we have to be able to talk about it using the English language, making use of only English words ”

Accordingly, for Islamic finance to become commonplace and normal, we have to be able to talk about it using the English language, making use of only English words.

The wonderful thing about English is that it expands unashamedly, voraciously swallowing words from foreign languages, and making them into English words. To give just one example, when I was young it was common to talk about

‘tidal waves’ even though the waves being spoken about were known not to be caused by tides but by undersea earthquakes. Japanese has a word for such waves; it calls them tsunamis.

At some stage in the last 50 years, English has absorbed the word tsunami. Now, newspaper reporters and TV broadcasters will use the word tsunami without feeling any need to explain the word. Tsunami has now become an English language word. The sentence “The tsunami came quickly” does not contain three English words and one Japanese word; all four words are English words. Some may find that statement strange, but only because the absorption of ‘tsunami’ is so recent. Nobody describes the word ‘shampoo’ as Indian, even though it came from there,

because English absorbed it long before today’s generation was born.

Islamic finance can be talked about using only English’s existing wide vocabulary but it takes long circumlocutions (eg ‘purchase and resale transaction’) and even then risks imprecision since there is more to Murabahah than just purchase and resale.

For precision and conciseness, English needs to absorb more words from foreign languages. That is already happening. For example, English bankers practicing Islamic finance regularly talk about commodity Murabahah transactions.

In practice, absorption will be limited to where English has real vocabulary gaps. Critically, the words must be written like any other words in the English language. That means no glottal stops (Shariah, not Shari’ah), no other accents, no Arabic ‘Al-’ prefixes (Murabahah, not Al-Murabahah), etc, since one is writing English, not Arabic.☺



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The essential role of speculators

By Mohammed Amin

Speculators always get a bad name but who are they? People who buy something because they expect prices to rise, or sell because they expect prices to decline. Speculators are much maligned, but their critics ignore speculators' essential role in making markets.

Look at cotton futures. Each Muslim must decide for himself if he considers a cotton futures contract to be Shariah compliant. However, the cotton futures market undeniably exists because it meets the real needs of cotton producers (farmers) and cotton users (spinners, weavers and cloth merchants).

Before deciding how much acreage to plant, how much fertilizer to apply, etc, farmers need to know the selling price of the cotton to be grown. Similarly, users need to know cotton costs to calculate prices for future finished products. They may be printing catalogues or otherwise quoting firm prices for an extended period of time. Unexpected cotton price variations risk turning those finished products, with fixed prices, into loss-makers.

The New York Board of Trade satisfies the needs of both producers and users by quoting cotton futures prices as far forward as July 2018.

These standardized futures contracts meticulously specify quantities and grades of cotton, with precisely specified dates and locations for delivery.

Some suggest these needs for price certainty can be met by cotton producers contracting directly with cotton users to grow and deliver cotton in the future for a price which is fixed today. While theoretically possible, I regard it as unfeasible in practice. The end-user would need to find farmers, often located in another country, to agree contracts with many farmers of an uncertain credit rating and agree terms over cotton of which future the quality is unknown today, etc.



The futures market meets producer and user needs quite differently and much more efficiently.

Most of the market consists of speculators, with no need for cotton, hoping to make money from price fluctuations. A farmer expecting to produce a quantity of cotton in the summer of 2018 can today sell July 2018 futures contracts totaling roughly his expected production. Critically, the cotton he grows does not need to match the precise quality in the futures contract; its price will still vary roughly in line with the futures contract. Nor does the

“ Almost all futures contracts are closed out by transacting the opposite contract; if you have sold a future, you close your position by buying the identical future ”

farmer need to find a user to agree the contract; he simply sells futures contracts to speculators. The opposite is done by cotton users, who buy futures contracts from speculators.

Almost all futures contracts are closed out by transacting the opposite contract; if you have sold a future, you close your position by buying the identical future. Delivery is not needed, since the producers and users are in most cases dealing in cotton with different characteristics, in different places, to that specified in the futures contract.⁽²⁾



Taxation of Islamic finance in the MENA region

By Mohammed Amin

Since late 2011, I have assisted the Washington-based International Tax and Investment Center in researching the taxation of Islamic finance in the MENA region, supported by the Qatar Financial Center Authority.

The first output was a survey of the direct tax (taxes on income) treatment of Islamic finance transactions. Later, I was asked to look at how value-added tax (VAT), also often called goods and services tax (GST), impacted on Islamic finance transactions. Just as most financiers regard tax as arcane, I suspect that most direct tax advisors regard VAT as an esoteric part of the tax universe!

After its early adoption by the EU, an increasing number of countries around the world have brought in VAT systems for a variety of reasons. Being normally broadly based, VAT generally raises revenue more efficiently and with less distortion of economic activities than a traditional sales tax. It also has no adverse impact upon exports. In my view, the record-keeping requirements of VAT can boost the general quality of tax compliance in adopting countries.



Last month, I found myself presenting the project's findings on VAT to the 6th MENA Tax Forum in Doha, to an audience containing many senior MENA region tax administrators as well as representatives from private sector multinational companies and professional services firms.

The key challenge Islamic finance presents for VAT is that Islamic finance transactions often have more steps than equivalent conventional finance transactions. For example, a commodity Murabahah transaction involves three sales of a commodity (from the market to a bank, from the bank to its customer, and from the customer to the market) whereas nothing is bought or sold in the case of an interest-bearing bank loan. Each of these sales may require VAT to be charged. That is a minor nuisance if the purchaser can recover the VAT but a crippling cost if the purchaser cannot recover the VAT.

I explained that both Malaysia and South Africa have legislated specifically for the VAT treatment of Islamic finance transactions. Meanwhile, the UK has relied on the operation of its general VAT rules; these work satisfactorily most of the time, but serious

problems sometimes arise, particularly when one of the parties (such as a private individual) is not registered for VAT.

“ The key challenge Islamic finance presents for VAT is that Islamic finance transactions often have more steps than equivalent conventional finance transactions ”

I advised the tax administrators in the audience to cater specifically for Islamic finance if their countries were planning to introduce a VAT system. In particular, since most Islamic finance transactions involve a regulated entity (eg a bank or a Takaful operator), the compliance risks can be minimized by requiring the regulated entity to report on the transactions it has with its (non-regulated and possibly unregistered) counterparties.☺

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The permissibility of your career path

By Mohammed Amin

My website intentionally makes me easy to contact and I regularly receive emails from younger Muslims seeking advice. The highly abridged essence of one received last month was: "I am currently 18 years old in Upper Sixth and will soon be applying for university. My intentions are to apply for an actuarial science course; however, to my understanding the practices that actuaries do are not 100% permissible due to the fact that they must deal with interest and insurance."

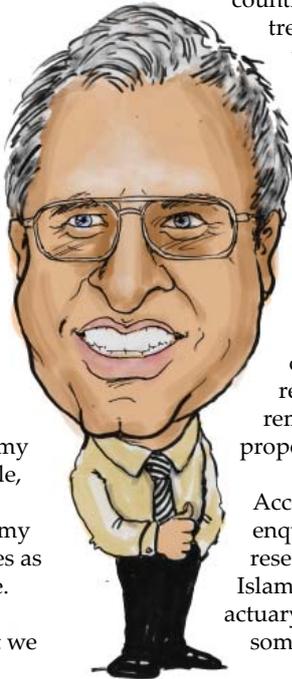
Many young people do not have access to knowledgeable advice, and are often misled by friends and family who themselves make assumptions without proper knowledge. For example, I have a Muslim friend who bitterly regrets abandoning a promising army career in his younger days because he allowed older Muslims to convince him that serving in the British army was religiously impermissible, a religious view that he now considers to be incorrect. In my opinion, much of what passes as religious advice is unreliable.

In my reply, I explained that we do not give religious advice

to other people because on the Day of Judgment each of us will be individually accountable to God for what we have done and for what we have not done. Accordingly, it is the responsibility of every Muslim to study Islam and to reach their own conclusions on all religious questions. That does not preclude ascertaining the views of others who may have spent many years studying Islam, but the final decision on what to do has to be that of the individual Muslim.

The aforementioned approach is similar to the law in the UK (and many other countries) regarding medical treatment. Sensible people who are not experts in medicine are well advised to consult qualified medical practitioners before deciding what treatments to undertake. However, the final decision is that of the patient, provided they are adults and of sound mind, ie not insane in the eyes of the law. While doctors can advise and make recommendations, the patient remains free to reject any proposed medical treatment.

Accordingly, I encouraged my enquirer to do his own religious research before deciding whether Islam allowed him to train as an actuary. However, I then gave him some helpful pointers.



“ While the religious scholars who give Islamic finance opinions consider conventional insurance impermissible, they regard Takaful as acceptable ”

While the religious scholars who give Islamic finance opinions consider conventional insurance impermissible, they regard Takaful as acceptable. I explained that unless the risks that a Takaful company is pooling are absolutely homogeneous, it needs actuarial expertise to ensure that customers representing one type of risk are not being subsidized or disadvantaged by customers representing a different type of risk. As illustration, I gave the young person a link to a page on the Malaysian Takaful Association advertising actuarial positions! (2)

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- Solutions to Manage Key Risk and Liquidity Management Challenges with Islamic Banks
- Identifying Risks Unique to Islamic banks due to ALM Structures
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Islamic banking treasury management requirements

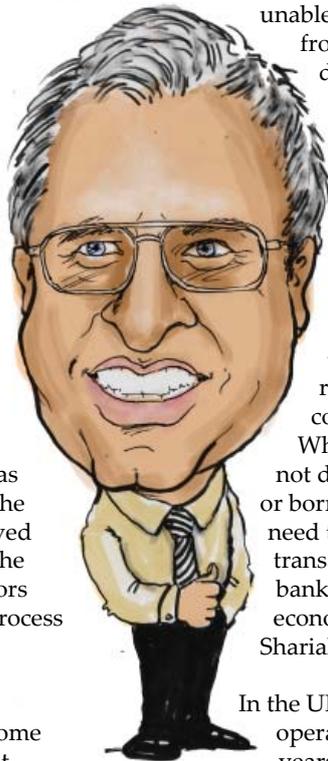
By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

As befits the home of the world's leading international financial center, for over a decade the UK has been the pioneer among Muslim minority countries in facilitating the development of Islamic financial institutions. Its general policy has been to adapt tax and regulatory law and practice with the goal of establishing a 'level playing field'. Islamic financial institutions should not be treated any worse, nor any better, than conventional financial institutions.

Where the UK has led the way, many other Muslim-minority countries have followed. Some have adopted the UK's general principles while others have virtually copied the UK's legal drafting. The UK's goal of levelling the playing field has not yet been achieved. Sadly, the complexity of the issues involved and the other demands upon the time of legislators and regulators mean that this is an ongoing process which will take many years to complete.

All conventional banks have some common treasury management

requirements. As many of their liabilities are repayable on demand, banks need to hold a significant proportion of their assets in a form that is safe from credit risk and can be accessed quickly while still earning some interest. They normally achieve this by holding deposits with the country's central bank. Indeed, most central banks require commercial banks to hold specified levels of such deposits for regulatory purposes. From time to time, some banks find that they are unable to finance themselves



from regular customer deposits and interbank deposits. They therefore need to be able to borrow from a 'lender of last resort'. This function is a key role of the central bank.

Islamic banks have exactly the same treasury management requirements as conventional banks. While Islamic banks do not deposit money at interest or borrow at interest, they need to be able to carry out transactions with the central bank which have equivalent economic effect and which are Shariah compliant.

In the UK, Islamic banks have operated for the last 10 years without such Shariah

compliant facilities being offered by the central bank, the Bank of England. This has made managing their treasury functions much more difficult than would have been the case if they had the type of access to the Bank of England, outlined previously, which conventional banks have.

In February 2015, speaking at the University of Warwick, Dame Nemat Talaat Shafik, the deputy governor for markets and banking at the Bank of England, said: "The bank will commence work in the second half of 2015 to assess the feasibility of establishing a Shariah compliant facility. By providing an additional highly liquid asset for Islamic banks, such a facility would be a significant step forward in their liquidity management capabilities."

A year later, this work has moved a step forward. In February 2016, the Bank of England issued a consultation paper titled 'Establishing Shariah compliant central bank liquidity facilities' which is available from its website. This proposes two alternative models intended to allow Islamic financial institutions to make the equivalent of deposits with the central bank in a Shariah compliant way. While enabling such deposits will be the initial goal, the paper also sets out two alternative models which might be implemented at a later date for the Bank of England to act as a lender to Islamic banks. The deadline for responses is the 29th April. ☺



BASEL III & IFSB REGULATIONS FOR ISLAMIC FINANCIAL INSTITUTIONS

3rd – 5th May 2016, Kuala Lumpur

SIDC CPE - accredited 10 CPE Points

Highlights:

- Know and understand Basel I, II and III as they relate to Islamic banks
- Know and understand IFSB standards for Islamic banks
- Practical insights into implementation of the standards

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Retirement provisions

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

As Islamic finance develops, it needs to cater to the totality of individuals' financial needs. One of these is retirement provision. In conventional finance, recent decades have seen a big swing away from private sector employers offering defined benefit pension schemes, which promise a defined amount of pension, often linked to final salary. Employers have realized that these create too much risk for them; a company's role is to run a profitable business, not to take on financial pension risks which run for decades.

The trend in the private sector is toward defined contribution schemes. These typically involve contributions into a pension fund being made by the employee and the employer which are tax-deductible, followed by the investment of the fund over the employee's working life, typically growing tax-free, and then retirement. The key question is what to do with the fund on retirement. Conceptually, there are three alternatives.

The first is to take out the entire lump sum from the pension scheme. However, if allowed at all by the applicable law, this may involve prohibitive tax costs. It still leaves

open the question of what to do with the lump sum afterward.

The second alternative is to leave the fund invested and to make periodic cash withdrawals as the retiree requires money to spend. That is what I have done with my own defined contribution pension arrangements since I retired.

The third alternative is to use the accumulated defined contribution pension fund to purchase an annuity. The annuity vendor (typically a large insurance company) contracts to pay the retiree an annuity for the remainder of his life. One can choose to have the annuity continue for the retiree's widow's life. The annuity may be level, may increase at a fixed rate or may be linked to an inflation index. All of these options are, of course, reflected in the annuity's initial pricing. Annuities are particularly appropriate for individuals with relatively lower pension fund amounts or other savings who cannot afford to have the continuing investment risk throughout retirement which the second alternative entails.

For Shariah compliant defined contribution pension funds, one requires a Shariah compliant solution for each of the

lifetime stages mentioned previously. It is relatively straightforward to set up a Shariah compliant defined contribution scheme into which individuals and their employers can pay. It is also relatively straightforward to provide Shariah compliant alternatives to invest the defined contribution pension fund until retirement, for example, using Shariah compliant mutual funds and Shariah compliant Sukuk funds.

The area where the market presently appears deficient is the provision of Shariah compliant annuities. When writing on Islamic finance, I always leave Shariah issues to others. However, I expect that it should be possible to manage the key actuarial risk, namely longevity risk, using the same Takaful concepts applied in the provision of Shariah compliant life insurance.

However, there is an economic challenge for potential providers of Shariah compliant annuities. To match the risks of the annuities they will sell, they need to be able to purchase very long-dated investments, such as Sukuk, with matching characteristics. This requires governments or corporates to issue very long-dated fixed rate Sukuk and indeed also very long-dated index-linked Sukuk if we are to see the growth of a market in Shariah compliant inflation-linked annuities.

The positive side is that if this market can develop, it will offer Sukuk issuers very long-term funding at potentially attractive rates.⁽²⁾



BASEL III & IFSB REGULATIONS FOR ISLAMIC FINANCIAL INSTITUTIONS

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- Practical insights into implementation of the standards

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How do we decide what to study at university?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

How do we decide what to study at university? Most of us apply two main criteria.

One criterion is our intrinsic interest in the subject. It is hard to study a subject you find totally uninteresting; conversely, if you find something utterly absorbing you are likely to study it with dedication and passion.

The other criterion is the instrumental question: "Will this subject lead to a rewarding and well paid career?"

The relative weight we give each criterion depends upon our personal circumstances. For the child of a billionaire, the second criterion may be completely irrelevant. For the child of indigent parents, it may be the main criterion.

As far as my own life is concerned, my parents were very poor. Despite that, perhaps because my parents never focused excessively on money themselves, I was driven primarily by my personal intellectual interests. At Cambridge in the 1960s, if your interest were theoretical physics then Mathematics would be the

subject to study (rather than natural sciences), and that is what I read.

During my time at university, my interests became even more abstract, and I concentrated on topics such as general topology, without thinking about what I was going to do for a living! Fortunately, I stumbled into accountancy, and then was attracted to taxation as a speciality that was both intellectually absorbing and well paid.

Against this background, I have become increasingly concerned by the large number of UK universities which are offering postgraduate Master's courses in Islamic finance, and in particular whether the courses are being mis-sold.

Whether mis-selling is occurring depends of course on whether the information provided to the customers (students are paying customers since universities charge fees) is accurate, and on the reasons why the students are taking the courses concerned.

While I do not have data regarding the geographical origins of students taking these degrees, a reasonable proportion are likely to be foreign students, in many cases already working in Islamic finance, burnishing their academic credentials by obtaining a degree from a UK university. In world rankings, many UK

universities rank relatively highly, and such a UK degree can enhance their promotion prospects and earning power in their home country.

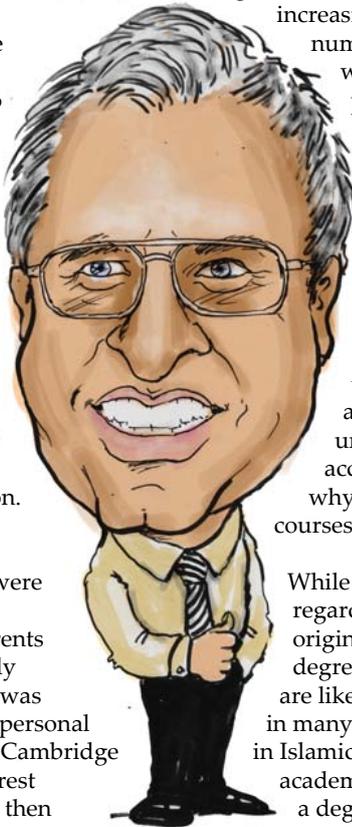
In the case of UK origin students, the issues become more problematical.

Some proportion of these will be choosing to study Islamic finance because they find the subject intrinsically interesting, without seeing it as a pathway to an Islamic finance career. For such individuals, provided that the course is taught well, mis-selling cannot be an issue.

However, I have a real concern that many UK origin students are persuaded to take a Master's degree in Islamic finance immediately after graduating, in the belief that the Master's degree will lead them into an Islamic finance career. If students spend time looking at universities' websites promoting such degrees, they are likely to be reinforced in that impression.

Unfortunately, the number of available positions in Islamic finance in the UK is very limited. Also, UK Islamic financial institutions are too small to train people, and typically only hire experienced Islamic bankers.

Unless the individual can find a trainee position overseas, entering the Islamic finance industry after the Master's degree is likely to be impossible. My concern is that UK universities fail to point out such issues when promoting their Islamic finance Master's degrees to UK origin students.☹



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Cross-border transactions and foreign exchange risk

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Cross-border transactions always give rise to foreign exchange transaction risk. Imagine UK Dealerco imports excavators from the US. When the US\$/GBP spot exchange rate is GBP1 = US\$1.5, Dealerco agrees to import an excavator costing US\$150,000 (GBP100,000) with payment being due in three months' time. Dealerco sells the excavator to a UK contractor for, say, GBP105,000 (US\$157,500).

In three months' time, if GBP1 still equals US\$1.5, Dealerco will buy US\$150,000 for GBP100,000, so making an overall profit of GBP5,000 (US\$7,500). However, in three months' time the GBP/US\$ exchange rate could be almost anything. If say GBP1= US\$1.4, then US\$150,000 will cost Dealerco GBP107,143 so overall instead of making the expected GBP5,000 (US\$7,000) it actually loses GBP2,143 (US\$3,000). (Conversely, if in three months' time GBP1=US\$1.6, the US\$150,000 will only cost Dealerco GBP93,750, so its overall profit becomes GBP11,250 (US\$18,000).)

Dealerco can eliminate this risk using a forward foreign exchange contract with a conventional bank. For example, Dealerco and the bank sign a contract today under which

Dealerco commits that in three months' time, it will buy (and the bank commits to sell) US\$150,000 from the bank at a fixed price of, say, GBP100,671. The implied rate of GBP1=US\$1.49 is called the forward rate. (The forward rate is not a guess by either party. It is set by taking into account three-month interest rates in pounds and dollars). Effectively, at a fixed cost of GBP671, Dealerco protects itself against unfavorable exchange rate movements, while also giving up the opportunity to profit from a favorable exchange rate movement.

Shariah scholars generally consider such conventional forward contracts impermissible. AAOIFI Shariah Standard No. 1: Trading in Currencies says: "A bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against currency devaluation risk..."

However, the need for protection against foreign exchange transaction risk is a real need. Islamic finance will always struggle against conventional finance if it lacks Shariah compliant instruments to meet such real needs.

Accordingly, I was pleased by the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) recently publishing template documentation for Islamic foreign exchange forwards. These templates are intended to be used under the umbrella of the ISDA/IIFM Tahawwut Master Agreement.

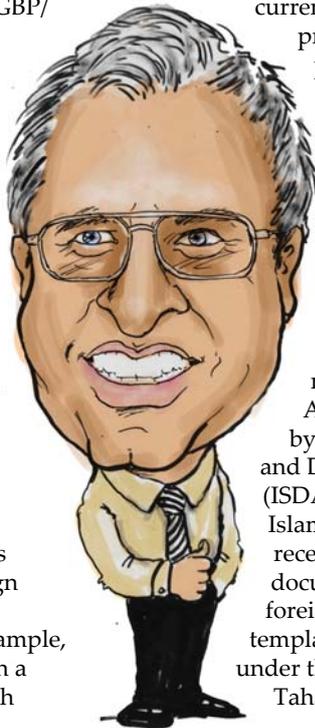
Two counterparties enter into one (quite long) Master Agreement between them, and then enter into much shorter agreements for specific transactions such as the Islamic foreign exchange forwards (IFXF).

The IFXF transaction involves two independent unilateral promises (Waad) being made. Each promise is intended to be legally binding. If the parties use English law, each promise will be executed as deeds, making it legally enforceable.

In our example, Dealerco promises that if, in three months' time, the spot value of GBP1 is greater than, or equal to, US\$1.49, it will buy US\$150,000 from the bank for a fixed price of GBP100,671. Meanwhile, the bank separately promises Dealerco that if, in three months' time, the spot value of GBP1 is less than US\$1.49, it will sell US\$150,000 for a fixed price of GBP100,671. Obviously, only one of these conditions will be satisfied, but regardless of which it is, Dealerco will get the US\$150,000 it wants for GBP100,671.

ISDA and IIFM also published a single promise version, which I will not discuss for lack of space.

As the economics of the IFXF are identical to that of the conventional forward contract, it is up to each individual Muslim to decide if there is a real religious difference. However, this documentation does enable corporate organizations to protect against foreign exchange transaction risk while remaining compliant with the requirements of their Shariah supervisory board.☺



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Why don't Islamic banks offer more fixed return contracts

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I was recently contacted by a European PhD student researching Islamic finance. He asked why Islamic banks provide relatively little finance using profit-sharing contracts such as Musharakah and Mudarabah, and instead provide most of their finance using fixed return contracts such as Murabahah and Ijarah.

As a simple illustration, the 31st December 2015 accounts of The Bank of London and the Middle East, which describes itself as the largest Islamic bank in Europe, can readily be downloaded from its website. The balance sheet shows customer financings of GBP613.75 million (US\$810.97 million). From note 21, after adjusting for Sukuk holdings and impairment provisions, I computed that 99.1% of the customer financings were Murabahah, while only 0.9% were Musharakah and Mudarabah combined.

The key point which many often forget is that Islamic banks are, first and foremost, banks. That means that their purpose is to make a profit for their shareholders by receiving money from one set of customers and using that money to provide finance to other customers.

While many advocates of Islamic banking are keen on having banks take genuine equity participation risk when financing projects, that is not normally the objective of the banks concerned. Providing finance with genuine

equity participation is a much riskier proposition than providing finance which has the economic characteristics of debt finance. In practice, such equity participation risk is not wanted by either banks or their customers.

Banks do not want equity participation risk because it exposes them to the risk of serious loss. Furthermore, regulators will require a higher level of bank capital to be allocated against equity-based financings than against debt-based financings. Also, in countries where fiduciary standards are low, it is not uncommon for customers to falsify their accounts when what they have to pay to the bank is directly linked to the results of their business.

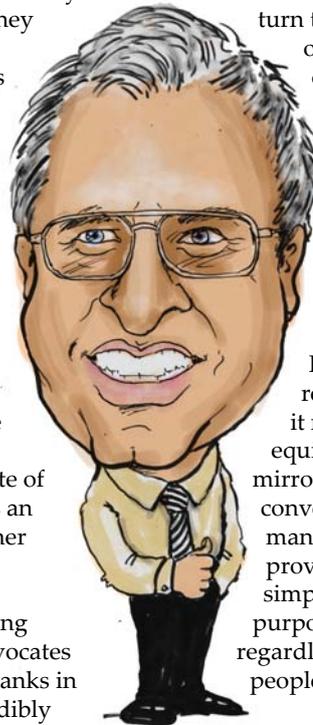
Most customers also do not want financing on the basis of genuine equity participation. Because of the higher levels of risk, anyone providing finance on genuine equity participation terms requires a much higher rate of return than someone providing finance on debt-based terms. That higher rate of return obviously represents an increased cost to the customer being financed.

Accordingly, notwithstanding the regular entreaties of advocates of Islamic finance, Islamic banks in the real world remain incredibly reluctant to provide finance to

customers on terms that involve genuine equity participation. In practice, almost all Islamic finance provided by banks uses contracts such as Murabahah that have debt-based (fixed return) characteristics.

The aforementioned behaviors are not a failing of Islamic banks; they are an essential consequence of them being banks, and it is just how conventional banks also behave. In conventional finance, equity-based finance comes from other providers such as high-net-worth individuals, venture capital funds and other investment companies. They in turn typically have permanent or semi-permanent capital, owned by people who can afford the losses that may arise, instead of being financed by deposits from people who will want their money back, in full, in a relatively short timescale.

To the extent that the Islamic finance community requires equity-based finance, it needs to develop Islamic equity capital providers mirroring those found in conventional finance. Indeed, many already exist. However, providing equity-based finance is simply not the commercial purpose of Islamic banks, regardless of how much some people want it to be.☺



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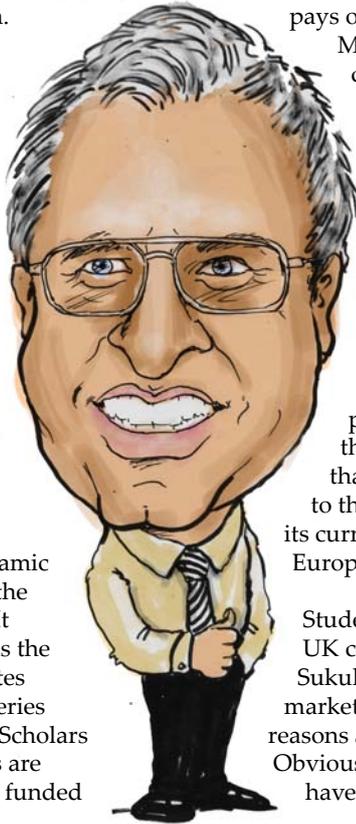
A day at Clare College Cambridge

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

My personal Islamic finance highlight in August was participating, pro bono, in the Cambridge Islamic Finance Leadership Program, a five-day development course organized by Cambridge IF Analytica.

The venue was Clare College Cambridge. All Cambridge colleges hire out their premises during the summer vacation to raise revenue, and Clare College is particularly well placed with its modern facilities and attractive location straddling the river Cam. The program included interviews with Islamic finance leaders, and I was interviewed for an hour.

The venue was particularly poignant for me. Clare is the college I attended over 40 years ago, from 1969-72. The room used for the interview, the Latimer Room, was the same location as the most prestigious Islamic finance lecture I have ever given. That was my lecture titled "Would Islamic finance have prevented the global financial crisis?" It was given in May 2009 as the annual lecture of the Gates Distinguished Lecture Series to the Cambridge Gates Scholars Society, whose members are scholars on the program funded



by Bill Gates of Microsoft. Previous speakers in the Gates Distinguished Lecture Series have included Stephen Hawking and Richard Dearlove, the former head of the UK Secret Intelligence Service, and I was delighted to get my name into the same list as them!

The wide-ranging nature of the interview is illustrated by three of the points I made.

In my view, the greatest product development need in the UK and Europe is for more Takaful offerings, both property Takaful to cover for domestic fire risk, and Takaful which pays out in the event of death.

Many Muslims will not buy conventional life insurance because they regard it as religiously prohibited. I have always regarded it as a terrible tragedy when a young breadwinner husband dies, leaving a widow and also young children whose lives are then blighted by poverty on top of the loss of their father. It is essential to provide protection against this financial risk in a form that is religiously acceptable to the people concerned, and its current absence in the UK and Europe is a major gap.

Students often ask me why large UK corporates have not issued Sukuk in the UK or European markets. I believe that the key reasons are cost and complexity. Obviously, large UK corporates have no religious reasons for

“ Large UK corporates have no religious reasons for distinguishing between raising fixed return funds by issuing conventional fixed interest-bearing bonds or by issuing fixed return Sukuk ”

distinguishing between raising fixed return funds by issuing conventional fixed interest-bearing bonds or by issuing fixed return Sukuk. With a deep and liquid European conventional bond market, it is much cheaper for UK corporates to borrow using interest-bearing bonds than by issuing Sukuk. Until that changes, I do not expect to see Sukuk issues. That does not preclude large UK corporates issuing Sukuk in other markets. For example, multinational companies have issued ringgit-denominated Sukuk in the Malaysian markets as a way of raising ringgit funds to hedge the exchange risks involved in their Malaysian operations or because ringgit Sukuk were cheaper than ringgit conventional bonds.☺



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Homo economicus

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Homo economicus, man as portrayed in classical economics, is very easy to mock. Coldly acting in his self-interest, he computes potential future outcomes, assesses trade-offs rationally and if a consumer maximizes his utility, or if a producer maximizes his profits.

“ Homo Islamicus is a man who behaves as Muslims should: unselfish, caring about others as much as he cares about himself, and conscious of the needs of all future generations yet unborn, not just his own descendants. Homo Islamicus is then used to build Islamic economic models ”

In the real world, homo economicus is nowhere to be found. Most people give something to charity; homo economicus never would. Indeed, many billionaires

plan to leave almost all of their estate to charity.

More importantly, research in the relatively new field of behavioral economics has shown how people regularly and consistently make economic decisions which are clearly irrational. The kind of decisions homo economicus would never make.

So if homo economicus does not exist in the real world, why does he continue to survive in the theoretical world? In my view, the answer arises from the need to build theoretical models of economic behavior. The actors in economic models are both humans (individuals) and also non-humans (companies and governments). However, even the non-human actors are, of course, led by groups of individuals who are the decision-makers. Accordingly, economic models require assumptions about how humans will make economic decisions.

By far the easiest economic decision-maker to model is homo economicus. That is one of the key reasons why classical economic theory is built around him. Real humans of the kind we encounter in behavioral economics are much more difficult to model. The peculiarity is that most of the time, relatively simple models built around homo economicus give rise to predictions which match real-world economic behavior to a reasonable degree of accuracy.

To give an everyday example, almost all people have some degree of unselfishness. However, if you assume

that all of the time people will act selfishly (as homo economicus would), you will not go far wrong.

Homo economicus is of course a problem for all religious people. All of the major religions, and certainly the ones I know best (Islam, Christianity and Judaism) teach us to be unselfish, to care for others, to care about humanity rather than focusing upon our own narrow self-interest. To put it at its bluntest, if homo economicus were a real person, he would stand very little chance of going to heaven!

Proponents of Islamic economics have recommended replacing homo economicus with homo Islamicus. Homo Islamicus is a man who behaves as Muslims should: unselfish, caring about others as much as he cares about himself, and conscious of the needs of all future generations yet unborn, not just his own descendants. Homo Islamicus is then used to build Islamic economic models.

The key question we are left with is which models more accurately predict how Muslim economic actors (Muslim individuals, Muslim-led companies and Muslim-led governments) operate in the real world? Is it economic models based on homo economicus or those based on homo Islamicus? Without attempting any kind of formal survey, my belief is that it is the economic models based on homo economicus which more accurately predict the behavior of real Muslims in the real world.

Where that leaves Islamic economics is beyond the scope of a short 'letter'!☺



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Who should do what in Shariah governance?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I believe greater clarity is needed regarding the Shariah governance of Islamic financial institutions.

Ultimately, the board of directors (BoD) is responsible for managing the Islamic financial institution and ensuring that it has proper Shariah governance in place. Standard industry practice is for the BoD to appoint an external Shariah supervisory board (SSB). The SSB members are not employees of the Islamic financial institution but external contractors who can demonstrate expertise on matters of Shariah. They are not subject to the orders of the BoD.

It should be the responsibility of the SSB to set out clear written policies regarding what transactions the Islamic financial institution may engage in without ceasing to be Shariah compliant, and if necessary detailed rules on how those transactions should be structured.

If the Islamic financial institution engages in bespoke transactions, each such bespoke transaction should be reviewed by the SSB in advance to decide whether the transaction will be Shariah compliant.

While it is not industry practice to publish the full text of all SSB Fatwas (detailed Shariah analyses leading to an opinion), I believe it should be.

Unlike the SSB, the Islamic financial institution's internal Shariah department (ISD) is a team of employees answerable to the BoD. The ISD can answer questions raised by other employees if the answer is clearly determinable from either external published



guidance (such as the AAOIFI Shariah Standards) approved in advance by the SSB or from the SSB's own written policies. In my view, the ISD should consult the SSB before taking a position on any other Shariah questions.

Everything discussed so far is prospective. Once the financial year has been completed, the Islamic financial institution needs to determine whether it has conducted its affairs in a Shariah compliant manner, just as it needs to determine whether its

accounts give a true and fair view in accordance with applicable accounting standards.

The Islamic financial institution's external auditors will of course provide their opinion on whether the financial accounts give a true and fair view. The key question is who should give an opinion on whether the Islamic financial institution has conducted its affairs in a Shariah compliant manner.

The current practice is for this opinion to be given by members of the SSB. However, to do so they need to enquire into the actual conduct of affairs by the Islamic financial institution throughout the year.

Where the Islamic financial institution undertakes many transactions, the SSB members will not have the manpower, and may lack the skills, to

audit large numbers of transactions for Shariah compliance. They risk relying upon an internal Shariah audit report from the ISD which, however, is not independent.

Where the Islamic financial institution has conducted only a few bespoke transactions, the SSB is likely to have been involved in some detail in their implementation. It is then at risk of auditing its own work.

“ All auditing of completed transactions should be carried out by external auditors. Their purpose should be to ensure that the transactions are compliant with the SSB's advance requirements ”

In my view, all auditing of completed transactions should be carried out by external auditors. Their purpose should be to ensure that the transactions are compliant with the SSB's advance requirements. The auditors would not report that “we consider that the Islamic financial institution has been Shariah compliant” but rather “we consider the transactions carried out by the Islamic financial institution to be compliant with the SSB's requirements.” In turn, the SSB could then give its opinion that the Islamic financial institution has been Shariah compliant.

I do not see any role for a second external party to give an opinion on whether the SSB's opinion is correct, just as no company has a second external auditor ‘second guessing’ whether the external auditors' opinion is correct.☺



Retaining an independent Shariah supervisory board is incompatible with an external Shariah audit

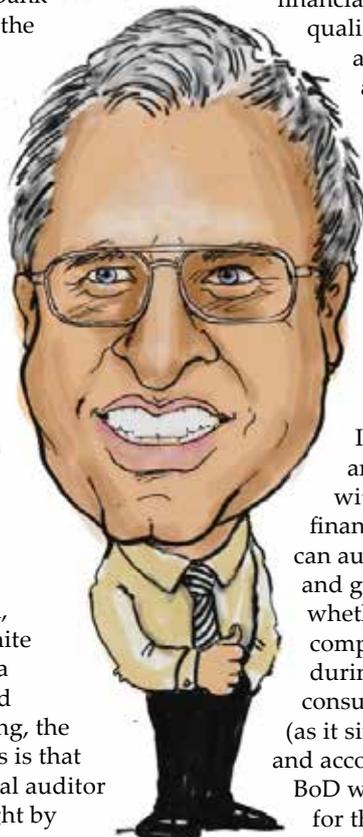
By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Shariah governance is currently much discussed. Many propose adding an external Shariah audit (ESA) to mirror the role of an external financial audit. However, in my view insufficient thought is being given to the implications of an ESA for the role of the Shariah supervisory board (SSB).

All financial institutions must obviously comply with state law and with accounting standards, normally the International Financial Reporting Standards (IFRS Standards). In addition, Islamic financial institutions must also comply with the rules of Shariah as specified by the following:

- Standards set by global bodies such as the AAOIFI Shariah Standards.
- In some countries, Shariah standards set by government bodies. For example, Malaysian Islamic banks must follow the standards specified by the SSB of the Bank Negara Malaysia, the country's central bank.
- The SSB of the Islamic financial institution, appointed by the board of directors (BoD) or shareholders (the precise appointment details varying from country to country).

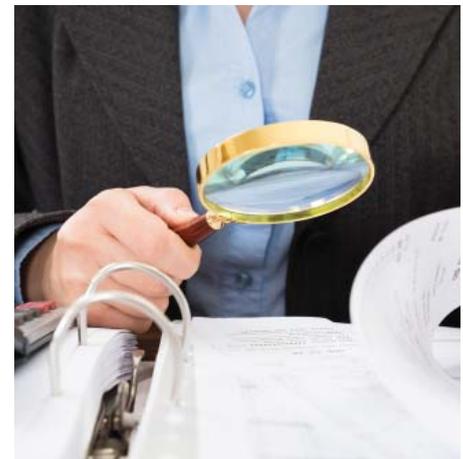
Compliance with standards, whether accounting or Shariah, is rarely a black or white issue but is normally a matter of finely judged opinion. For accounting, the opinion which matters is that of the external financial auditor (subject to the oversight by



“ The SSB as presently constituted should be entirely abolished if an ESA is appointed. Otherwise, the SSB's continued existence would cause confusion with the role of the ESA ”

the courts in the event of negligence, unlawful behaviour, etc) The BoD is responsible for preparing the accounts, but will be aware that if the external financial auditor disagrees with the financial institution's accounting and qualifies his opinion, shareholders and the market generally are overwhelmingly likely to follow the view of the external financial auditor since he is recognized as an expert and as being independent.

The aforementioned model maps perfectly well to compliance with Shariah standards. The BoD is responsible for managing the Islamic financial institution and ensuring that it complies with Shariah. At the end of the financial year, the ESA auditor can audit what has happened and give his opinion regarding whether what has been done complies with Shariah. Obviously during the year, the BoD is free to consult Shariah experts if it wishes (as it similarly consults legal experts and accounting experts) but it is the BoD which takes responsibility for the actions of the Islamic



financial institution and the transactions undertaken.

The problem with the aforementioned model is squaring it with the present role of the SSB.

At present, the SSB is held out as being independent of management, its members are named in the annual report and they give an opinion regarding whether the Islamic financial institution has complied with Shariah. Here, there is a risk of confusion if the independent SSB gives one opinion while the independent ESA gives the opposite opinion.

If an opinion regarding compliance with Shariah is to be given by an independent ESA, then in my view there is no role for an independent SSB. Obviously, the Islamic financial institution will employ staff experts on Shariah in the internal Shariah department. If during the year, the BoD considers that additional Shariah expertise is required for specific purposes (just as external lawyers are often hired for complex projects even though the institution has an internal legal department), then of course they are free to acquire such additional Shariah expertise from external consultants. However, there should be no special status for such external Shariah consultants. The SSB as presently constituted should be entirely abolished if an ESA is appointed. Otherwise, the SSB's continued existence would cause confusion with the role of the ESA.☺

Murabahah and the time value of money in Islamic finance

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Even though the way Islamic banks operate should by now be well understood, I still come across people who contend that there is no concept of the time value of money in Islamic finance. Normally, these are young people with no practical experience of Islamic banking.

If you want to buy a car costing US\$10,000, and don't have the money but are otherwise creditworthy, a conventional bank may lend you the US\$10,000 so you can buy the car today. In return, you agree to repay the bank, say, US\$12,500 in 60 months' time. (This corresponds to simple interest at 5% for five years.)

If you approach an Islamic bank, they will of course refuse to undertake the aforementioned loan transaction.

However, assuming you are creditworthy, the Islamic bank will agree to buy that car from the dealer (paying the dealer US\$10,000) and sell you the car for US\$12,500 payable in 60 months' time, while giving you immediate ownership and possession of the car. The net cash flows for you, the bank, and the dealer, both today and in 60 months' time, are identical.

For accounting purposes, the conventional bank will, of course, record US\$500 interest income in each of the five years. (This column uses simple interest to avoid clogging up the text with compound interest calculations.)

An Islamic bank accounting under International Finance Reporting Standards (IFRS) will report the same figures

as the conventional bank, since IFRS fundamentally account for the economic substance of transactions.

An Islamic bank following the standards of AAOIFI is required to apply AAOIFI's Financial Accounting Standard No. 2 'Murabahah and Murabahah to the Purchase Orderer'. Paragraph 2.4.2 states:

"2.4.2 Profits of a credit sale which will be paid for either by means of one payment due after the current financial period or by installments over several future financial periods shall be recognized by using one of the following two methods:

- a) Proportionate allocation of profits over the period of the credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received. This is the preferred method.
- b) As and when the installments are received. This method shall be used based on a decision by the Shariah supervisory board of the Islamic bank or, if required, by the supervisory authorities."

Under the preferred method, the Islamic bank will also recognize US\$500 of profit each year.

A quick search will find many articles seeking to distinguish the time value of money in conventional finance and the time value of money in Islamic finance.

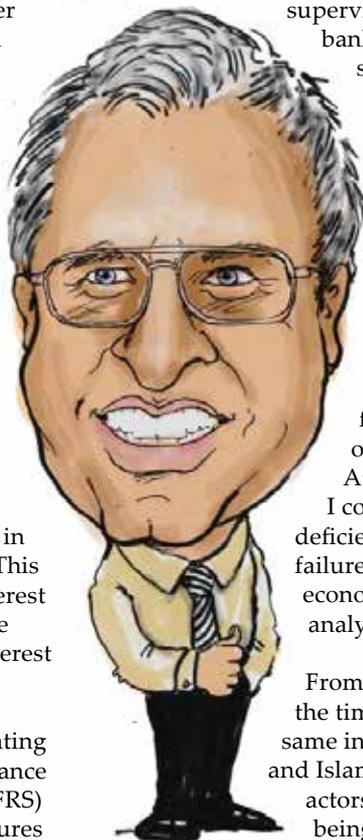
At the risk of generalizing, I consider that the main deficiency of such articles is the failure to distinguish between economic analysis and religious analysis.

From an economic perspective, the time value of money is the same in conventional finance and Islamic finance. The economic actors involved are real human beings, whose motivations

and attitudes will differ from person to person, but such motivations and attitudes are not neatly classifiable by religion.

“ From an economic perspective, the time value of money is the same in conventional finance and Islamic finance. The economic actors involved are real human beings, whose motivations and attitudes will differ from person to person, but such motivations and attitudes are not neatly classifiable by religion ”

The analysis from a religious perspective is a separate issue, and each researcher (indeed each individual Muslim) needs to consider it carefully for themselves. However, this religious question should not be confused with the economic question.☺



The need for more life Takaful

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Most of us do not like to think about dying. That is probably why so many people fail to make wills. Most of us have dependants: elderly parents, unemployed spouses, young children – all of whom would suffer from the loss of family income if we died unexpectedly.

Many non-Muslims fail to buy life insurance term policies to protect against the financial impact of sudden death. These are the simplest sort of life policy, paying out a large lump sum if you die during the insurance term, and nothing if you survive. Structurally, they are just like buying fire insurance on your house, except that the term of the insurance may be 10 or 20 years instead of one year as with most fire policies.

There is a saying in the conventional insurance industry: "Life insurance is sold, not bought." That means customers only take out life policies when persuaded to do so by a salesman. Even when people buy life insurance, they often buy much less cover than they really need. I recommend cover of a lump sum payment on death of at least 20 times your annual income, since if you die unexpectedly, the insurance money needs to last for a very long time.

I would hope that Muslims would be more prudent than non-Muslims. Actually, they are less prudent. Surveys show that insurance penetration (the percentage of GDP paid in insurance premiums) is lower in Muslim-majority countries than in

countries where Muslims are a minority, even when allowing for differences in per capita income between countries. (It is well established that richer people spend a higher percentage of their income on insurance than poorer people.)

What accounts for the lower penetration of life insurance among Muslims?

Part of it must be religious attitudes. Undoubtedly, some people will feel that buying life insurance indicates a lack of trust in God to protect them. They should remember the Hadith of the

man who said to the Prophet (peace be upon him) that he trusted in God for his camel to not wander away. The Prophet told him to first tie his camel and then trust in God.

Other Muslims appreciate the need to cover against the risk of unexpected death but consider conventional insurance to be religiously impermissible.

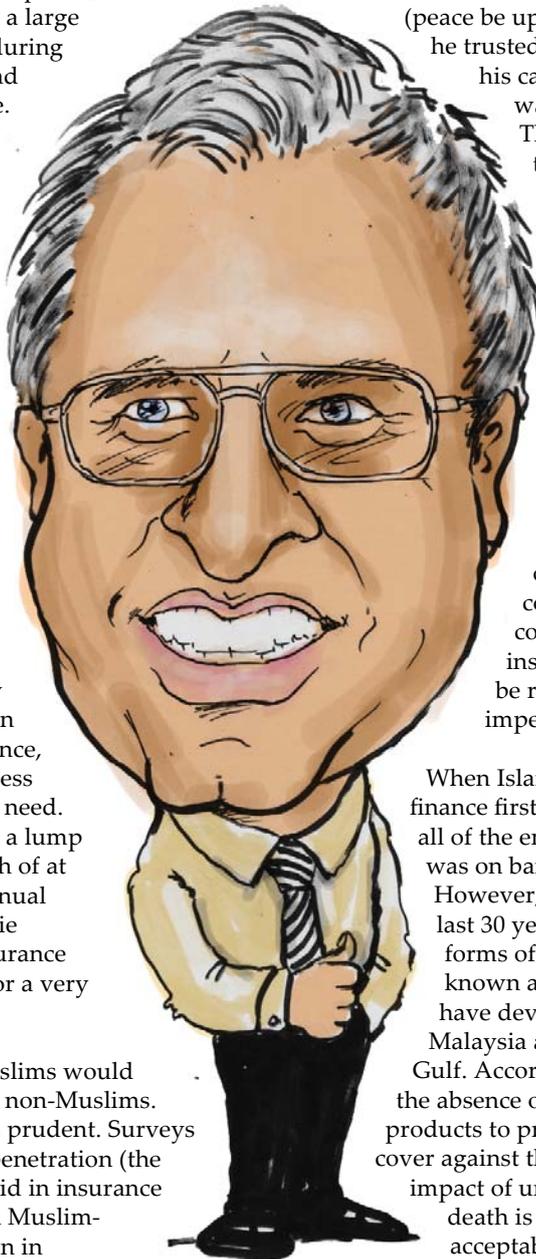
When Islamic finance first started, all of the emphasis was on banking. However, over the last 30 years, Islamic forms of insurance, known as Takaful, have developed in Malaysia and the Gulf. Accordingly, the absence of available products to provide cover against the financial impact of unexpected death is no longer an acceptable excuse for

Muslims in Malaysia or the Gulf to leave their dependants exposed.

“ Over the last 30 years, Islamic forms of insurance, known as Takaful, have developed in Malaysia and the Gulf. Accordingly, the absence of available products to provide cover against the financial impact of unexpected death is no longer an acceptable excuse for Muslims in Malaysia or the Gulf to leave their dependants exposed ”

The situation is worse in countries where Muslims are a minority. For example, in the UK there are several Islamic banks but, as far as I am aware, nobody is currently offering life Takaful. (One company offered Takaful motor policies a few years ago, but it was undercapitalized and unsuccessful in the very competitive motor insurance market.)

In my opinion, this is a market where there is a meaningful customer need which is not presently being met.☺



The relative costs of conventional and Islamic mortgages

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I have been thinking about the relative prices of conventional mortgages and Islamic mortgages (for this purpose, diminishing Musharakah transactions) for residential real estate.

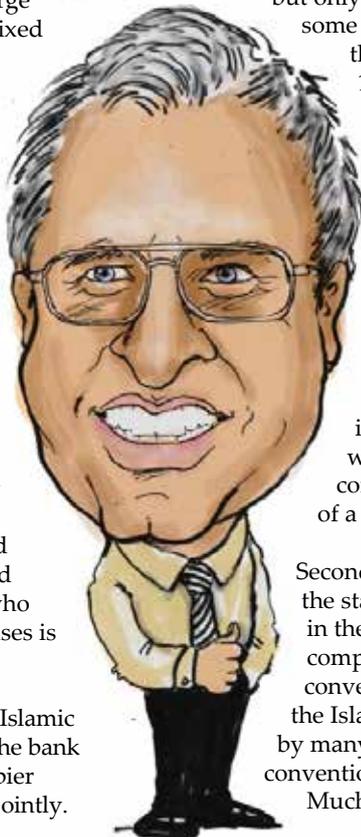
In the UK, Muslims who want to avoid taking out a conventional mortgage are often surprised to find that Shariah compliant Islamic mortgages are noticeably more expensive. As a result, Islamic mortgages tend to be taken out only by those Muslims who regard conventional mortgages as being religiously prohibited.

There are two relatively straightforward reasons why UK Islamic mortgages are more expensive than conventional ones.

Firstly, a conventional mortgage is a reasonably simple transaction to document legally. The property is purchased and conveyed just once from the third-party seller to the new owner occupier, while the bank is protected by a registered fixed charge over the property. That fixed charge stops the new owner doing anything to sell or lease the property to a third party until he or she has paid off the bank's mortgage loan.

Repaying the mortgage simply involves the new owner sending money to the bank. Once the mortgage is fully paid off, the bank's fixed charge over the property will be canceled. All of the legal paperwork used is extremely standardized and every UK solicitor who handles property purchases is familiar with it.

Conversely, a residential Islamic mortgage involves both the bank and the new owner occupier purchasing the property jointly.



A lease is then required from the bank since the new owner will be a tenant of that part of the property which is owned by the bank.

The way that the Islamic mortgage is reduced is that the new owner buys additional fractional shares of the property from the bank over the life of the mortgage.

Even if there is no immediate conveyance of these additional fractions of the property from the bank to the owner, but only a memorandum record, at some stage (for example, once the new owner has acquired 100%) the bank will have to transfer ownership of its share of the property to the new owner.

The contracts used are less standardized, and relatively few UK solicitors are familiar with them. Furthermore, there are simply more legal paperwork involved in an Islamic mortgage which adds to the legal costs compared with the legal costs of a conventional mortgage.

Secondly, and more significantly, the stand-alone Islamic banks in the UK are very small compared to the very large UK conventional banks. Indeed, the Islamic banks are dwarfed by many of the second-tier conventional banks in the UK. Much of the costs of running

a bank (the need to have a compliance department, the need to have banking technology and backup arrangements) do not diminish proportionately as a bank becomes smaller in size. Consequently, such costs are a much greater burden for small banks than they are for large banks.

“ There are simply more legal paperwork involved in an Islamic mortgage which adds to the legal costs ”

All these costs must ultimately be borne by the customers who take out Islamic mortgages and are reflected in the higher prices Islamic banks charge for Islamic mortgages.

In countries where Islamic banks are of a comparable size to conventional banks, the second aforementioned factor should disappear. Greater prevalence of Islamic mortgages should also reduce the impact of the first factor, so the relative cost disadvantage of Islamic mortgages should diminish.

That raises the interesting question of whether Islamic mortgages can be cheaper than conventional mortgages. Insha' Allah, I will consider that in a future letter.☺

Shariah compliant student finance inches closer in the UK

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

Almost a year ago, my June 2016 column illustrated how long achieving change can take with the struggle to achieve a government-operated scheme of Shariah compliant student finance in the UK. I mentioned that discussions had been held with the government as far back as 2011. The efforts had culminated in the government some five years later (May 2016) publishing a White Paper stating: "We plan to legislate for the secretary of state to offer an alternative [Shariah compliant] student finance product alongside his current powers to offer grants and loans."

I cautioned readers: "However, given the need for legislation, the earliest I would expect students to be able to access such financing is September 2017." This caution was realistic, but I was not realistic enough!

The good news is that the government is following through with its promise to legislate. The Higher Education and Research Bill (the Bill) is currently before parliament. Clause 82 confers certain powers on the secretary of state for education.

When the clause is read by someone familiar with the statutory language used for Islamic finance in the UK, it is clear that this clause confers the long-promised power to implement a Shariah compliant student finance system.

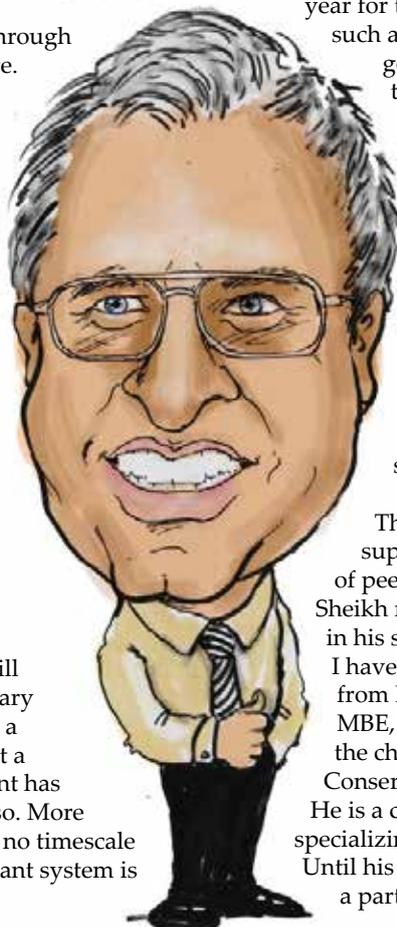
The bad news is that the Bill does not require the secretary of state to implement such a system. Of itself, that is not a problem, as the government has committed itself to doing so. More seriously, the Bill contains no timescale for when a Shariah compliant system is likely to be in place.



When the Bill was reviewed in the committee in the House of Lords, Lord Sharkey proposed an amendment to give a deadline of the 2018-19 academic year for the introduction of

such a scheme, which the government rejected. In the full House of Lords debate on the 13th March 2017 (which can be read on the Hansard website, <https://hansard.parliament.uk/>), Lord Sharkey instead proposed an amendment requiring quarterly progress reports from the secretary of state.

This amendment was supported by a number of peers. In particular, Lord Sheikh referred to the writer in his speech: "Additionally, I have received a letter from Mohammed Amin MBE, who is currently the chairman of the Conservative Muslim Forum. He is a chartered accountant specializing in Islamic finance. Until his retirement, he was a partner and head of UK



Islamic finance at PwC. He is firmly of the view that it is possible for Shariah compliant arrangements for students to be introduced by autumn 2018. I also forwarded a copy of this letter to my noble friend the minister."

Lord Sharkey's amendment was pressed to a vote, and only lost narrowly, by 227-225. This is a creditable result, given that it was opposed by the weight of the government.

“ When the clause is read by someone familiar with the statutory language used for Islamic finance in the UK, it is clear that this clause confers the long-promised power to implement a Shariah compliant student finance system ”

The final outcome is that the Bill will proceed forward, and once it has completed all of its parliamentary stages and received the royal assent, the secretary of state for education will have the power to implement a Shariah compliant student finance system.

While there is no deadline, and (due to the amendment being defeated) no requirement for regular progress reports, peers will still be able to ask the secretary of state about progress. I hope they do so regularly and have not given up on implementation by autumn 2018.☺

The UK consults again on Shariah compliant central bank deposit facilities

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

I have often commented on how long it requires to take steps forward in the development of Islamic finance in the UK. This arises from the need to find solutions which are appropriate to the complex legal, tax and regulatory environment of the UK while being Shariah compliant.

There has long been a need for UK-based Islamic banks to have access to high-quality, preferably risk-free, assets to manage their liquidity. While conventional banks have always been able to make deposits with the UK's central bank, the Bank of England, it is not currently possible for Islamic banks since such deposits would not be Shariah compliant.

Just over a year ago, the Bank of England consulted on possible mechanisms for offering Shariah compliant central bank deposit facilities. It received 32 consultation responses, including one from me which is available on my website.

The Bank of England outlined four possible models, while making it clear that its preferred model was a Wakalah fund model, with the fund being invested in Sukuk.

My response emphasized the need for greater clarity regarding how holdings of foreign currency-denominated Sukuk would be hedged into the pound sterling.

I also pointed out that non-sovereign Sukuk would still have default risk and therefore the proposed deposit facility would not be equivalent to a conventional deposit at the Bank of England since that is completely risk-free.



In this new consultation, the Bank of England has refined the Wakalah fund model, which is now the only model being consulted on. The Wakalah fund will be held by an SPV which will be wholly owned by the Bank of England. When the SPV holds foreign currency-

denominated Sukuk, it will enter into Shariah compliant hedging arrangements to eliminate the foreign exchange

risk. These hedges will be with the same external counterparties that the Bank of England already uses for currency hedging.

Furthermore, the Bank of England will give a free guarantee to the Islamic banks using the facility, covering the principal value of all Wakalah deposits with the SPV.

The Bank of England, as a matter of policy, offers no opinion on the Shariah compliance of the proposed facility. Instead, it will be for each Islamic bank using the Wakalah deposit facility to satisfy itself that the facility is Shariah compliant.

However, all interested parties, including

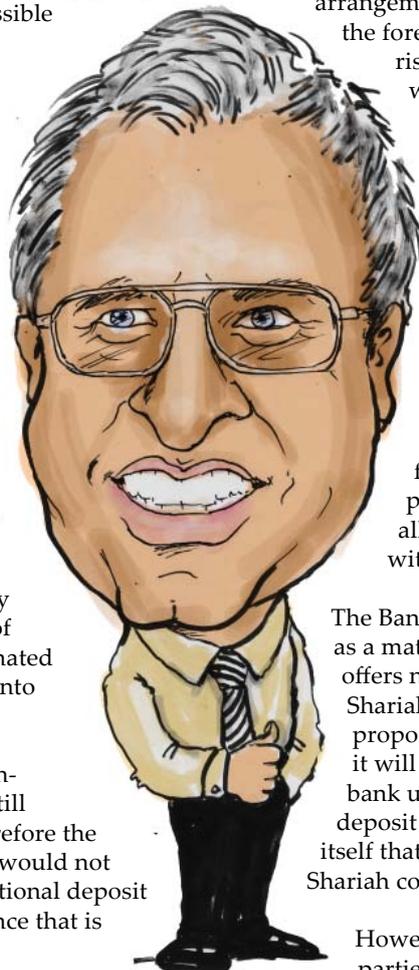
members of the Shariah supervisory boards of the UK Islamic banks, have had the opportunity to respond to the first consultation. They can also be expected to review this new consultation, and if necessary respond.

Accordingly, we can expect that in practice the Wakalah deposit facility that is finally offered should be regarded by Islamic banks operating in the UK as being Shariah compliant.

“ We can expect that in practice the Wakalah deposit facility that is finally offered should be regarded by Islamic banks operating in the UK as being Shariah compliant ”

The full consultation document is titled ‘Consultation Paper Shariah compliant liquidity facilities: Establishing a fund-based deposit facility April 2017’ is available from the Bank of England’s website and the deadline for consultation responses is the 23rd May 2017. I will not be responding to this iteration of the consultation as the revisions to the structure addressed the questions that I raised when responding to the first consultation. Furthermore, from my perspective, the proposed structure appears acceptable.

The UK is to be commended for the way that it continues to adapt its tax and regulatory environment with the goal of enabling Islamic finance to take place without suffering significant impediments or extra burdens compared to conventional finance.☺



Does Islamic finance have an innovation deficit?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I recently received a reader's enquiry via my website. In conventional finance, he saw the disruption from alternative companies and fintech outfits, with major conventional finance incumbents sometimes partnering with start-ups. He asked why this is not happening within Islamic finance.

The easy answer is to say that it is. Indeed, Islamic Finance news (IFN) now has a monthly newsletter, IFN Fintech, and the IFN website has many articles on current fintech developments in the Islamic finance industry.

However, the fact that the question was asked suggests that innovation might well be slower in Islamic finance than in the conventional finance industry. If that is indeed true, and I do not have hard data either way, three possible explanations suggest themselves immediately. These are the size of the industry, cultural factors and religious conservatism.

“ An almost inevitable consequence of requiring all legal developments to be based on prior sources is that it limits the scope for innovation ”

As many Islamic finance practitioners are all too well aware, the industry is tiny compared to conventional finance.

Every few years I compare worldwide aggregate Islamic finance assets to global conventional finance assets. The proportion has been rising over the years but remains tiny. For example,



S&P Global Ratings's 'Islamic Finance Outlook 2017 Edition' estimated global Islamic finance assets at US\$2.1 trillion at the end of 2016. Compare this to BNY Mellon Investment Management's 'The History and Future of Global Capital Markets June 2016' which estimated global cash (non-derivative) financial assets in May 2016 as being US\$195 trillion. This means Islamic finance assets are only 1.07% of total financial assets. This is the first time I have ever computed the ratio as being over 1%.

With the relative sizes of the markets, it would be no surprise to find most budding fintech entrepreneurs focusing on conventional finance rather than Islamic finance.

Culturally, Muslim-majority countries such as the Gulf states, Pakistan, Malaysia and Indonesia display much more respect for age and seniority than do locations such as Silicon Valley in California or the fintech hub in London. As a general point, respect for age, seniority and current practice is somewhat inconsistent with the pioneering of disruptive technologies aimed at overturning the current way of doing business.

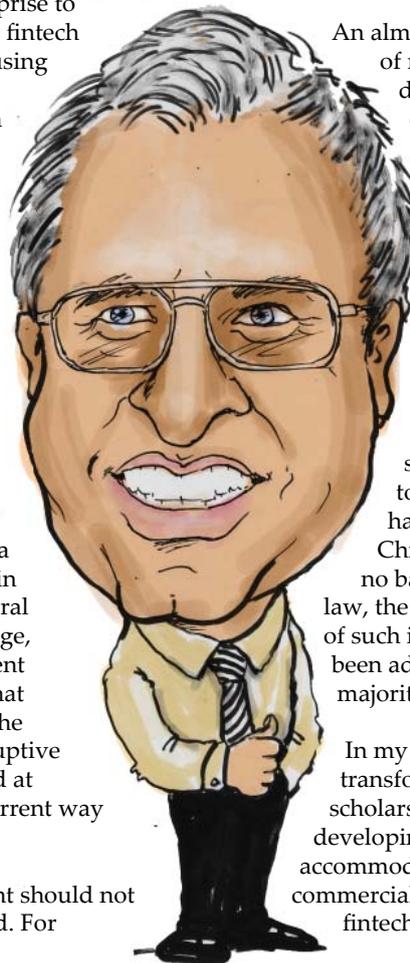
However, this point should not be overemphasized. For

example, Japan has long been a pioneer in electronics and robotics despite being a society that also puts great weight on age, seniority and deference to authority.

Finally, there is the question of religious conservatism. The rules of traditional Islamic law (Fiqh in Arabic) have always been derived by Islamic scholars from the original sources of the Quran and the Hadith, and from past judicial rulings, using the methodology explained by Mohammad Hashim Kamali in his magnum opus, 'Principles of Islamic Jurisprudence'.

An almost inevitable consequence of requiring all legal developments to be based on prior sources is that it limits the scope for innovation. As a specific illustration, although traditional Islamic law contains many rules about partnerships, it never developed the concept of a corporation which has a legal personality and a perpetual life independent of the identities of its shareholders from time to time. However, despite having been created in Christian Europe, and having no basis in traditional Islamic law, the concept of a corporation is of such immense utility that it has been adopted by every Muslim-majority country I am aware of.

In my opinion, fintech can only transform Islamic finance if Shariah scholars are sufficiently agile in developing traditional Islamic law to accommodate the disruptive commercial and legal innovations that fintech is likely to stimulate. ☺



To grow Islamic finance, we need to minimize contractual uncertainty

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

Reliable and efficient contract enforcement is essential for a successful economy. When you compare countries, those which have courts with independent, well-trained and non-corrupt judiciaries are on average much more successful economically than those countries which do not. That is why the World Bank in its annual 'Doing Business: Measuring Regulatory Quality and Efficiency' publication has a section on enforcing contracts, and gives a score for every country covered in the survey.

Obviously, anything which creates uncertainty regarding the enforceability of contracts is undesirable. Sadly, one of the factors which from time to time creates uncertainty in the enforceability of Islamic finance contracts is the assertion of non-compliance with Shariah.

The 2004 case of Beximco Pharmaceuticals and others v Shamil Bank of Bahrain EC illustrates the issues very well. The Bangladesh-based company Beximco had obtained finance of over US\$40 million from a bank in Bahrain using Murabahah contracts. However, when the time came for Beximco to pay, it asserted that the contracts used were not Shariah compliant and that accordingly it was not required to pay Shamil Bank.

Fortunately, the contracts were written under English law. The English courts had no difficulty concluding that Beximco should pay.

The case is famous because the precise words used in the clause which specified the applicable law

were: "Subject to the principles of the Glorious Shariah, this Agreement shall be governed by and construed in accordance with the laws of England."

The High Court and the Court of Appeal concluded that Shariah was not a separate system of law applicable to this contract and that the reference to Shariah should properly be ignored.

The key point is that without the words referring to Shariah, the matter would probably never have gone to court since Beximco would have had no case to argue in seeking to avoid payment.

Last month, Islamic Finance news reported that the Sharjah-based company Dana Gas was asserting that its Sukuk facility, governed by UAE law, was no longer Shariah compliant and therefore it did not have to pay the Sukukholders. Instead, it would restructure the Sukuk. (The proposed restructured terms are significantly worse for Sukuk investors than the original terms.)

This article, of course, cannot comment on the merits of the Dana Gas case.

However, I believe that Islamic finance practice should seek to maximize contractual certainty and seek to eliminate the risk of either party subsequently asserting Shariah non-compliance. The following would help:

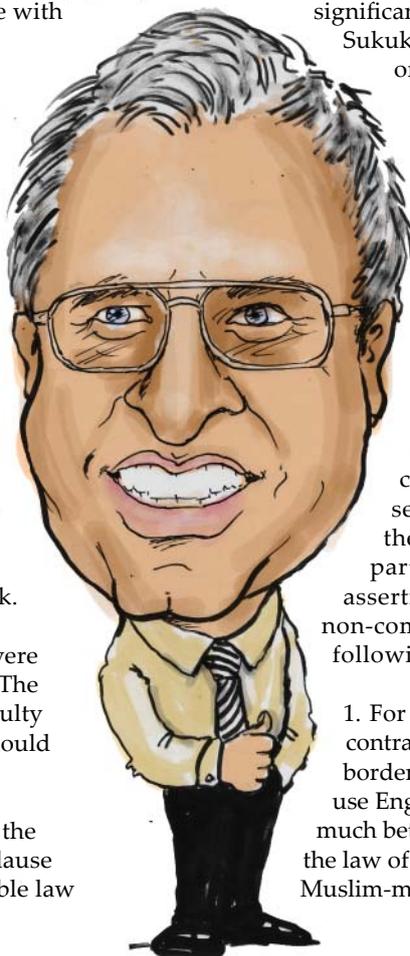
1. For international contracts, such as cross-border Sukuk, always use English law as this is much better developed than the law of most, if not all, Muslim-majority countries.

“ Islamic finance practice should seek to maximize contractual certainty and seek to eliminate the risk of either party subsequently asserting Shariah non-compliance ”

(Obviously, purely domestic transactions will normally be governed by the domestic law of the country concerned.)

2. To avoid Beximco-type arguments, the contractual documents should not refer to compliance with Shariah, except as indicated in the following.
3. Each party to the contract should affirm in the contract that it has taken appropriate Shariah advice, is satisfied that the contract is Shariah compliant and explicitly waive any future right to assert Shariah non-compliance.
4. To the extent that either party is concerned that the future conduct of the other party may cause the contract to become Shariah non-compliant, it should ask for explicit undertakings in the contract regarding the other party's conduct (eg "The other party will not sell alcohol"). However, these undertakings should be drafted in normal legal language, and should not mention Shariah.

If this can become standard practice, arguments in cases such as Beximco and Dana Gas should disappear. ☺



Transfer pricing and Islamic banks

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Academics researching Islamic finance often approach me with interesting questions. Most recently, an email came from a Muslim lawyer in the US looking at transfer pricing issues.

'Transfer pricing' sounds esoteric, and many wrongly associate it with abusive behavior by multinational corporations. In reality, all multinational corporations have to deal with transfer pricing.

If a multinational group consists entirely of companies that are 100% owned by the parent, directly or indirectly, then the ultimate shareholders, in principle, do not care which company makes the profits. Where goods or services are traded between wholly-owned group members, the shareholders are indifferent (subject to the point below) to the prices that one group member charges to another group member.

The differentiator is that profits made in different countries may suffer different amounts of corporate tax and withholding tax before those profits can be paid to the ultimate shareholders as dividends.

The tax authorities of each individual country understandably seek to maximize that country's tax revenues. Accordingly, they invariably argue that group companies based in that country should charge more when selling goods or services to group members located in other countries.

Conversely, the tax authorities of the countries whose group members are buying those goods or services will argue that the companies concerned are overpaying, and should have paid less.

The serious risk that the multinational group faces is that

the tax authorities of the selling/buying countries impose artificial prices for tax purposes which cause the underlying profits to be taxed twice, due to the tax authority-imposed selling price being higher than the tax authority-imposed buying price.

Fortunately, a growing number of countries have entered into tax treaties with dispute resolution mechanisms which ensure that the tax authority-imposed selling/buying prices have to be the same.

Obviously, to minimize disputes with tax authorities, multinational corporations always seek to start by using prices between group companies (transfer prices) which are as close as possible to those which would apply between arm's-length third parties.

The researcher asked me a series of questions relating to transfer pricing within multinational Islamic banking groups. The key point I made when responding was that, when attempting to calculate an arm's-length price, there was no fundamental difference between an Islamic finance transaction such as Murabahah and a conventional interest-bearing loan.

Both have the effect of transferring money from a group bank company in one country to a group bank company in another country.

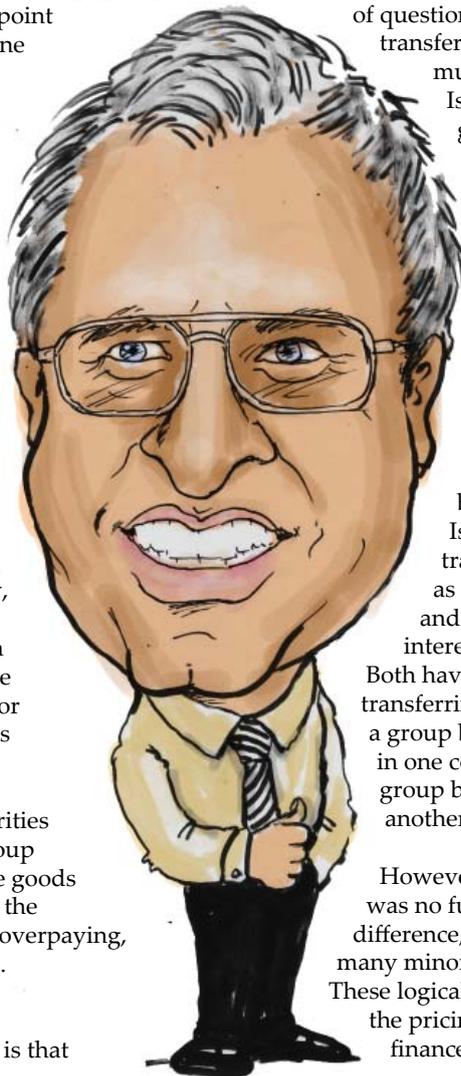
However, while there was no fundamental difference, there were many minor differences. These logically should cause the pricing of the Islamic finance transaction to

be different from that of a conventional transaction which might be used to assess arm's-length comparability.

For example, additional legal work is often required to create the Islamic finance transaction and the supplier of the funds needs to earn an extra return to compensate for these additional legal costs.

“ When attempting to calculate an arm's-length price, there was no fundamental difference between an Islamic finance transaction such as Murabahah and a conventional interest-bearing loan. Both have the effect of transferring money from a group bank company in one country to a group bank company in another country ”

Furthermore, as occasionally seen in litigation, there is a risk that recoverability of the money in the Islamic finance transaction may be made more difficult by subsequent claims that the transaction was not Shariah compliant. These risks also need to be compensated by an extra return compared to a conventional transaction.⁽³⁾



All Islamic banks should be allowed to do accounting using IFRS

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Last month, a journalist asked me a question I have often encountered before. Very briefly, she wanted to understand the relative merits of Islamic finance with regards to the accounting standards published by AAOIFI and the International Financial Reporting Standards (IFRS) published by the International Accounting Standards Board (IASB).

Looking at detailed accounting technicalities is not the way to address this question. Instead, we need to focus on two facts:

1. Almost everybody uses IFRS.
2. IFRS and AAOIFI standards have entirely different goals.

Leaving Islamic finance to one side, virtually the whole world does accounting under IFRS. The only significant exception, consistent with the general attitude of 'American exceptionalism', is the US with the US Generally Accepted Accounting Principles (US GAAP) published by the Financial Accounting Standards Board.

When it comes to Islamic finance, a few countries require Islamic financial institutions to use AAOIFI accounting standards, in particular, Bahrain (where AAOIFI is based) and nearby Qatar. However, the largest GCC country, Saudi Arabia, uses IFRS, as do Malaysia, Pakistan and the leading OECD country in Islamic finance, the UK.

The accounts of Bank Melli of Iran, (the country with the



largest Islamic finance sector since all Iranian banks are required to be Islamic) do not mention either IFRS or AAOIFI. Instead, Bank Melli uses local Iranian standards.

Similarly, the accounts of Islami Bank Bangladesh show that Bangladesh has its own local accounting standards, which I expect to be influenced by external standards from both AAOIFI and the IASB.

Overall, apart from a few countries which have particular loyalty to AAOIFI, most countries with a significant Islamic banking sector use IFRS.

Secondly, the most important point to appreciate is that IFRS and AAOIFI standards seek to achieve entirely different goals.

The IASB, a promulgator of IFRS, states in its Framework for the Preparation and Presentation of Financial Statements that: "The objective of financial statements is to provide information about the financial position, performance and changes in [the] financial position of an entity that is useful to a wide range of users in making economic decisions."

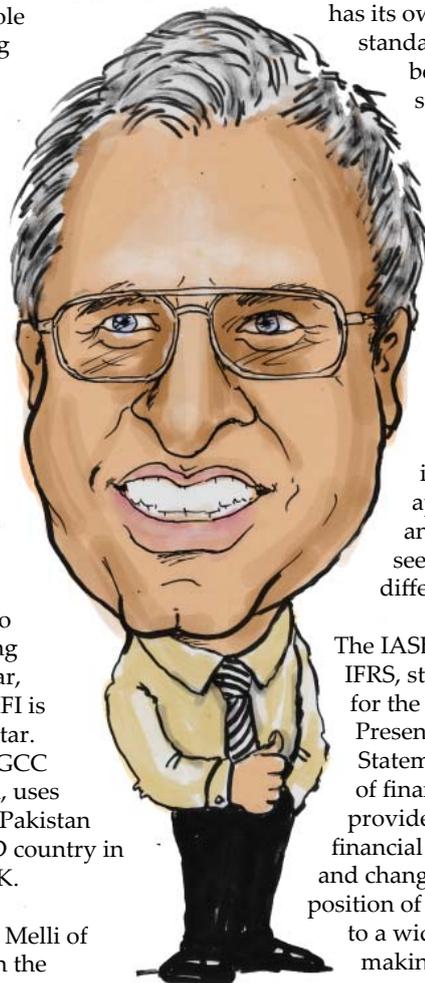
Conversely, AAOIFI states in its Objectives of Financial Accounting for Islamic Banks and Financial Institutions that: "Financial accounting in Islam should be focused on the fair reporting of the entity's financial position and results of its operations, in a manner that would reveal what is Halal (permissible) and Haram (forbidden)."

Focusing reporting on revealing what is Halal and what is Haram is of course quite different from focusing reporting on providing information that is useful to a wide range of users in making economic decisions. Accordingly, one would not expect accounts prepared under IFRS and under AAOIFI to be comparable. Indeed they are not.

“ One would not expect accounts prepared under IFRS and under AAOIFI to be comparable. Indeed they are not ”

In my view, regulators should prescribe the use of IFRS for all Islamic banks within their jurisdiction. This would result in Islamic banks' accounts conveying the maximum amount of information useful to shareholders, customers and other economic actors. It would also lead to maximum comparability of Islamic banks' accounts within and between countries. Any necessary additional information regarding Halal and Haram can be included in additional notes.

This would make AAOIFI's accounting standard-setting role redundant. In turn, that would save much standard-setting efforts that are presently largely wasted, given the low international usage of AAOIFI accounting standards.☺



How Islamic finance helps humanity

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I am often asked whether Islamic finance genuinely makes any difference to the world compared to conventional finance. I believe that it does, in two main ways.

Firstly, while many Muslims have no fundamental objection to using conventional finance (as demonstrated by the significant market share for conventional finance in countries where Muslims have a free choice between conventional finance and Islamic finance), some Muslims absolutely refuse to engage in conventional finance.

If the only bank accounts offered are conventional ones, those Muslims will keep their savings in cash or gold, rather than putting them into a bank or indeed purchasing other conventional financial investments such as interest-bearing bonds or quoted shares.

The consequence is that such savings are effectively 'sterile' and do nothing to contribute to the total level of investment in that economy. When you buy and store gold (or keep cash in a safe deposit box), nobody else can use that money to build a factory.

The provision of Islamic finance brings such savings into economic circulation. It means that the individual with the savings is able to earn an economic return which will vary with the level of risk that he or she takes on, for example by putting money into an Islamic bank or alternatively buying shares in a Shariah compliant equity investment fund.

Even more importantly, that individual's savings are no longer sterile. The Islamic bank will use the money the individual has put into it to make Shariah compliant advances to businesses. The effect is that the total level of investment in that economy will be greater than if the savings had remained sterile. The overall effect is to make that society richer.

The second way that Islamic finance helps humanity, or perhaps more accurately should help humanity, is by promoting attitudinal change. Conventional finance sees borrowing merely as a form of discretionary time-

shifting of income. "Borrow US\$1,000 to go on holiday now, and pay back US\$1,100 out of your future income, if you prefer to have the holiday now rather than in the future."

For religious and also practical reasons, I have always considered this attitude wrong. Instead, I believe that you should always aim to spend less than your income. Borrowing should only be undertaken to purchase major capital items (such as a house or a car) or for genuine revenue investment such as paying for a training course that will enhance your



future employability. Otherwise, you should not borrow.

Islamic finance should help to propagate and reinforce this attitude, since Islamic financiers regularly make the point that the advances they make should only be used for "investment in the real economy". The greater the proportion of finance in an economy that is Islamic, the lower should be the proportion of borrowing that is used for consumption expenditure.

Sadly, in this case, I am not convinced that action always matches the rhetoric when I see Islamic banks promoting financial services such as Shariah compliant credit cards.☹

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Shariah compliance does not differentiate Islamic banks from each other

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

A leading business school recently asked me for advice regarding marketing literature to sell an executive education program to Islamic financial institutions. While advising the school, I was reminded of a concept in business strategy that I first encountered about 25 years ago as a relatively new partner in PwC.

That concept is the distinction between 'foundation attributes' and 'leverage attributes'. A foundation attribute is something that you must have to 'play in the game'. For example, you cannot participate in the audit marketplace unless you are a qualified auditor. Foundation attributes, however, convey no competitive advantage. If every competitor in the audit marketplace is, by definition, a qualified auditor, then your being qualified does not distinguish you.

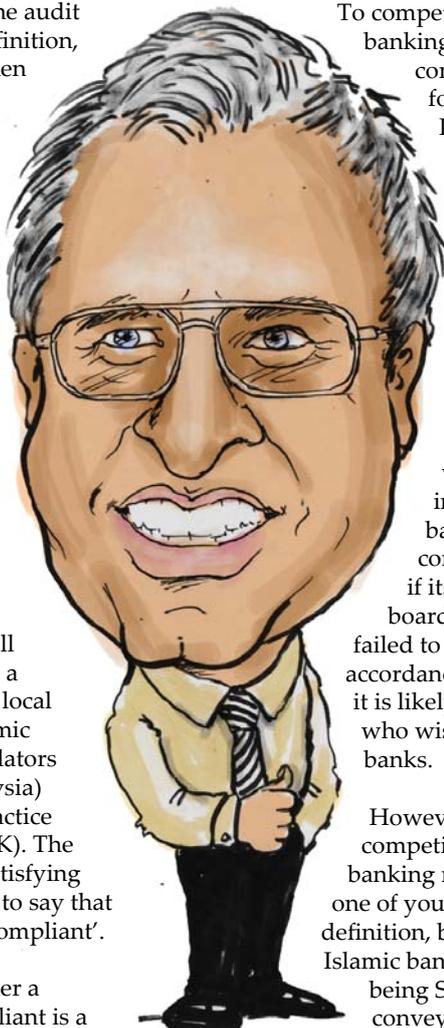
Conversely, leverage attributes are those which can give you a competitive advantage. For example, you may have developed proprietary auditing software which enables you to perform audits more quickly.

In the context of Islamic banking, to call itself an Islamic bank, a bank must satisfy the local requirements for Islamic banks set out by regulators (for example in Malaysia) or by local market practice (for example in the UK). The shorthand term for satisfying these requirements is to say that the bank is 'Shariah compliant'.

In my opinion, whether a bank is Shariah compliant is a

binary question. The answer is either yes or no. There are no degrees of Shariah compliance.

“ Whether a bank is Shariah compliant is a binary question. The answer is either yes or no. There are no degrees of Shariah compliance ”



To compete in the Islamic banking marketplace, Shariah compliance is then a foundation attribute.

If a bank fails to be Shariah compliant, its regulator may prohibit the bank from describing itself as an Islamic bank, and may even require the bank to close. Even if the banking regulator does not assess Shariah compliance, which is the situation in the UK, once a bank fails to be Shariah compliant (for example if its Shariah supervisory board rules that it has failed to conduct its affairs in accordance with Shariah), then it is likely to lose all customers who wish to use only Islamic banks.

However, if you are competing in the Islamic banking marketplace, every one of your competitors will, by definition, be a Shariah compliant Islamic bank. Accordingly, your being Shariah compliant conveys no competitive

advantage; it is merely a foundation attribute.

A very short survey in two mature Islamic banking markets (Malaysia and Qatar) conducted by visiting the homepages of some Islamic banks demonstrated that they understand this point. All the banks I looked at used their homepages to publicize specific banking products or their business results, with negligible mention of their Shariah compliance. Obviously, each bank, either by its name or otherwise, ensured that visitors to the website knew immediately that it was an Islamic bank. These banks all understand that Shariah compliance is only a foundation attribute.

Conversely, Al Rayan Bank is the only Islamic bank that I am aware of in the UK which targets ordinary retail customers. With the UK being a very immature retail Islamic finance market, Al Rayan's homepage gives very prominent coverage to its Shariah compliance and to educating visitors about the distinction between conventional banking and Islamic banking. That is because Al Rayan is not competing against other retail Islamic banks but rather seeking to create a retail Islamic finance market where none has existed before.

Next month, I envisage looking at leverage attributes for Islamic banks.☺

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International investors are right to be wary of local country legal systems

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

All commercial contracts carry the risk that your counterparty may be unable, or unwilling, to perform their obligations. Accordingly, every country needs a legal system which enables the enforcement of contractual claims. As I mentioned in my July 2017 column, the World Bank in its annual 'Doing Business: Measuring Regulatory Quality and Efficiency' survey has a section on enforcing contracts, and gives a score for every country covered in the survey.

One key concern with international investment is that local country law may favor the counterparty located in that country, either because the international investor may know less about local law, or because local law may be designed to favor nationals of that country, or because the country's courts choose to favor nationals.

Accordingly, international investors typically choose to have commercial contracts drawn up under the law of a reliable jurisdiction, avoiding local law wherever possible. The most commonly used is English law, even for commercial arrangements that have nothing to do with the UK, because English law is well-developed and English courts have a deserved reputation for legal competence and impartiality.

Sometimes local law cannot be excluded entirely, for example, transferring land located within a country normally requires a



local law instrument. In such cases, common legal practice is to split the legal documentation, with local law being used for those parts where it is mandatory, and the preferred foreign law being used for the rest of the legal documentation.

The case of Dana Gas v. Dana Gas Sukuk (DGSL) illustrates the issues very well. Very briefly, DGSL raised money from international investors by issuing Sukuk. The money so raised was invested by DGSL in a Mudarabah agreement with Dana Gas, written under UAE law.

DGSL and Dana Gas also entered into a purchase undertaking, written under English law.

The purchase undertaking required Dana Gas to make specified payments to DGSL in various circumstances (basically default) and upon those payments being made required DGSL to enter into a sale contract with Dana Gas to sell its interest in the Mudarabah back to Dana Gas, the consideration being the payments just made by Dana Gas.

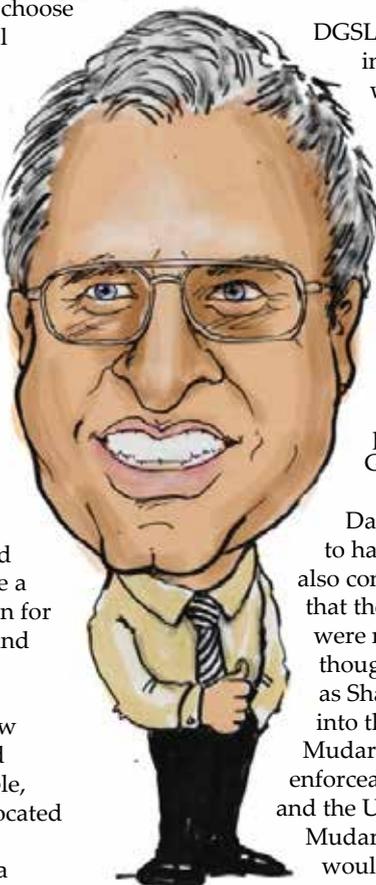
Dana Gas did default. It appears to have had financial problems, but also contended that it had legal advice that the commercial arrangements were not Shariah compliant, even though Dana Gas had accepted them as Shariah compliant when entering into them. Under UAE law, the UAE Mudarabah agreement would not be enforceable if not Shariah compliant, and the UAE sale contract to sell the Mudarabah assets back to Dana Gas would then also not be valid.

Under UAE law, DGSL and the Sukuk investors would have been sunk, having to litigate in the UAE courts about whether the commercial arrangements were or were not Shariah compliant. However, they were saved by the purchase undertaking being under English law.

On the 17th November 2017, the UK High Court decided the case. The citation is [2017] EWHC 2928 (Comm). The judge held that the enforceability of Dana Gas's obligation to pay DGSL under the purchase undertaking was unconditional, and not contingent upon the Shariah compliance of the UAE Mudarabah agreement, or the Shariah compliance of the subsequent UAE sale contract.

“ To grow Islamic finance, we need to minimize contractual uncertainty. That requires countries such as the UAE to improve their legal system to eliminate claims of Shariah noncompliance when they are essentially retrospective ”

To grow Islamic finance, we need to minimize contractual uncertainty. That requires countries such as the UAE to improve their legal system to eliminate claims of Shariah noncompliance when they are essentially retrospective. Meanwhile, well-advised international investors should continue to avoid local law wherever possible.☺



The 'Doomsday Fatwa' and the purpose of Islamic finance

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

At a Muslim conference recently, one of the sessions I attended was about Islamic finance. I found myself transported back in time by about a decade!

In 2007, Deutsche Bank (DB) published on its website something with the neutral sounding name of 'Deutsche Bank Academic Paper'. At the same time, on the 30th January 2007, DB issued a press release titled 'Deutsche Bank publishes white paper to increase supply of Shariah compliant alternative investments'.

When writing this column, I managed to find the press release on the DB website, with a link to the paper, but clicking through goes to a default DB website page, not to the paper. However, the paper can easily be found by doing a Google search for 'Deutsche Bank Academic Paper'. Today, nothing published on the internet ever disappears completely!

The paper is quite short, about 15 pages. It outlines a structure which I will summarize as follows:

1. An investor transfers money (say US\$1 million) to DB, and in exchange DB issues investment instruments to the investor, which I will call Sukuk.
2. DB invests the US\$1 million in Shariah compliant investments, such as Shariah compliant listed equity shares, which are fully segregated from DB's other assets.

3. The Sukuk carry full rights to the income and capital value of the Shariah compliant investments.

At this stage, all one has created is a pool of Shariah compliant shares, whose ownership is expressed through the Sukuk instruments.

4. DB pays US\$1 million to acquire an asset, called Reference Asset A.
5. The investor gives a unilateral promise (Waad in Arabic) to DB that if DB requests, the investor will sell the Sukuk which the investor owns to DB for a price equal to the formula price.
6. DB gives a unilateral promise to the investor that, if the investor requests, DB will buy the Sukuk which the investor owns, for a price equal to the formula price.

7. The formula price is equal to US\$1 million plus all of the income paid by Reference Asset A during the period of the structure's existence, plus any growth in the value of Reference Asset A, or less any reduction in the value of Reference Asset A, as appropriate.

The overall effect is that, using the language of conventional finance, the investor has entered into a total return swap with DB, whereby DB will earn the total return on the (initially US\$1 million) pool of Shariah compliant investments, while the investor will earn the total return on the (initially US\$1 million) Reference Asset A.

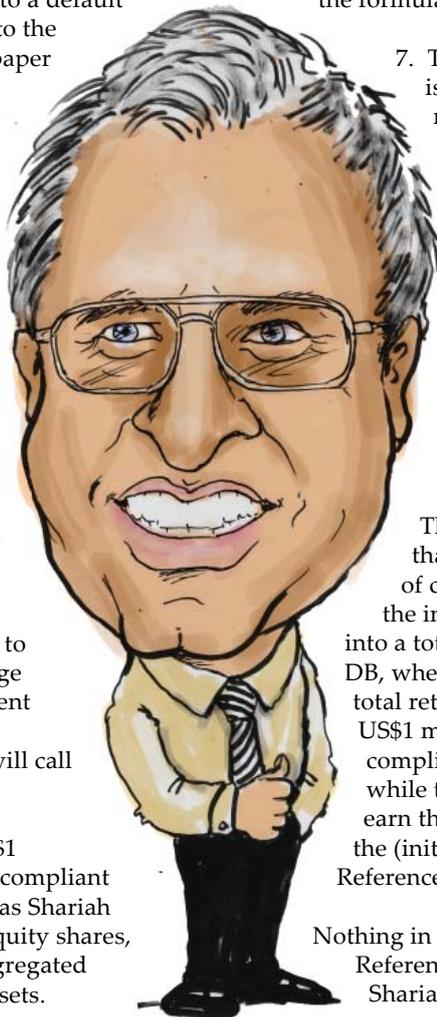
Nothing in the structure requires Reference Asset A to be Shariah compliant. Nor

does the investor ever own Reference Asset A.

Effectively, if a Muslim investor believes that, say, the shares of a particular brewery would be a good investment, but does not wish to own brewery shares for religious reasons, this structure allows the investor to achieve the economic results of investing US\$1 million in those brewery shares without ever owning any. That is why I have been dismissive of the structure since I first encountered it. If there is any purpose underlying the Shariah scholars' rules on what shares Muslims should invest in, how can a structure which sidesteps those rules be approved by Shariah scholars?

“ If there is any purpose underlying the Shariah scholars' rules on what shares Muslims should invest in, how can a structure which sidesteps those rules be approved by Shariah scholars? ”

I had, however, never previously encountered the name the conference speaker gave this paper. He called it 'The Doomsday Fatwa', presumably because it raises the purpose question so severely. Of course, the same purpose question is raised, albeit less severely, by most of the other structures in Islamic finance since they achieve the same economic outcomes as conventional finance but using Shariah compliant contracts. ☺



Islamic and conventional securitizations have essentially the same economics

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I was pleased that in February the UK's largest retail Islamic bank, Al Rayan Bank, issued a Sukuk facility which is the first from any UK Islamic bank.

The prospectus issued by Tolkien Funding Sukuk No 1 (the Sukuk-issuing SPV) is freely available on the internet. It makes interesting reading, at least if you are used to such turgid documents.

The 211 pages reinforce something I have said previously. Islamic banking is banking, and the business models of Islamic banks are essentially the same as those of conventional banks. The only difference is that Islamic banks conduct their business in accordance with guidelines set by Shariah scholars. In the case of this Sukuk, my point is demonstrated by asking two questions:

1. How does Al Rayan Bank benefit from issuing the Sukuk?
2. What do the investors get from buying the Sukuk?

“ Banks sell assets to securitization vehicles to remove them from the balance sheet, thereby improving their CET1 ratio ”

Al Rayan Bank used to be called the Islamic Bank of Britain (IBB). As the IBB, it made losses for many years because its capital base was relatively small, restricting its ability to provide finance to customers while the bank had

significant operating costs and received large amounts of customer deposits that it could not usefully invest, instead having to lend them for low returns in the interbank market.

After the IBB was taken over by Qatari bank Masraf Al Rayan in 2014 and renamed, it received a big capital injection. This allowed it to provide commercial property finance and residential finance in the form of home purchase plans which are diminishing Musharakah transactions.

Since then, the bank has been profitable. The most recently published accounts, for the year ended the 31st December 2016, showed that during 2016, commercial and residential property financing combined increased from GBP726 million (US\$1.02 billion) to GBP1.03 billion (US\$1.44 billion).

Consequently, the bank's common equity Tier 1 (CET1) ratio fell from 23.2% to 17.1%. Assuming that customer financings continued to grow during 2017 (the accounts have not been published yet), the CET1 ratio will have fallen further, which is undesirable.

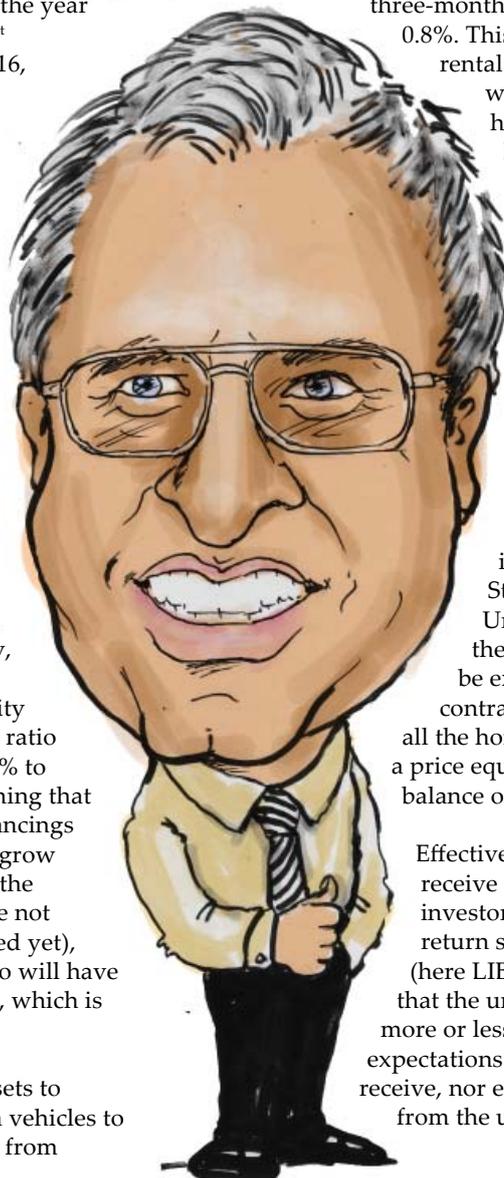
Banks sell assets to securitization vehicles to remove them from

the balance sheet, thereby improving their CET1 ratio. In this case, Al Rayan Bank sold home purchase plans on which customers owed GBP301 million (US\$421.73 million) to Tolkien for GBP245 million (US\$343.27 million) plus a promise to pay the GBP56 million (US\$78.46 million) balance in the future. That removed GBP245 million of home purchase plan risk from Al Rayan's balance sheet; the GBP56 million not paid reduces the riskiness of the Sukuk for investors, allowing the Sukuk to receive a high credit rating.

What investors receive from the Sukuk will be income payments computed as three-month Sterling LIBOR plus 0.8%. This will be paid from the rental payments that Tolkien will receive from the householders under the home purchase plans. If there is an income shortfall, neither Tolkien nor Al Rayan Bank are liable, but this is very unlikely given the levels of rent payable by the householders and the GBP56 million deferred consideration.

After three years, the income payments will increase to three-month Sterling LIBOR plus 1.6%. Unless Al Rayan Bank is then in difficulties, it can be expected to exercise its contractual right to buy back all the home purchase plans for a price equal to the outstanding balance on the Sukuk.

Effectively, Sukuk investors will receive what any securitization investor receives, namely a return specified in advance (here LIBOR plus 0.8%) provided that the underlying assets perform more or less in accordance with expectations. What they will not receive, nor expect, is any upside from the underlying assets. ☺



Harmonizing the taxation of conventional and Islamic finance requires careful detailed work

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Every country I know originally developed its taxation system when all finance was conventional. This applies even with Muslim-majority countries.

Although Islamic banks serve the same economic functions as conventional banks, they carry out transactions which are structurally quite different from those of conventional banks. Since the applicable tax systems were developed in a conventional finance environment, the consequence is that Islamic finance transactions are regularly taxed more heavily than equivalent conventional finance transactions.

“ The Islamic finance transaction involves the property being sold twice, once by the individual to the bank and then by the bank back to the individual. Countries that charge tax on transfers of real estate will typically do so for both sales ”

To illustrate this, consider what happens when an individual owns commercial property which has appreciated in value and wishes to borrow money using the property as collateral. Assume that the property originally cost US\$100,000, is now worth US\$1 million and that the

individual wishes to borrow US\$750,000 secured on the property.

The conventional finance transaction is straightforward. A conventional bank will lend the individual US\$750,000 secured by a legal charge on the property. The loan will have agreed terms for repayment of the capital and for payment of interest. From a taxation perspective, there has been no sale of the property since the individual continues to own it throughout. This applies even if the legal title is transferred to the bank as security for the loan; the individual continues to be the beneficial owner of the property and most (if not all) countries' tax systems will therefore ignore the transfer of the legal title.

As there has been no sale, in most countries there will be no real estate transfer tax either on the creation of the mortgage or on its repayment. Similarly, in most countries, as there is no sale of the property, there is no disposal of it so borrowing the loan does not cause any part of the inbuilt US\$900,000 capital gain to be taxed.

The equivalent Shariah compliant transaction is more complex. Typically, the individual and the bank will engage in a diminishing Musharakah transaction. The individual sells the property to the bank for, say, US\$750,000. The bank then rents the property back to the individual for an annual rent, which in

practice corresponds to market interest rates on US\$750,000.

Over the life of the diminishing Musharakah transaction, the individual buys back the property, normally for the same US\$750,000 price and normally in partial stages. As the individual increases his ownership share in the property, the proportion of the property on which he pays rent reduces correspondingly.

Accordingly, the Islamic finance transaction involves the property being sold twice, once by the individual to the bank and then by the bank back to the individual. Countries that charge tax on transfers of real estate will typically do so for both sales.

Furthermore, the individual has sold for US\$750,000 a property that cost him US\$100,000, so if the country taxes gains arising on the sale of property, the individual can expect to be taxed on the US\$650,000 gain.

In the UK, the aforementioned real estate transfer tax charges were eliminated by the UK's earliest changes to facilitate Islamic finance around 2003. However, the capital gains tax charge triggered by the sale remains in the case of sales to Islamic banks, although the equivalent gain on a sale to a Sukuk-issuing SPV is not taxed.

With the assistance of the author, the UK's Chartered Institute of Taxation has now written to the UK tax authorities proposing that the gain on the Islamic financing transaction as described should not be taxed provided appropriate conditions are complied with. ☺



Does having principles make you poorer or richer?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

This is actually a silly question. My principles are integral to my identity, because I am accountable to God for how I live my life. I did not choose my principles because I thought they would make me richer.

However, in the context of Islamic finance, it is an interesting question to ask. For example, several providers screen quoted stock market companies to identify those which are approved for Shariah compliant investors and the major index providers publish Shariah compliant versions of their indices. During the global financial crisis, many speakers at Islamic finance conferences delighted in pointing out that, on average, Shariah compliant shares had performed much better than those which were not.

The speakers were accurate, as demonstrated by the statistics for the period 2008-11 in Table 1. These show the performance of two US dollar-denominated indices published by the FTSE.

The FTSE Shariah All-World Index significantly outperformed its

conventional counterpart in 2008, the worst year of the global financial crisis. The reasons are obvious when you look at the composition of the two indices. In particular, see the relative representation of banks, insurance companies and financial services as shown in Table 2.

The global financial crisis devastated the share prices of most banks and insurance companies and harmed the financial services industry more widely.

Accordingly, it is no surprise that the FTSE Shariah All-World Index, in which these supersectors were almost unrepresented, outperformed its conventional counterpart.

However, once the world emerged from the crisis, the FTSE Shariah All-World Index has consistently underperformed its conventional counterpart. Part of this is no doubt due to the bouncing back of depressed share prices in the banking and insurance sector. However, in my view, there is also a more fundamental reason.

A conventional investor who is selecting shares from the complete universe of shares will, on average, outperform a Shariah compliant investor who selects shares only

from the Shariah compliant subset of the universe. If the Shariah compliant subset has characteristics that make them better than the average share in the universe, the conventional investor is always free to buy such high-quality Shariah compliant shares, since he selects from the whole universe. However, the Shariah compliant investor can never buy high-quality non-Shariah compliant shares.

“ A conventional investor who is selecting shares from the complete universe of shares will, on average, outperform a Shariah compliant investor who selects shares only from the Shariah compliant subset of the universe ”

This is simply a fact of life to be accepted. For example, I know that tobacco shares and casinos make good investments, but I refuse to buy them for moral reasons. ☹️

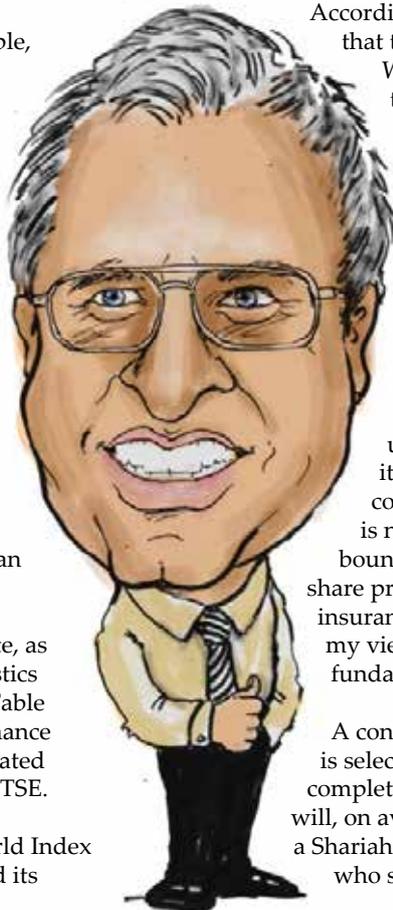


Table 1: Performance of FTSE Shariah All-World versus FTSE All-World for 2008-11

Index % increase (decrease)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
FTSE Shariah All-World	-38	36.2	13.1	-6	13.4	20.4	3.9	-4.2	8.5	24.1
FTSE All-World	-41.8	36.2	13.2	-7.3	17.1	23.3	4.8	-1.7	8.6	24.6
Shariah outperformance	3.8	0	-0.1	1.3	-3.7	-2.9	-0.9	-2.5	-0.1	-0.5

Source: FTSE

Table 2: Relative representation of banks, insurance companies and financial services of FTSE Shariah All-World and FTSE All-World

Industry Classification Benchmark: Supersector	FTSE Shariah All-World weight (%)	FTSE All-World weight (%)
Banks	0.04	10.55
Insurance	0	4.78
Financial services	0.07	4.35

Source: FTSE

The tax system gives, and the tax system takes away

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Tax law is, of course, country-specific. Nevertheless, an aspect of UK tax law that a reader recently asked me about brings out some points of general interest.

Diminishing Musharakah is an Islamic finance structure commonly used by banks to finance the purchase of real estate by their customers. Very briefly, the customer and the bank purchase a property together. The customer has occupancy rights over the entire property, and therefore must pay rent to the bank on the bank's share of the property. Over time, the customer will buy out the bank's share, normally at a predetermined price.

While the economics of the transaction will depend on the precise contractual terms, normally the contract is structured so that the rent payable to the bank is set by reference to market interest rates, rather than by reference to property rental yields. The

reason is that the bank typically wishes to avoid the economic risks associated with property ownership and uses the contractual terms to pass these risks to the customer. Consequently, the bank's return from the transaction will be purely a financing return, equivalent to a conventional property mortgage loan.

Countries vary in the extent to which their tax rules give priority to the economic aspects of a transaction or to the contractual legal form.

Historically, the UK has been at the legalistic end of the spectrum, which is the reason so much specific tax law has been required in the UK to enable Islamic finance transactions to take place without adverse tax costs.

Since 2006, the UK has had specific tax legislation for diminishing Musharakah transactions, which in UK tax law are referred to as 'diminishing shared ownership'.

Provided the requirements stipulated in the legislation are met, the rent paid by the customer to the bank is treated for all tax purposes as if it were interest on a loan equivalent to the bank's investment in the property.

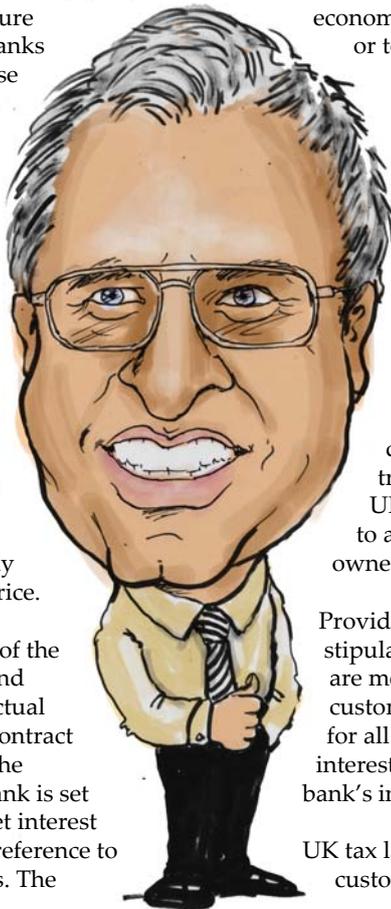
UK tax law is not saying that the customer's payment to the bank

is interest; that would be very hurtful to Muslims who have specifically structured a transaction that involves paying the rent, because they regarded the payment of interest as religiously impermissible. However, what the tax law is saying is that, for all tax purposes, the rental payment will be treated as if it were a payment of interest.

Treatment as interest for tax purposes is normally desirable. As an illustration, consider the situation when the bank is outside the UK. Rent on UK land paid to a foreigner is subject to withholding tax. However, due to double tax treaties, interest paid by a UK person to overseas banks is in most cases not subject to withholding tax.

However, the UK recently introduced restrictions on the ability of individuals to deduct interest expense on real estate rented to individual tenants who live there, colloquially called 'buy to let' property. My reader was hopeful that where diminishing Musharakah has been used to acquire the buy to let property, his interest expense would continue to be deductible on the grounds that his payment to the bank was not actually interest but rent.

While I do not give tax advice to readers, I shared with him my expectation that the buy to let rules would restrict a deduction for his rent paid to the bank since UK tax law specifies that for all tax purposes, the rental payment is treated as a payment of interest. Sometimes you win, and sometimes you lose! ☹️



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Do Shariah compliant share indices really perform worse?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

In my 6th June 2018 column title “Does having principles make you poorer or richer?”, I looked at the performance of the FTSE All-World Index and the FTSE Shariah All-World Index from 2008 to 2017. For convenience, the figures are reproduced in Table 1.

A reader disagreed with me, saying that with a longer timescale, Shariah compliant shares outperformed conventional shares. He cited the MSCI indices which stated that from the 31st May 2002 to the 29th June 2018, the MSCI World Islamic Index returned an annualized 7.59% whereas the MSCI World Index returned only 7.56%. Readers can decide if the 0.03% per annum difference is significant.

I want to look at the year-by-year results. The MSCI datasheet does not give these from 2002, but has the following annual figures. (The Shariah advantage is my subtraction.)

FTSE and MSCI of course use slightly different methodologies. Hence, it is no surprise that they report slightly different but generally consistent numbers. For example, the conventional FTSE index for 2017 shows +24.6% while the conventional MSCI for 2017 shows +23.07%.

What is more important is the consistency of the two sets of indices. The Shariah compliant index generally underperforms its conventional analogue before the global financial crisis years of 2007 and 2008, outperforms during the global financial crisis (due to the absence of banks and insurance companies as I mentioned in my previous column), and then underperforms again afterwards.

Like me, you may want to compute the average annual



results. If so, remember that you cannot take the arithmetical average of the annual results. If your investment returns +50% in Year 1 and -50% in Year 2, your average annual return is not 0%. Your US\$100 initial capital has grown to US\$150, and then shrunk to US\$75, making your average annual return -13.4% since $US\$100 \times (1-0.134)^2 = US\75 .

Similarly, if r_i is the return in year i , whether positive or negative, and there are n years, your average rate of return is found by multiplying $(1+r_1)(1+r_2)\dots(1+r_n)$ and then computing the n 'th root, and then subtracting 1.

Doing that to the foregoing figures gives the average annual returns in Table 3.

Table 1: Performance of FTSE All-World Index and FTSE Shariah All-World Index from 2008 to 2017

Index % increase (decrease)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
FTSE Shariah All-World	-38	36.2	13.1	-6	13.4	20.4	3.9	-4.2	8.5	24.1
FTSE All-World	-41.8	36.2	13.2	-7.3	17.1	23.3	4.8	-1.7	8.6	24.6
Shariah outperformance	3.8	0	-0.1	1.3	-3.7	-2.9	-0.9	-2.5	-0.1	-0.5

Source: Author's own from FTSE data

Table 2: Performance of MSCI World Islamic and MSCI World from 2004 to 2017

Index % increase (decrease)	MSCI World Islamic	MSCI World	Shariah advantage
2004	13.02	15.25	-2.23
2005	10.39	10.02	0.37
2006	19.54	20.65	-1.11
2007	17.67	9.57	8.1
2008	-34.71	-40.33	5.62
2009	30.81	30.79	0.02
2010	13.79	12.34	1.45
2011	-3.12	-5.02	1.9
2012	11.4	16.54	-5.14
2013	23.16	27.37	-4.21
2014	3.77	5.5	-1.73
2015	-4.11	-0.32	-3.79
2016	8.33	8.15	0.18
2017	20.15	23.07	-2.92

Source: MSCI with author's calculation for Shariah advantage

Table 3: Average annual returns of FTSE and MSCI for conventional and Shariah (%)

% Average annual returns	FTSE	MSCI
Conventional	5.29	7.9
Shariah	5.09	8
Shariah outperformance	-0.2	+0.1

Source: Author's own from FTSE and MSCI data

The difference between the two groups of indices arises from the MSCI figures including both years of the global financial crisis, 2007 and 2008, (which boosts the relative performance of the Shariah compliant index) while the FTSE figures only include 2008.

More importantly, nothing about the numbers affects my fundamental point. We should expect the conventional investor to do better, since he can select from the entire universe of investments, some of which are prohibited to the Shariah compliant investor. ☹️

Islamic finance requires accurate vocabulary

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

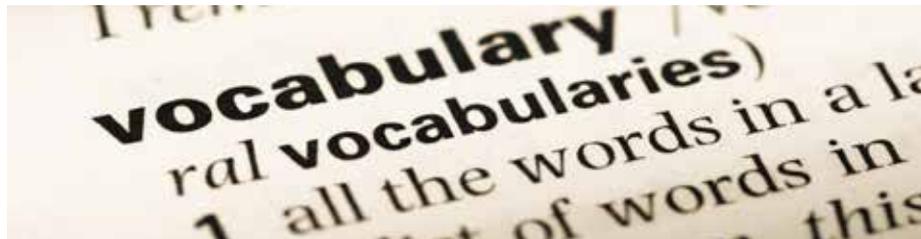
Many people encountering real-world Islamic finance for the first time experience disillusionment. For example, they hear Islamic finance evangelists wax lyrical about its profit-sharing basis, but are then dismayed to find that the overwhelming majority of Islamic banking uses fixed return contracts such as Murabahah and Ijarah.

One of my particular concerns is the language often used to name the payment made to a Takaful fund by a customer who is seeking protection against a risk.

With conventional insurance, I pay an insurance premium to an insurance company. In return, the insurance company promises to pay me specified amounts of money if my house experiences fire damage in the next 12 months. Shariah scholars consider conventional insurance prohibited for two reasons:

1. The insurance company holds the premiums received, and invests them until claims need to be paid, typically buying impermissible investments such as interest-bearing bonds.
2. They regard my contract with the insurance company as containing a prohibited level of uncertainty (Gharar in Arabic). If my house burns down in the next year, I receive far more from the insurance company than I paid in my insurance premium. If my house does not burn down during the year, I receive nothing from the insurance company.

Conversely, Shariah scholars approve of Takaful for risk



protection. Obviously, Takaful companies do not buy prohibited investments such as interest-bearing bonds. More importantly, the equivalent uncertainty in a Takaful contract (I receive a large amount from the Takaful company if my house burns down) is permissible because underwriting surpluses arising in the Takaful fund belong to the Takaful participants, and collectively in the long run they bear any underwriting deficits. Shariah scholars refer to this as the principle of Tabarru' in Arabic.

When writing in English, Shariah scholars often translate Tabarru' as a donation or gift. That is the point at which their vocabulary becomes inaccurate, and indeed in my view, grossly misleading.

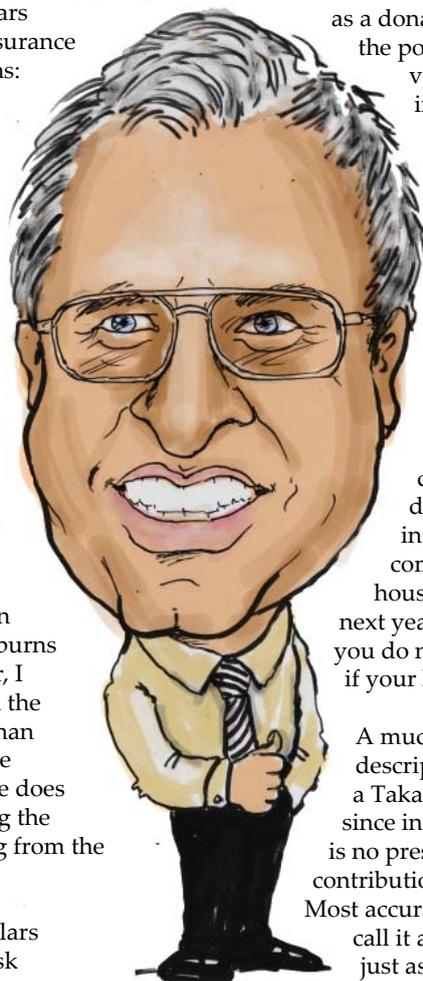
In English, a donation is something given freely and with no requirements for any reciprocation. A payment into a Takaful fund can never be accurately described as a donation. If you pay into the fund, you get compensated if your house burns down in the next year. If you do not pay, you do not get compensated if your house burns down.

A much less misleading description is to call it a Takaful contribution, since in English there is no presumption that contributions are gratuitous. Most accurate of all would be to call it a Takaful premium, just as premiums paid

to insurance companies are called such irrespective of whether the insurance company is a proprietary company or a mutual company, which is the conventional analogue of Takaful (apart from the fact that conventional mutual insurance companies still invest in interest-bearing bonds and other impermissible investments).

“ When writing in English, Shariah scholars often translate Tabarru' as a donation or gift. That is the point at which their vocabulary becomes inaccurate, and indeed in my view, grossly misleading ”

Calling the payment a Takaful premium would make it as clear as possible that the economic function of a Takaful company is the same as the economic function of an insurance company, namely to enable people who cannot afford to bear the uncertainty of a large, potentially catastrophic, risk (such as the house burning down) to remove that risk from themselves by paying a much smaller amount of money each year and in return receiving compensation if the unwanted event (the house burning down) materializes. ☺



What makes a bank ethical?

Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

In September, I enjoyed attending the London Islamic Finance Forum organized by Islamic Finance news. It provided a good update on current developments in the industry, as well as being a venue for meeting old friends!

The presentation I found most interesting was 'What is Value-Based Intermediation and how does it fit with Islamic Banking and Finance?' given by David Korslund, a senior economist at Global Alliance for Banking on Values (GABV). Subsequently, I spent some time learning more about GABV from its website, as I had not come across the organization before.

GABV describes itself as a global network of "banks, banking cooperatives and credit unions, microfinance institutions and community development banks".

Its mission is "to use finance to deliver sustainable economic, social and environmental development, with a focus on helping individuals fulfill their potential and build stronger communities".

The organization was founded in 2009 (which was of course during the depths of the global financial crisis which followed the bankruptcy of Lehman Brothers in September 2008) and now has 54 member institutions whose total assets are reported as being approximately US\$163 billion.

What struck me was the relatively small number of members and the tiny size of the total assets of the members. Given the size of the banking industry worldwide, it is clear that even banks well below the size of the international giants have not been interested in joining. For example, the only UK member



reported is Ecology Building Society which had total assets reported in its most recent accounts of only GBP178 million (US\$234.43 million).

GABV should be a natural organization for Islamic banks to join. Indeed, the only Malaysian member is an Islamic bank, Bank Muamalat Malaysia. However, where are the other Malaysian Islamic banks? Similarly, the GABV website reports only one member in the whole of the Middle East and North Africa, namely the Bank of Palestine, which appears to be a conventional bank. None of the UK Islamic banks are members either.

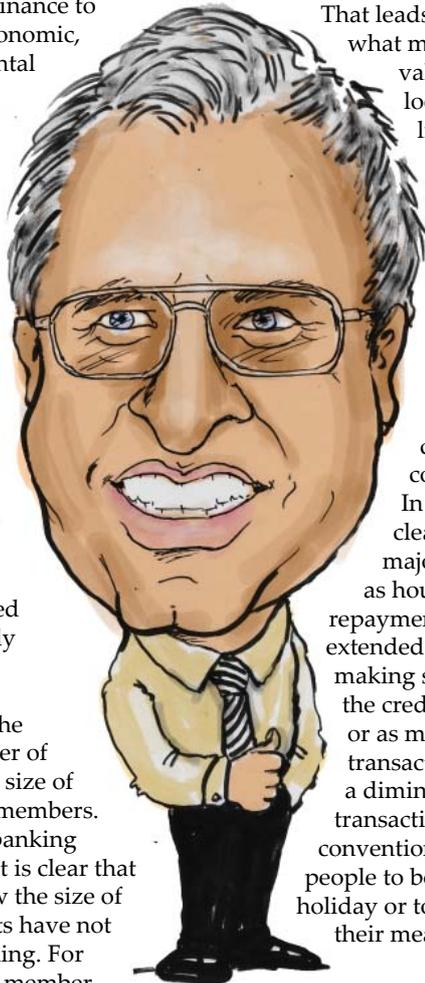
That leads to the wider question: what makes a bank ethical or values-based? When you look at the marketing literature of Islamic banks, most of them appear to operate on the presumption that because they are Islamic, and therefore do not charge interest, they are automatically ethical.

People will of course differ on what constitutes being ethical. In my view, individuals clearly need finance for major purchases such as houses and cars, with repayment being over an extended period and the financier making some kind of charge for the credit, whether as interest, or as mark-up on a Murabahah transaction, or as rent on a diminishing Musharaka transaction. Conversely, I detest conventional banks encouraging people to borrow money to go on holiday or to otherwise live beyond their means.

I carried out a little test by looking at the websites of one Islamic bank in the GCC and one in Malaysia, focusing on their personal finance offerings. Quite properly, both offered finance for the purchase of houses and cars.

“ When you look at the marketing literature of Islamic banks, most of them appear to operate on the presumption that because they are Islamic, and therefore do not charge interest, they are automatically ethical ”

However, both also offered credit cards. While the way that an Islamic credit card charges the customer for credit differs from the mechanism of a conventional credit card, there is no meaningful difference in the economics. In both cases, unless the full balance is cleared monthly (relatively uncommon), the credit card is a tool for individuals to live beyond their means to their detriment, and for the bank to profit from the customer's desire to spend more than he or she earns. Are such Islamic banks any more ethical than conventional banks? ☹



Why is the taxation of Islamic finance still unequal?

Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Because tax is country-specific, the article's heading is wrong to generalize. However, in the UK and many other countries, even when Islamic banks and Takaful companies can operate, Islamic finance is treated less favorably than conventional finance.

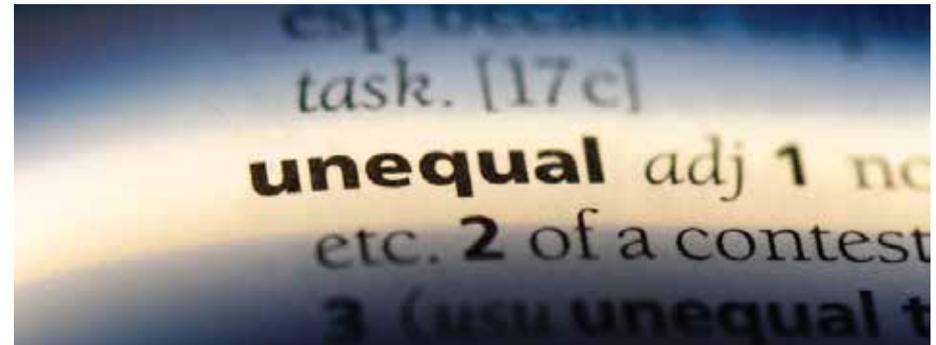
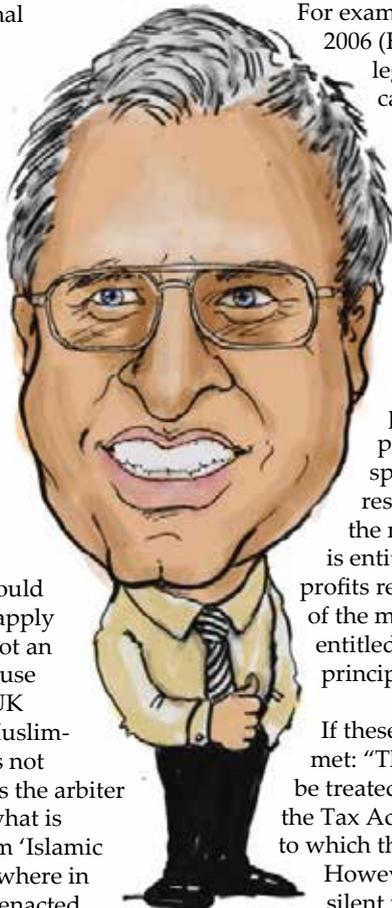
For example, the UK has legislated a tax regime for Murabahah transactions (called purchase and resale), but it only applies where at least one of the parties is a financial institution as defined.

Accordingly, if two individuals, or two non-financial-institution companies enter into a Murabahah transaction, none of the laws enacted to facilitate Islamic finance applies. Instead, the party being financed is likely to be unable to claim tax relief for its finance cost.

Why have such issues not been resolved, almost two decades after the UK first started looking seriously at the additional tax burdens faced by Islamic finance compared to conventional finance?

The answer is that it is very difficult to change a tax system which developed over almost 200 years in an environment where all finance was conventional. Every change requires immensely painstaking legal analysis, and every change risks inadvertently creating opportunities for tax avoidance.

At its simplest, what should any revised tax regime apply to? 'Islamic finance' is not an acceptable answer, because the government of the UK (or of most other non-Muslim-majority countries) does not want to hold itself out as the arbiter of what is Islamic and what is not. That is why the term 'Islamic finance' is not used anywhere in the UK's tax legislation enacted



to enable Islamic banking, even though the words 'Islamic finance' are used in explanatory materials.

Instead, the law uses purely secular language to define certain transactions, such as 'purchase and resale', which replicate transactions used in Islamic finance such as Murabahah. The law then specifies the tax treatment of the parties to a purchase and resale transaction.

Unfortunately, tax law is so complex that mistakes are easy to make, even when experts do the drafting.

For example, in the Finance Act 2006 (FA 2006), the parliament legislated for something called 'profit share agency' which was intended to replicate Wakalah. The key part of the definition is that a person ('the principal') appoints a financial institution as his/her agent; the agent uses money provided by the principal with a view to producing a profit; the principal is entitled, to a specified extent, to profits resulting from the use of the money; and the agent is entitled to any additional profits resulting from the use of the money (and may also be entitled to a fee to be paid by the principal).

If these requirements are met: "The principal shall not be treated for the purposes of the Tax Acts as entitled to profits to which the agent is entitled."

However, the FA 2006 was silent regarding whether the

agent was taxable on the profits which the agent was entitled to retain. UK tax law is incredibly prescriptive, and it was perfectly arguable that, in the absence of clear legislation, the agent was not taxable on anything.

“ The overall message from the UK's experience of legislating is that specific incremental tax law changes are possible, when clearly needed for the development of Islamic finance ”

The parliament took this concern sufficiently seriously that in the following year, the FA 2007 had to fix the legislation by stipulating "and the agent is treated as entitled to the profits specified".

The overall message from the UK's experience of legislating is that specific incremental tax law changes are possible, when clearly needed for the development of Islamic finance. However, we are unlikely to see complete equality between the taxation of Islamic and conventional for many decades, if at all. ☹

Is there scope for private sector Shariah compliant student finance in the UK?

Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

A reader recently asked about progress on the UK implementing the promised Shariah compliant student finance scheme I have previously written about. After discussing the long implementation delay, our correspondence moved on to wider issues.

Some students had said to the reader that they could not see the difference between the UK's proposed Shariah compliant student finance scheme and the UK's conventional student finance scheme. I reminded my reader that it was essential for the UK government that any Shariah compliant student finance scheme should have identical economic characteristics to the conventional scheme. The Shariah compliant student and the conventional student should make identical payments on identical dates if their other circumstances were the same.

The conventional student finance scheme involves a loan which is uplifted for interest and inflation, with the student, after he leaves university, repaying at the rate of 9% of his income over GBP25,000 (US\$31,868.6) a year, with the loan being waived after 30 years if not previously repaid.

The Shariah compliant scheme is based upon a Takaful model, where the student makes the same payments as with the conventional scheme. The repayments being identical was not an accident; it was a fundamental design requirement for any UK Shariah compliant government student finance scheme. Shariah scholars have signed off upon the proposed Takaful-



based scheme as Shariah compliant, and ultimately Muslim students will need to decide for themselves whether they regard the scheme, when eventually implemented, as being religiously acceptable.

My reader went on to ask why private sector Islamic financial institutions do not themselves offer an alternative student finance scheme. In particular, they would not need to replicate the economics of

the conventional student finance scheme. Instead, the financier could, for example, pay for a student's university education in exchange for, say, 5% of the student's future earnings. Such a scheme would get away from any implications of interest being charged on loans as the financier would have a simple equity interest in the student's future earnings.

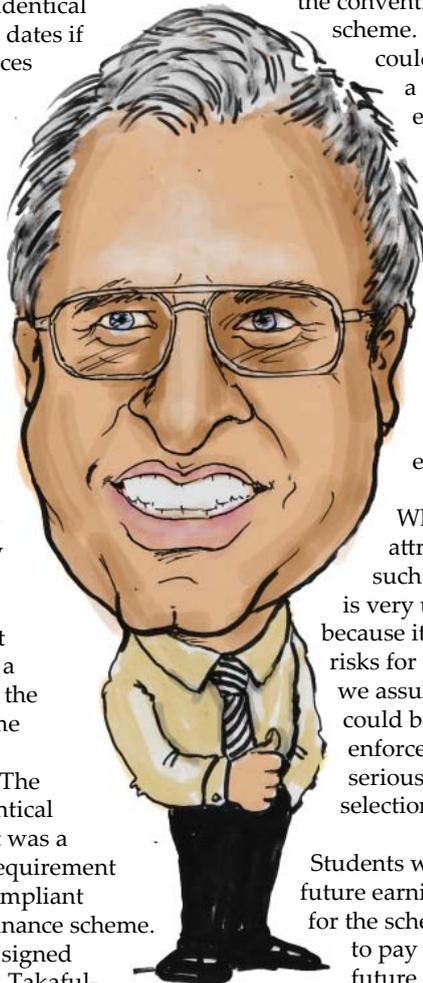
While apparently attractive, I considered that such a proposed scheme is very unlikely to happen because it creates unacceptable risks for the financier. Even if we assume that the contract could be made legally enforceable, there is a very serious likelihood of 'adverse selection'.

Students who expected low future earnings would sign up for the scheme, undertaking to pay a percentage of all future earnings in exchange

for the student finance. However, students who expected high future earnings, for example future Islamic investment bankers, would never sign up to a contract where they had to pay a percentage of their future earnings without any upper limit. Instead, they would sign up for the conventional (or Shariah compliant when available) UK government student finance scheme since under that, once their liability is cleared, all payments cease.

“ Solutions that are apparently 'more Islamic' than real-world Islamic banking are in most cases not implementable due to those risks and constraints ”

Our discussion illustrates a point that often comes up. Islamic finance as practiced by real Islamic financial institutions normally mirrors conventional finance for very good reasons. Both systems seek to address the same real-world financial needs, and face the same real-world risks and constraints. Conversely, solutions that are apparently 'more Islamic' than real-world Islamic banking are in most cases not implementable due to those risks and constraints. ☺



Making money in UK Islamic banking is tough

Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

This month, I have done something anyone could do for themselves. The Bank of London and the Middle East (BLME) is the largest dedicated Islamic bank in the UK. I downloaded BLME's annual reports and summarized them.

Their results are horrible. BLME did make profits in seven out of the 11 years, but the best result, a profit of GBP4.3 million in 2013, was only 1.8% of shareholders' funds. Banks typically aspire to have a return on equity exceeding 10%. In the other four years, the bank made large losses. Since starting, BLME has lost its shareholders a cumulative GBP31.6 million (US\$40.2 million).

There are many reasons why BLME has found life so difficult.

Firstly, the decade since the global financial crisis has been hard for most banks. Regulators have imposed many additional risk management costs upon banks such as increased anti-money-laundering compliance among others.

These additional costs come on top of the unavoidable operating costs of any bank such as having an internal audit department, financial accounting systems, a board of directors, etc.

All costs of this kind bear much more heavily on a small bank such as BLME than they do on much larger conventional banks. For example, at the end of 2017 Barclays had shareholders' funds of GBP66 billion (US\$83.95 billion), making it 300 times larger than BLME.

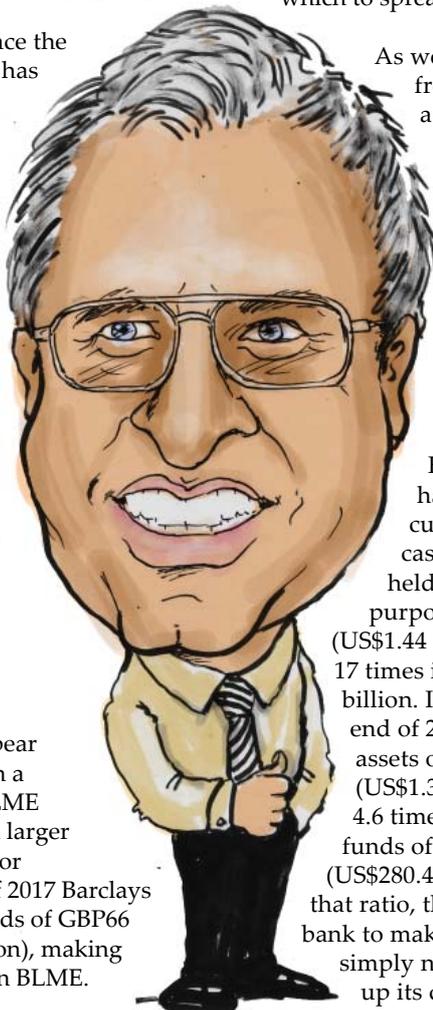


Table 1: History of calendar year results of BLME

Year	Profit/(loss) after tax (GBP million)	Shareholders funds (GBP million)	Return on equity %
2007	0.2	179.4	0.1
2008	2.4	252.4	1
2009	(13.2)	243.5	(5.4)
2010	3.5	247	1.4
2011	(8.9)	238.6	(3.7)
2012	3.8	239.6	1.6
2013	4.3	242.8	1.8
2014	1	243.8	0.4
2015	(6.8)	237.8	(2.9)
2016	(21.4)	217.1	(9.9)
2017	3.5	220.5	1.6
Cumulative	(31.6)		

Source: BLME (summary by author)

Barclays has a much larger base over which to spread its overhead costs.

financing activities sufficiently to earn a reasonable rate of return on its equity.

As well as the inefficiencies from being small, being a new player in the market is always hard. Banks make money by using their own capital plus money from customers (deposits) to finance other customers. Most of the finance is provided using customers' money.

For example, Barclays had assets (mainly customer financings plus cash and investments held for prudential purposes) of GBP1.13 trillion (US\$1.44 trillion), which is 17 times its capital of GBP66 billion. In comparison, at the end of 2017, BLME's total assets of GBP1.03 billion (US\$1.31 billion) were only 4.6 times its shareholders' funds of GBP220.5 million (US\$280.49 million). The lower that ratio, the harder it is for a bank to make money. BLME has simply not managed to scale up its deposit-taking and

“ Banks make money by using their own capital plus money from customers (deposits) to finance other customers. Most of the finance is provided using customers' money ”

Finally, there is another problem from being a new bank. It is harder to find reputable customers to finance at an acceptable rate of profit return. BLME has clearly suffered from this problem. The accounts show that in the years when there were big losses, they arose from impairments. That is accounting terminology for the losses you suffer from providing finance to businesses which are no longer likely to pay you back. ☹

The UK's first Islamic bank — a financial history

Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Islamic Bank of Britain (now called Al Rayan Bank) was set up in mid-2004. It was the UK's first Islamic bank, and until recently its only retail Islamic bank.

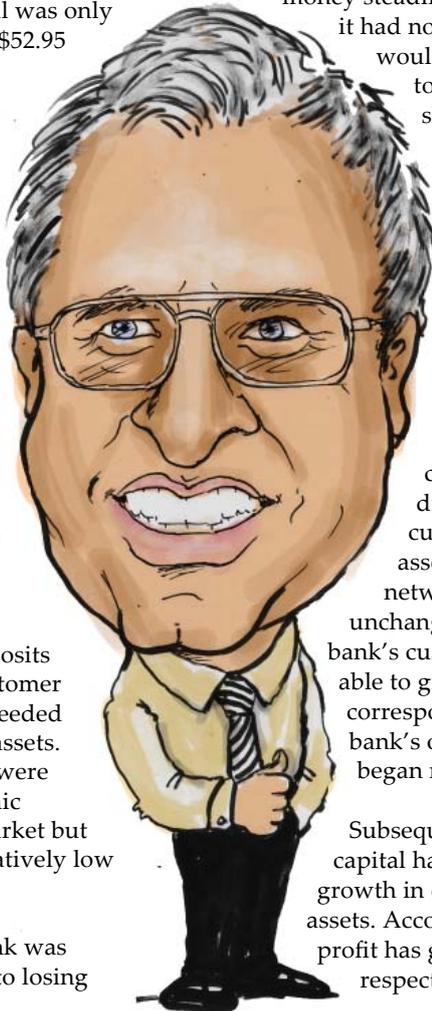
As with Bank of London and The Middle East last month, I have downloaded the accounts and summarized them in the table. Until 2014, the results were steadily horrible. Then they changed. Like football, this bank's history is a game of two halves!

From inception, the bank steadily lost money, relying upon additional injections of shareholders' funds to avoid having to shut down. Why were the results so awful?

Very simply, the bank was too small. Its 2005 capital was only GBP40.5 million (US\$52.95 million). Its strategy involved physical branches, which entailed relatively high fixed costs. Those could only be justified if the branches facilitated a large volume of income earning customer financings.

Unfortunately, the bank's small capital severely constrained the amount of customer financing it was permitted to do. The table shows that deposits from customers (customer liabilities) vastly exceeded customer financing assets. The excess deposits were invested in the Islamic interbank money market but will have earned relatively low rates of return.

Accordingly, the bank was effectively locked into losing



money steadily year after year. If it had not been taken over, it would eventually have had to shut down once its shareholders became tired of putting in additional share capital to cover its operating losses.

Post takeover, it is a different story. 2014 shows a very large increase in shareholders' funds. This additional share capital allowed a dramatic increase in customer financing assets while the branch network was essentially unchanged. Accordingly, the bank's customer financings were able to grow, but without any corresponding increase in the bank's operating costs. Hence it began making a profit.

Subsequently, the additional capital has allowed continued growth in customer financing assets. Accordingly, the annual profit has grown to a more respectable figure.

Table 1: History of calendar year results of Al Rayan Bank (in GBP million)

Year	Profit/(loss) after tax	Customer financing assets	Customer liabilities	Shareholders funds	Return on equity %
2005	(6.4)	4.4	47.7	40.5	(15.8)
2006	(8.8)	10.3	83.8	31.7	(27.8)
2007	(6.9)	15.6	134.6	24.8	(27.8)
2008	(5.9)	23.4	153.3	18.9	(31.2)
2009	(9.5)	46.1	186.0	16.8	(56.5)
2010	(8.1)	54.2	187.8	26.2	(30.9)
2011	(9.0)	69.3	195.2	17.1	(52.6)
2012	(7.0)	129.0	237.5	20.1	(34.8)
2013	(5.7)	241.5	320.4	24.3	(23.5)
2014	1.2	450.2	509.8	103.1	1.2
2015	10.3	725.4	730.7	113.5	9.1
2016	9.5	1,031.2	1,222.8	123.3	7.7
2017	8.6	1,406.1	1,596.7	128.8	6.7

Although the return on equity remains well under 10%, that is not too bad in the challenging environment of UK retail banking. For example, the conventional industry's UK-focused retail banking giant, Lloyds Banking Group, achieved a 2017 return on equity of only 6.5%.

“ Although the return on equity remains well under 10%, that is not too bad in the challenging environment of UK retail banking ”

There remains significant scope for growth in customer financing assets. In 2018, Al Rayan Bank made the first ever UK Islamic bank sukuk issue (see my article in *Islamic Finance news* for April 2018) specifically to enable it to continue expanding its home purchase plan assets. ☺

A liability by any other name is still a liability

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

Because my website makes me easy to contact, I receive interesting questions from time to time.

A reader recently asked me whether the UK's bank levy provisions would discriminate against Islamic banks. He explained that under the UK's Finance Act 2011 (FA 2011): "The bank levy is charged on certain types of equity and liabilities of certain groups of entities and individual entities." Underlying his question was possible uncertainty regarding the nature of some of the transactions Islamic banks enter into.

Since the UK's bank levy only applies where equity and liabilities total more than GBP20 billion (US\$26.4 billion), at present the question is academic, since all UK Islamic banks are much smaller than that size.

While some questions can be difficult, in this case there is a clear answer. When preparing the text of FA 2011, the parliamentary draftsman thought about Islamic finance.

In the detailed bank levy provisions, FA 2011 schedule 19 paragraph 13(4) contains a definition of lending activities, one of which is "provision of alternative finance arrangements" (which is the UK's legal terminology for Islamic finance provision.)

More generally, the bank levy legislation in FA 2011 schedule 10 paragraph 14(1) provides that: "For the purposes of this Schedule, 'assets',



'equity' and 'liabilities' have the same meaning as they have for the purposes of international accounting standards."

From time to time, one encounters the argument that when an Islamic bank takes in customers' money in the form of profit and loss-sharing investment accounts, such

accounts should not appear on the bank's balance sheet as liabilities, and the corresponding assets financed using that money should not appear on the bank's balance sheet as assets.

While local country accounting rules sometimes permit very peculiar treatments, the position under the International Financial Reporting Standards is pretty clear.

Where the money received from customers is commingled with other money from the bank, including money from other kinds of customers, such profit and loss-sharing investment accounts are in practice (looking at substance over form) liabilities of the Islamic bank and should be presented as such on the bank's balance sheet.

Similarly, the assets financed with the money received from customers should be shown as assets.

The point is further strengthened by the way Islamic banks operate such accounts in practice. The profit and loss-sharing customers typically receive a profit share which is comparable to market interest rates, with any excess returns from the financed assets being retained by the bank.

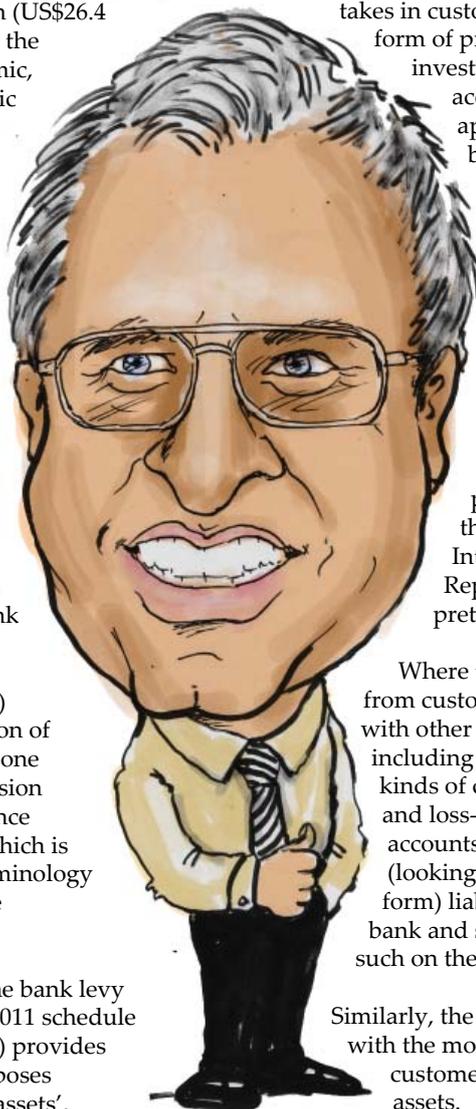
Furthermore, banks often operate profit and loss-equalization reserves to smooth out the returns earned by profit and loss-sharing customers.

Banks bend over backwards to avoid customers suffering losses, and sometimes supplement the returns to customers from the bank's own resources. All of these features are indicators of profit and loss-sharing investment accounts being liabilities.

It is of course possible for banks to hold customers' money in entirely different ways. For example, conventional (and Islamic) banks often manage equity investment portfolios, either for individual clients, or on a pooled basis whereby the bank is the trustee of a collective investment scheme.

In such circumstances, with total segregation between the bank and the customers' assets, and 100% of the positive or negative investment returns accruing to the customers, nothing appears on the bank's balance sheet.

However, the more one compares such different arrangements, the clearer it becomes that normal profit and loss-sharing investment accounts are nothing like that, and are instead liabilities of the bank. ☹



Islamic finance prohibits preference shares — but why?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

One of my website readers recently asked whether preference shares were permitted in Islamic finance. I explained that almost all Shariah scholars who set down the rules for what is allowed in Islamic finance prohibit them.

A more interesting question is to ask why preference shares are prohibited.

As Timur Kuran, a Turkish–American economist, has explained in depth, traditional Islamic law (Fiqh) never developed the concept of a corporation. That is, an entity which is a legal person, distinct from its shareholders, which continues in existence irrespective of any changes among shareholders.

As it had no concept of a corporation, traditional Islamic law had no concept of share capital, and therefore no concept of preference shares.

Obviously, traditional Islamic law could not prohibit something which it had never conceptualized.

While all Muslim-majority countries specify legal processes for creating and regulating corporations, this is new secular law and does not purport to be derived from traditional Islamic law.

Consequently, without even needing to check, one can be sure that all books of

Islamic law written prior to contact with the modern Europeans who brought the concept of a corporation with them would have had nothing to say about preference shares.

When considering whether preference shares are permissible, modern Shariah scholars cannot simply cite earlier rulings from traditional Islamic law. Instead, they have to analogize from rulings about other situations.

Of itself, there is nothing wrong with analogizing since it has been a part of Islamic jurisprudence from the earliest days of Islamic legal scholarship.

Shariah scholars reached their decision about preference shares by analogizing from the rules for partnerships.

Under traditional Islamic law, in a commercial partnership, all capital providers (assuming for simplicity that none of them does any work for the partnership) are required to share in profits in proportion to the amount of capital that each has provided.

No capital-providing partner should have any priority over another.

In the case of partnerships, it would clearly be wrong for one partner to exploit other factors (for example that partner may have a government position with an implied threat of coercion against the other partners) to achieve a disproportionate profit share.

Any form of coercion or exploitation of power in such manner is clearly wrong.

However, even in the case of partnerships, provided there is equality of information and bargaining power, there is

no obvious reason why the capital-providing partners could not agree to share the profits in a different way from straightforward proportionality to capital provided.

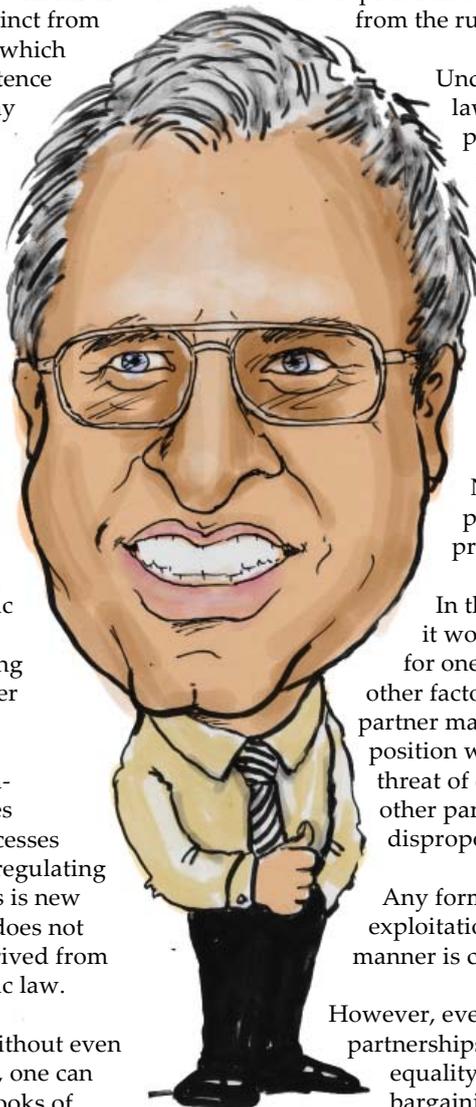
For example, the partners could agree between them that one partner will have a higher share of the first US\$1 million of profits while taking a lower share of profits in excess of US\$1 million. There may be very good reasons for all of the partners to agree to such an allocation.

“ One thing we need to remember is that the early books on traditional Islamic law were written at a time when commerce was much simpler than it is today ”

One thing we need to remember is that the early books on traditional Islamic law were written at a time when commerce was much simpler than it is today, record-keeping systems were less sophisticated and even mathematics was less well-developed, even though it was the Arabs who invented algebra.

Finally, one often-heard argument against preference shares, namely that preference share dividends are Riba, is clearly invalid.

In most jurisdictions, company law prohibits companies from paying dividends, both ordinary share dividends and preference share dividends, unless they have distributable profits from which those dividends are paid. (2)



Never forget the regulatory barriers to Islamic finance

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

As a taxation specialist, I have always focused on eliminating those taxation burdens on Islamic finance which do not apply to conventional finance. Left in place, they would risk making Islamic finance prohibitively expensive compared to conventional finance.

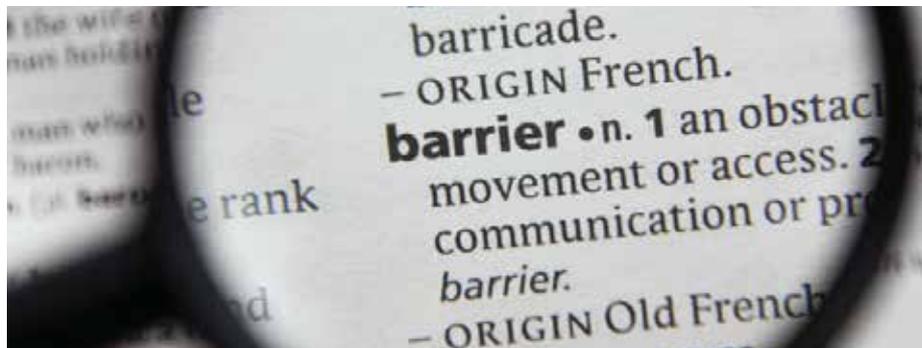
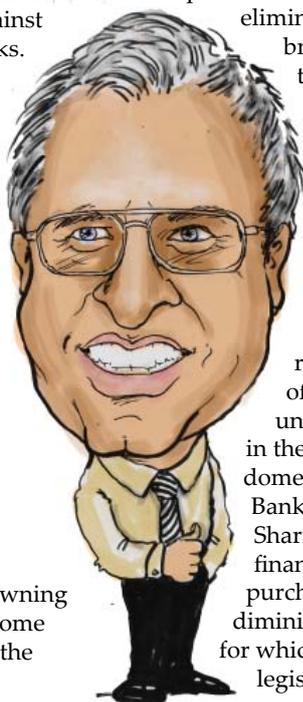
However, a reader's email recently reminded me that regulatory barriers can make Islamic finance impossible unless they are addressed by governments.

For example, a decade ago when visiting Russia, I learned that Russian banks are not allowed to trade in commodities. Of itself, that is a perfectly sensible piece of banking regulation since commodity trading involves very high risks which could threaten the solvency of a bank.

Unfortunately, that rule also makes it impossible for Russian banks to provide finance to customers using commodity Murabahah transactions. Even though commodity Murabahah transactions are structured to reduce a bank's exposure to commodity price risk to a microscopic amount, for Shariah compliance reasons the bank needs to be seen to be trading in the commodity, which falls foul of the Russian prohibition against commodity trading by banks.

As far as I am aware, this problem has not been legislated away in the last decade.

In the UK, at one stage Sukuk faced a regulatory impediment which risked making them prohibitively difficult to issue. Legally, Sukuk are normally structured as undivided fractional ownership interests in an asset, usually real estate or a business. The trustee administering the Sukuk divides the rewards from owning the asset (such as rental income or business profits) among the Sukukholders.



This looks very much like a collective investment scheme, whereby investors pool their money to collectively invest in an asset. However, the UK has many detailed rules governing collective investment schemes which are intended to protect unsophisticated investors. For example, operators of collective investment schemes require approval from financial regulators.

These detailed rules would have imposed additional burdens on the issuance of Sukuk which would have made them prohibitively expensive from the perspective of a corporate issuer compared to the issuance of conventional interest-bearing bonds.

Once the UK professionals specializing in Islamic finance pointed out the problem to the government, it was eliminated by legislation. Very briefly, if an instrument meets the detailed definitions set out for "alternative finance investment bonds" (the UK regulatory name for Sukuk), then it is automatically excluded from being a collective investment scheme.

The regulatory impediment raised by my reader is one of which I was previously unaware. Most home finance in the UK is provided by banks as domestic conventional mortgages. Banks are also able to offer Shariah compliant home purchase finance in the form of 'home purchase plans' normally using a diminishing Musharakah structure for which there is also specific tax legislation.

Building societies are a form of conventional mutual financial institutions which pool members' money (paying interest on the deposits) and use that to provide domestic conventional mortgages. However, there is a serious impediment to building societies offering Shariah compliant home purchase plans.

“ In practice, building societies could never offer more than an immaterial number of home purchase plans. Consequently, they do not venture into Islamic finance ”

The Building Societies Act 1986 specifies that the purpose, or principal purpose, of a building society must be "making loans which are secured on residential property". Home purchase plans do not qualify as they are not loans. While building societies are permitted to hold some assets falling outside their principal purpose, in practice, building societies could never offer more than an immaterial number of home purchase plans. Consequently, they do not venture into Islamic finance. Parliament would need to amend the law for the position to change. (3)

Can you pay interest to yourself?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

An email came via my website from someone who is writing a doctoral thesis on the taxation of multinationals in the MENA region. He mentioned my website article 'Islamic and conventional banks face almost identical transfer pricing issues' and had two questions:

1. Did Shariah scholars accept corporations as permissible?
2. My website article contains the text: "All of these kinds of advances can probably be found between affiliates of Islamic banks. I recall that there is a Shariah principle that interest-bearing loans between wholly-owned subsidiaries are permissible." The researcher wanted to know more.

On corporations, I explained that although traditional Islamic law (Fiqh) never invented them, every Muslim majority state I know about has legislation for corporations.

The religious permissibility of corporations is clearly accepted by the scholars who set Shariah standards such as the Shariah board of AAOIFI.

The second question was more challenging. Before addressing it, to help non-tax specialists I will explain the background.

Within wholly-owned multinational groups, it is often desirable for tax-planning purposes to have interest-bearing loans between companies.

For example, assume that Country X charges a corporation tax of 25% on rental income, but allows a deduction for interest paid, and has a zero withholding rate on interest paid from Country X to Country Y.

If a Country Y company purchases a Country X investment property using US\$100 million of its own funds, it will suffer a 25% Country X corporation tax on the rental income.

Alternatively, the Country Y company could set up a wholly-owned subsidiary in Country X and capitalize it with US\$25 million-worth of share capital. The Country Y parent then makes a US\$75 million interest-bearing loan to the Country X subsidiary which then has US\$100 million to buy the investment property.

Now the Country X corporation tax will be significantly lower because interest on the US\$75 million loan is deductible from the rental income before computing the Country X subsidiary's corporation tax liability.

I was not aware of any Fatwas from organizations such as AAOIFI on this subject. However, I would not expect any. The Shariah standards are all about transactions with third parties rather than purely internal transactions. A subsequent review of

the AAOIFI Shariah standards has not found anything.

However, in my professional practice before I retired, I regularly came across such loans set up in private transactions by investors who wished to be Shariah compliant, approved by their Shariah advisors.

“ From a religious perspective, any transaction between you and your 100%-owned company does not exist ”

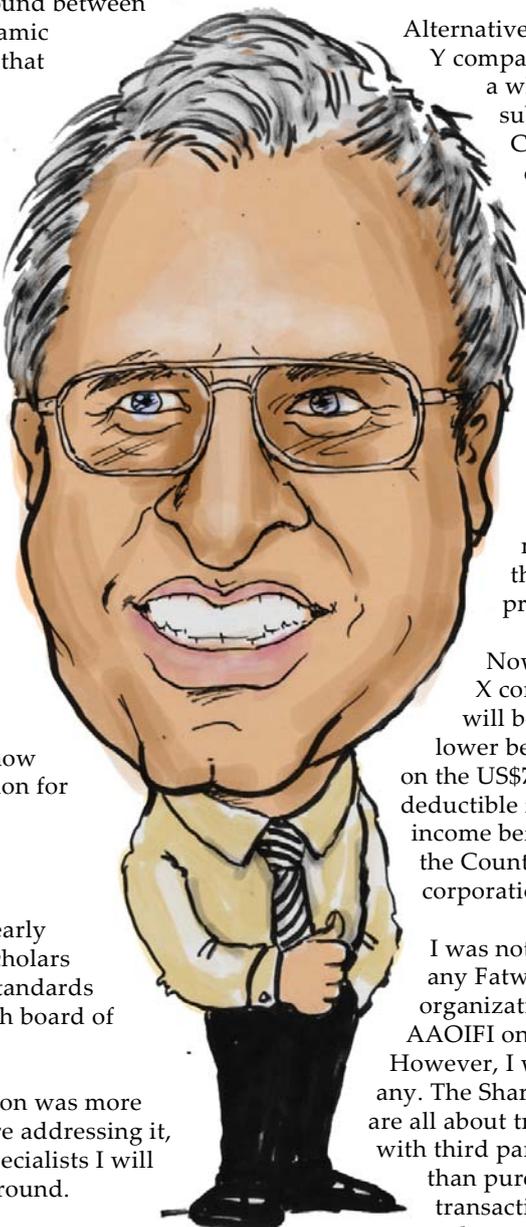
The religious analysis here is relatively straightforward.

If you own 100% of a company, it is entirely your creature (apart from local legal requirements). Accordingly, if you cannot do something religiously, such as running a casino, neither can a company which you wholly own.

The same logic says that from a religious perspective, any transaction between you and your 100%-owned company does not exist. (The transaction does exist for state law since the company has a legal personality.)

Conceptually, it is no different from keeping a tin of money for buying food and another tin of money to pay for utilities. If you 'borrow' US\$10 from the utility tin and add it to the food tin, and later 'repay' US\$11 from the food tin to the utility tin as compensation, nobody would ever complain that you had paid an interest of US\$1 between the two tins. They are both 100% yours.

The companies look more complicated, but if 100%-owned, the religious logic is the same. ☺



The sorry saga of European Islamic Investment Bank, now called Rasmala

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

From the perspective of 2019, a world of widespread slow growth and the fear of trade wars, it is hard to remember the heady optimism of the mid-2000s prior to the global financial crisis.

At that time, several Islamic banks were set up in the UK. One of them, the Islamic Bank of Britain, was the only retail bank; my 4th February 2019 column looked at its financial history. The others were all investment banks; on the 8th January 2019 I summarized the history of the Bank of London and the Middle East (BLME). Its cumulative losses by the 31st December 2017 of GBP31.6 million (US\$40.1 million) illustrated how hard it can be for a new Islamic investment bank to make money.

The other large Islamic investment bank set up at the same time, the European Islamic Investment Bank (EIIB), was only slightly smaller than the BLME. However, its track record is even worse!

Table 1, using figures from the published accounts, shows that, despite being smaller, the EIIB managed to lose even more money than the BLME, with cumulative losses by the 31st December 2017 of GBP64.3 million (US\$81.6 million).

Why did the EIIB perform so badly?

In my view, one key reason was the frequent changes of management. The accounts report the executive directors as shown in Table 2.

In the first five years of operation, there was continuity of CEO but three

Table 1: Annual results of the EIIB

Calendar year	Total comprehensive income for the year post-tax (GBP million)	Year-end equity shareholders' funds (GBP million)
2005	1.3	111.2
2006	1.2	185.7
2007	-4.5	180.9
2008	-14.8	163.4
2009	-18.9	140.4
2010	7.5	143
2011	-9.9	128.7
2012	-10.4	119.7
2013	-0.8	122.9
2014	0.3	122.2
2015	-0.7	101
2016	-11.4	90.1
2017	-3.2	58.7
	-64.3	

Source: Compiled by author based on the bank's published accounts

different finance directors. This was followed by a period where the finance director stayed put but there were several changes of CEO. The years 2013 and 2014 without a finance director

in place are particularly disturbing. I always worry that the absence of a finance director indicates that the authority of the finance function within a firm has been downgraded. In my opinion, a key role of the finance director is to ensure that the firm is managing its downside risks.

Reading the accounts, one also finds changes in strategy; some of the biggest losses appear to have arisen from forays into principal investing such as purchasing a large stake in a diamond mine which then had to be written down.

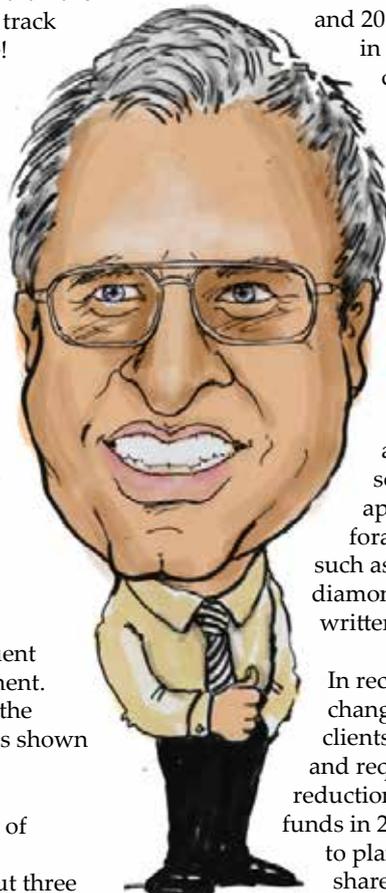
In recent years, the strategy has changed to managing assets for clients. This should be lower risk and requires less capital. The large reductions in equity shareholders' funds in 2015 and 2017 were due to planned returns of capital to shareholders.

I would hope that with this revised strategy, the EIIB (now called Rasmala) can leave behind its track record of consistent failure. ☹

Table 2: Executive directors of the EIIB from 2005 to 2017

Calendar year	Chief executive	Finance director
2005	John Weguelin	Tony Ellingham
2006	John Weguelin	Atif Raza
2007	John Weguelin	Atif Raza
2008	John Weguelin	Keith McLeod
2009	Keith McLeod (acting CEO)	Keith McLeod
2010	Subhi Benkhadra	Keith McLeod
2011	Zulfi Caar Hydari	Keith McLeod
2012	Zulfi Caar Hydari	Keith McLeod
2013	Zulfi Caar Hydari	None
2014	Zulfi Caar Hydari	None
2015	Zulfi Caar Hydari	Neil McDougall
2016	Zulfi Caar Hydari	Neil McDougall
2017	Zulfi Caar Hydari	Neil McDougall

Source: Compiled by author based on the bank's published accounts



Two directly comparable banks — one conventional, one Islamic

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

I often stress that an Islamic bank is a bank. Complying with the requirements of its Shariah supervisory board makes that bank Islamic.

I compared two Malaysian banks, both owned by CIMB Group Holdings (CIMB Group). Given common ownership, both should have the same management culture, and achieve similar financial results apart from differences due to size.

The following numbers all come from the accounts for the year ended the 31st December 2018.

CIMB Bank is a conventional bank. Its consolidated assets of RM451.9 billion (US\$109.52 billion) comprise about 85% of CIMB Group's consolidated assets of RM534.1 billion (US\$129.44 billion).

CIMB Bank also owns an Islamic bank, CIMB Islamic Bank (CIMB Islamic). CIMB Islamic is much smaller, being about a quarter of the size of its conventional parent with consolidated assets of only RM103.7 billion (US\$25.13 billion).

As well as owning CIMB Islamic, CIMB Bank also undertakes some Islamic banking itself. These Islamic operations are small, with income during the year of only RM149 million (US\$36.11 million) out of CIMB Bank's total net income before overheads of RM8.1 billion (US\$1.96 billion).

I expected CIMB Bank to be more profitable than CIMB

Islamic, due to economies of scale. The raw figures I computed surprised me.

For 2018, CIMB Bank had a net profit after tax and Zakat of RM2.8 billion (US\$678.58 million). The 31st December 2018 ordinary shareholders equity was RM33.4 billion (US\$8.09 billion), apparently giving a return on closing equity of only 8.38%.

However, this ignores the fact that RM6.5 billion (US\$1.58 billion) of CIMB Bank's equity is financing the investment in shares of CIMB Islamic. Reducing the equity to $RM33.4 - 6.5 = RM26.9$ billion (US\$6.52 billion) (the equity financing the banking operations) gives a noticeably higher return on closing equity of 10.4%.

CIMB Islamic had a 2018 net profit after tax and Zakat of RM800 million (US\$193.88 million). The 31st December 2018 ordinary shareholders equity was RM5.3 billion (US\$1.28 billion), resulting in a return on equity of 15.1%.

This surprised me. I had expected it to be less profitable than CIMB Bank. The explanation lies in its balance sheet.

CIMB Bank's own balance sheet (not the consolidated balance sheet) shows total assets of RM321.9 billion (US\$78.01 billion).

Logically, we should eliminate the RM6.5 billion investment in CIMB Islamic shares, leaving banking assets of RM315.4 billion (US\$76.44 billion).

Comparing them with the reduced banking equity of RM26.9 billion computed previously gives a basic (not risk-weighted) leverage ratio of $315.4/26.9 = 11.7$.

Conversely, the CIMB Islamic balance sheet has total assets

of RM103.7 billion. With ordinary shareholders' equity of RM5.3 billion, its basic leverage ratio is 19.57. That is surprisingly high in today's regulatory environment.

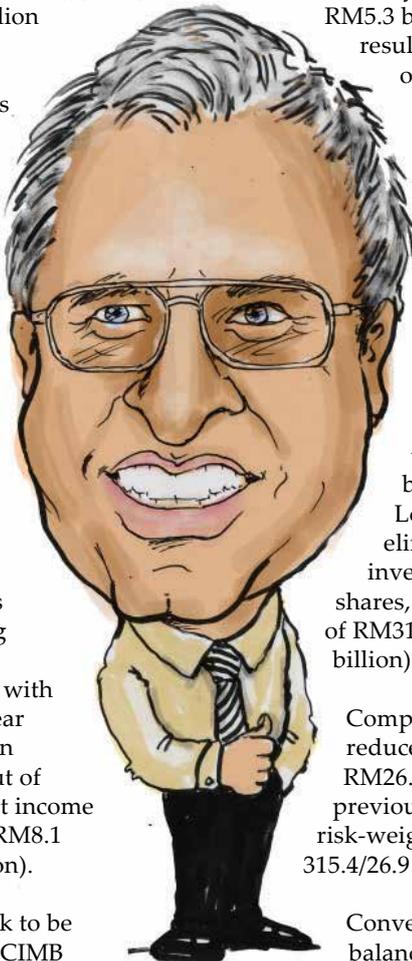
“ Both sets of results look credible given that the business environment for banks remains challenging with interest rates being comparatively low by historical standards ”

At present, I have not investigated how it has been allowed to operate with so much leverage, but there may be an implied promise of support from its parent for which there is no intercompany charge.

To have the same 11.7 basic leverage ratio as computed for CIMB Bank, CIMB Islamic would need extra equity of RM3.6 billion (US\$872.46 million) since $103.7/(5.3+3.6) = 11.7$.

With this extra equity, CIMB Islamic's return on equity would fall to $0.8/(5.3+3.6) = 9\%$. That looks more sensible in comparison to the adjusted figure for CIMB Bank of 10.4%, given the size difference between the two banks.

Both sets of results look credible given that even 11 years after the global financial crisis, the business environment for banks remains challenging with interest rates being comparatively low by historical standards. ☺



CIMB Bank and CIMB Islamic — still puzzling

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

In the previous article, I was surprised by the fact that CIMB Islamic was noticeably more profitable (measured by return on equity) than its much larger conventional parent, CIMB Bank. A close look at the accounts showed that CIMB Islamic was able to operate with a significantly higher leverage ratio (gross assets/equity) than CIMB Bank.

In that article, I only had space to speculate regarding why CIMB Islamic was permitted to have a higher leverage ratio. I return to that question in the following paragraphs.

A reader pointed out to me that CIMB Islamic has a significantly lower expense ratio than CIMB Bank and wondered whether the Islamic subsidiary was being subsidized.

When you look at overheads/ (total income before interest expense), CIMB Islamic does indeed have a much lower ratio than CIMB Bank. The respective figures are 14% Islamic and 33% bank.

Accordingly, the lower level of overhead expense is definitely part of the explanation for CIMB Islamic's higher profitability.

I have not investigated further, partly because I suspect that the published accounts won't give enough details about why CIMB Islamic's overheads are lower.

Different tax rates are often a reason for a parent company to subsidize a subsidiary. However, the 2018 tax



rate for CIMB Bank of 21% is virtually identical with that of CIMB Islamic at 20%.

I also wondered whether CIMB Islamic was charging its customers higher rates than CIMB Bank.

However, the ratio of interest income (or its Islamic equivalent)/gross assets, at 4.2% Islamic and 4.1% bank, is virtually identical for both banks.

From the CIMB website, I downloaded the group's Basel II Pillar 3 Disclosures for the period ended the 30th June 2018.

Reading these, one must be careful since the figures for CIMB Bank are consolidated ones including its subsidiary CIMB Islamic which constitutes about one-fifth of the CIMB Bank consolidated numbers.

However, the CIMB Bank/CIMB Islamic size difference is so great that for most practical purposes you can treat the CIMB Bank numbers as if they were all conventional.

The first important point is that CIMB Islamic has a Tier 1 ratio (Tier 1 capital/total risk-weighted assets (RWA)) of 14.7% compared to 13.8% for CIMB Bank. This is the opposite way round from the gross leverage ratios discussed in the previous article.

The straightforward reason is that CIMB Islamic has much less risky assets than CIMB Bank.

The Pillar 3 Disclosures report gives total credit risk gross exposures for CIMB Islamic of RM97.9 billion (US\$23.27 billion) which reduces to RWA after the effects of PSIA (profit-sharing investment accounts) of RM30.1 billion (US\$7.16 billion), ie RWA/gross exposures ratio of 30.8%.

For CIMB Bank, the equivalent figures are RM427.8 billion (US\$101.7 billion) gross credit exposures, RM220.6 billion (US\$52.44 billion) RWA, giving an RWA/gross exposures ratio of 51.6%.

Furthermore, remember that about one-fifth of the CIMB Bank consolidated assets are those of CIMB Islamic, so the CIMB Bank conventional assets must have an even higher ratio than 51.6%.

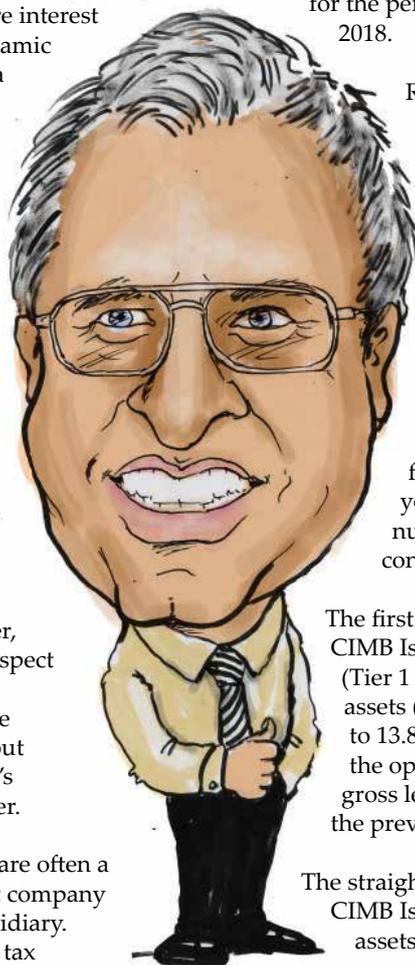
“ The lower level of overhead expense is definitely part of the explanation for CIMB Islamic's higher profitability ”

Some simple arithmetic shows that CIMB Bank's purely conventional assets have a ratio of 57.7%.

CIMB Bank is not earning a higher rate of interest as compensation for having riskier assets.

As stated previously, interest income/gross assets is virtually identical for CIMB Bank and CIMB Islamic. Unlike CIMB Islamic, CIMB Bank earned RM4 billion (US\$950.95 million) of non-interest income, some of which might require it to hold these higher risk assets.

Otherwise, the shareholders could reasonably ask CIMB Bank's management why they are bothering financing assets which are higher risk, while earning no extra reward. ☹



Islamic banks also create money

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

There are many valid reasons for supporting the growth of Islamic banking. There are also invalid reasons sometimes cited, the most egregious being those which are simply incorrect.

I hear from time to time at Islamic finance conferences that “unlike conventional banks, Islamic banks do not create money since all transactions have to involve real assets”.

This sounds plausible but is incorrect. Like conventional banks, Islamic ones also create money.

The economy and the aggregate banking sector are complicated, and not easy to think about. Accordingly, I have adapted a simple explanation of money creation that I first encountered in a conventional economics textbook over 40 years ago.

Imagine a remote town, for example on a small island. Due to the size of the town, there is only one (Islamic) bank, so everyone who has a bank account has it with this bank. (In real life, one considers the aggregate of all banks together, but it is simpler to illustrate with just one bank.)

Before anything happens, the bank has the following condensed balance sheet as shown in Table 1.

One of the bank’s customers wants to buy a car with Murabahah financing

Table 1: Before transaction	
Assets	US\$
Deposit with national central bank	100,000
Other assets, mainly customer financings	900,000
Total assets	1,000,000
Liabilities	
Customer deposits	800,000
Shareholders’ equity	200,000
Total	1,000,000

Source: Author’s own

from the bank. Accordingly, the bank purchases a car from the local car dealer for US\$30,000 and sells it to the customer for, say, US\$35,000 payable in equal monthly installments over three years.

“ The important need when promoting Islamic banking is to understand where it differs from conventional banking, and where it does not ”

The car dealer having received US\$30,000 from the bank of course deposits that money in his bank account. Indeed, the bank probably paid him by simply crediting US\$30,000 to his account.

In accordance with accounting standards for Murabahah transactions, the bank must spread the US\$5,000 profit on selling the car over the 36-month period of the Murabahah transaction in an appropriate way.

Of course, on the day of the transaction, no part of the 36 months has elapsed. Accordingly, immediately after the aforementioned Murabahah transaction, the bank’s balance sheet is as shown in Table 2.

Table 2: After transaction	
Assets	US\$
Deposit with national central bank	100,000
Other assets, mainly customer financings	900,000
Murabahah financing of car	30,000
Total assets	1,030,000
Liabilities	
Customer deposits	800,000
Deposit made by car dealer	30,000
Shareholders’ equity	200,000
Total	1,030,000

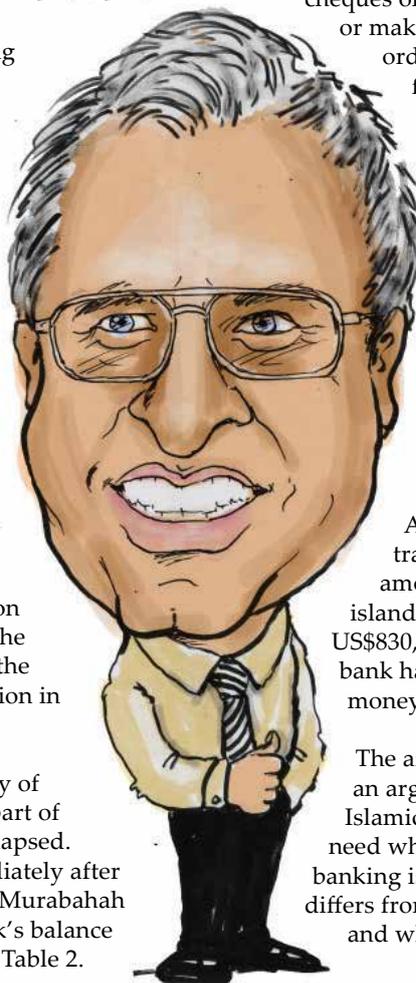
Source: Author’s own

Prior to the Murabahah transaction, people living on the island had US\$800,000 of spendable money being the customer deposits.

In other words, they could write cheques on their bank accounts or make electronic transfers in order to make purchases from vendors on this island, up to a total of US\$800,000. Of course, in practice they would be unlikely to spend all of the money immediately. However, even if it was all spent immediately, as long as it was only spent on this island, it would all be redeposited back in the bank.

After the Murabahah transaction, the total amount of money on the island that can be spent is US\$830,000. Accordingly, the bank has created US\$30,000 of money.

The aforementioned is neither an argument for, nor against, Islamic banking. The important need when promoting Islamic banking is to understand where it differs from conventional banking, and where it does not. ☺



The financial history of Qatar Islamic Bank's UK subsidiary

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK.

QIB (UK) is a UK Islamic bank. Unlike the three Islamic banks I reviewed previously which were set up as independent entities with a spread of shareholders, QIB UK is the wholly-owned subsidiary of Qatar Islamic Bank (QIB).

As previously, this column is based entirely on the published accounts and contains no private knowledge.

It was once commonplace for foreign banks to set up UK branches. However, UK regulators have become very reluctant to permit new UK branches. Instead, they require the foreign bank to incorporate a UK subsidiary, independently regulated by the UK, with independent non-executive directors alongside management who may have come from the overseas parent.

There is always an inevitable tension between the regulatory and taxation requirements that the UK subsidiary operates independently, with all transactions with its foreign parent on arm's-length terms, and the business reality that the UK subsidiary is a creature of its parent.

QIB UK became operational in 2007, although that year was spent getting started. In Table 1, I have summarized its historical results.

The overall story is lamentable. Since operations started, the parent company has injected GBP85.8 million (US\$110.97 million) into QIB UK. Of this, GBP21 million (US\$27.16 million) has been lost.

The loss in 2007 was predictable, since costs were unavoidably incurred when negligible banking business was being undertaken. However, the losses continued year by year, culminating in a stupendous loss in 2013.

The 2013 accounts explain that QIB UK had built up a significant portfolio of financings to development stage SME businesses which were proving non-viable, and had also taken equity stakes in those businesses. Impairment losses

on those financings plus write-downs of the equity stakes were the bulk of the loss.

This accumulation of high-risk activity illustrates the business challenges faced by small new investment banks. They lack the deal flow of larger and more established competitors, which tempts them to take on risky customers. The temptation to seek higher, and therefore riskier, returns is increased by their small size which makes it harder to spread their fixed overheads.

In recent years, QIB UK appears to have stabilized. While the 2018 return on equity of 6% is not brilliant, given the generally difficult banking environment it can be regarded as respectable. The 2018 accounts show that most of QIB UK's customer financings are relatively short-term financings of real estate transactions with little over five years' maturity. However, I believe that poses its own risk of the bank becoming overexposed to real estate. (f)



Year ended the 31 st December	Profit (loss) after tax (GBP million)	Year-end shareholders funds (GBP million)	Share capital increase during year (GBP million)	Return on average of opening and closing equity (%)
2007	-2.8	-	-	N/A
2008	-2.4	19.8	25	-24.2
2009	-1.7	18.1		-9
2010	-1.2	16.9		-6.9
2011	0.1	17		0.6
2012	-3.4	13.9		-22
2013	-15.7	16.4	19	-103.6
2014	1.3	30.5	12.5	5.5
2015	2.5	55.6	23.1	5.8
2016	-3.1	51.9		-5.8
2017	1.7	60.1	6.2	3
2018	3.7	62.8		6
	-21		85.8	

Source: Author's own

The financial history of Gatehouse Bank

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

Like the four other Islamic banks I have previously reviewed, Gatehouse Bank (Gatehouse) was established in the mid-2000s. The optimism about the banking industry at that time, before the global financial crisis and the era of low interest rates, is hard to remember.

Gatehouse was established as a wholly-owned subsidiary. Its 2007 accounts report its parent company as The Securities House.

Such companies are prohibited from conducting banking or insurance business, so Gatehouse was not the subsidiary of a bank. In later years, The Securities House reduced its shareholding as Gatehouse issued extra share capital.

Table 1 shows the key figures up to the year ended the 31st December 2018, the latest accounts on its website.

As with the four other Islamic banks I have reviewed, the accounts tell a sorry tale.

The first-year loss is no surprise. Operational costs are inevitably incurred before a new bank earns anything. However, the second year showed increased losses from staff and other operational costs significantly exceeding income.

Gatehouse by then had GBP50 million (US\$64.62 million) of share capital, but almost no liabilities to customers.

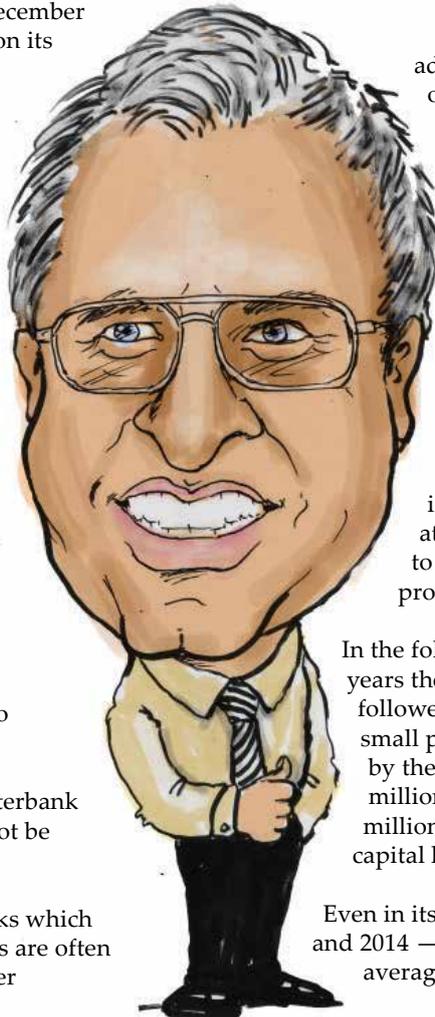
Almost all assets were interbank placements. A bank cannot be profitable that way.

Management of new banks which are short of earning assets are often tempted to make customer

Table 1: Historical results of Gatehouse Bank

Year ended 31 st December	Profit (loss) after tax (GBP million)	Year-end shareholders' funds (GBP million)	Share capital increase during year (GBP million)	Return on average of opening and closing equity (%)
2007	(4.4)	5.6	10	N/A
2008	(8.5)	37.2	40	(39.7)
2009	(12.1)	25.2	-	(38.8)
2010	(5.7)	19.5	-	(25.5)
2011	(4.3)	115.2	100	(6.4)
2012	2.4	117.4	(1)	2.1
2013	4	119.1	-	3.4
2014	4.1	125.5	1	3.4
2015	(0.8)	122.2	-	(0.6)
2016	1.6	128.9	-	1.3
2017	(0.4)	127.5	-	(0.3)
2018	(15.9)	110.5	-	(13.4)
	(40)		150	

Source: Website of Gatehouse Bank



advances which other banks might not, convincing themselves that the credit quality will be acceptable.

That appears to have happened with Gatehouse, since the significant increase in losses for 2009 is primarily attributable to impairment provisions.

In the following two years the losses reduced, followed by three years of small profits. However, by then another GBP100 million (US\$129.24 million) of extra share capital had been injected.

Even in its best years — 2013 and 2014 — the return on average of shareholders'

equity was only 3.4%. For that to be the best result is lamentable.

In 2018, the bank reported another large loss, primarily due to recognising a GBP12 million (US\$15.51 million) negative revaluation on finance provided to a customer in 2013 for real estate construction in France.

Stepping back, over its life the shareholders have injected GBP150 million (US\$193.86 million) of capital and watched more than 25% of it being lost.

Despite that, each year, including 2018, the accounts have upbeat language, with little detail about problems or strategic challenges. Gatehouse Bank is not alone. The same was true with the other Islamic banks' accounts.

Overall, making money in UK Islamic banking has proved very difficult. The industry is new, the institutions are small and the UK's low interest rate environment impairs banking profitability.

However, poor management execution must also be part of the explanation for the losses. ☹️

What does the UK general election result portend for Islamic finance?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

In last month's general election, the Conservative Party led by Boris Johnson won with a majority of 80. Accordingly, barring unforeseen circumstances, this government can expect to be in power for the next five years and the majority means it can pass any legislation it wishes.

Many UK Muslims have expressed concern about the result worried by Johnson's long history of making derogatory comments about ethnic minorities and, most notably, Niqab and Burqa-wearing Muslim women.

Leaving aside general political questions, what do the result mean for the Islamic finance industry? This matters primarily for the UK but is also relevant globally since the UK is the leading non-OIC country in Islamic finance.

It helps to remember why, since the mid-2000s, the UK government has been so supportive of Islamic finance. Its goals were:

- Making financial services available to UK Muslims who might otherwise self-exclude themselves from the financial system for religious reasons.
- Promotion of the Islamic financial services industry in the UK as part of the UK's overall financial services sector.

The inclusion task has largely been achieved, although for commercial reasons many gaps in the retail Islamic financial services space remain. I do not expect any negative government policies.

Indeed, since the government has a secure majority, progress on unfinished business such as implementing the long-delayed Shariah compliant student finance scheme may even accelerate.

The bigger question is what will happen to the wholesale Islamic finance sector where the UK has several dedicated Islamic investment banks, and many UK conventional banks offer wholesale Islamic financial services, not just to UK customers but also internationally.

The key uncertainty is what happens to the ability of UK-based entities to provide financial services in EU countries ('passporting rights') once the UK leaves the EU on the 31st January 2020, or more precisely once the Brexit transition period ends on the 31st December 2020.

The government has stated that it is committed to preserving its freedom of regulatory divergence from EU rules after the 31st December 2020.

I expect that, in response, the EU will terminate passporting rights.

This termination is likely to be gradual rather than instantaneous to minimize disruption, but the political and commercial imperatives for the EU appear aligned on this point.

Historically, these passporting rights were a key selling point for London as a location for international Islamic investment banks.

Accordingly, London will be a less attractive location in future for any new international Islamic investment banks.

London-based bankers may seek to console themselves with the opportunity to do more international business outside the EU, once they are no longer constrained by EU financial services rules, since the UK will be an independent rulemaker.

However, I expect them to be disappointed.

“ The long-term consequence of leaving the EU will be to weaken the industry by reducing the available international market ”

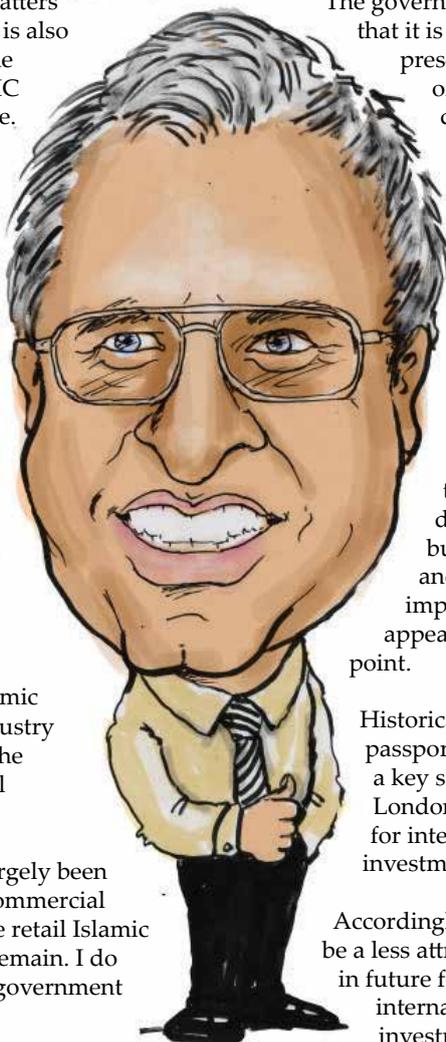
The most important potential customer territories, because they are the largest economies, are countries such as the US, China, Japan and India.

However, such countries are adept at enacting financial services rules which have the effect of making it prohibitively difficult for foreigners to provide financial services within that country.

Negotiating as a single entity, the UK will have little leverage to counteract such protectionist rulemaking.

Accordingly, the international market will reduce to smaller countries which have less scope for protectionist rulemaking.

To summarize, I do not expect the government to do anything to directly harm the UK Islamic financial services industry. However, the long-term consequence of leaving the EU will be to weaken the industry by reducing the available international market. ☹



Why has ADIB UK lost so much money?

By Mohammed Amin, an Islamic finance consultant and former tax partner at PwC in the UK

In the optimistic years leading up to the global financial crisis, five Islamic banks were established in the UK. In previous articles, I had reviewed their dismal financial results.

The sixth UK Islamic bank is slightly different. ADIB UK opened in 2012, a few years later than the others. However, that has made no difference to its performance compared to its predecessors.

ADIB UK is a wholly-owned subsidiary of Abu Dhabi Islamic Bank (ADIB). By Islamic banking standards, this is a reasonably-sized bank, with the 31st December 2018 total equity equivalent to US\$4.8 billion. The accounts state that ADIB UK's goals are to serve ADIB Group priority and high-net-worth and corporate customers. One cannot tell from reading the accounts whether it has developed any significant independent customer base.

Reading the accounts, unlike some of the other UK Islamic banks, there is no sign of any material impairment losses from taking on customers who prove to be poor credit risk. Despite that, as shown by Table 1, the bank has consistently lost money.

The consistency of the results, with small losses every year, is striking. Each year, net financing income has failed

to cover its operating costs. The figures show that the business activities have been subscale.

In relation to its equity, the bank has attracted relatively small levels of customer deposits. On the asset side of its balance sheet, customer financings have always been relatively low as a proportion of total assets, with the balance of the assets comprising Sukuk holdings and interbank placements.

Given the low-interest rate environment following the global financial crisis, the margin between what ADIB UK earns on its assets and what it pays on its customer deposits has been insufficient to cover its operating costs. The losses have not been dramatic, due to the successful avoidance of material impairment losses, but they have been steady.

The key statistic to look at is shareholders' funds as a percentage of total assets,

without risk-weighting the assets. Shareholders' funds have been as high as 60%, and even by 2018 had fallen to only 14%. With these being non-risk-weighted numbers, the figures are far too high. Banks cannot make money this way unless they have very significant income from fee earning services.

The other factor which stands out when reading the results is management stability, or rather the lack of it. When a bank has regular changes of management, as with European Islamic Investment Bank, one expects to find significant losses. (Sadly, management stability does not guarantee profitability, as with the Bank of London and the Middle East.)

While I have not listed them, in the seven years I reviewed, I found four chief executives, and a year when no chief executive was named. This suggests that the parent company was dissatisfied by ADIB UK's performance. However, changing personnel is not a solution unless one can also change the strategy. ☹️

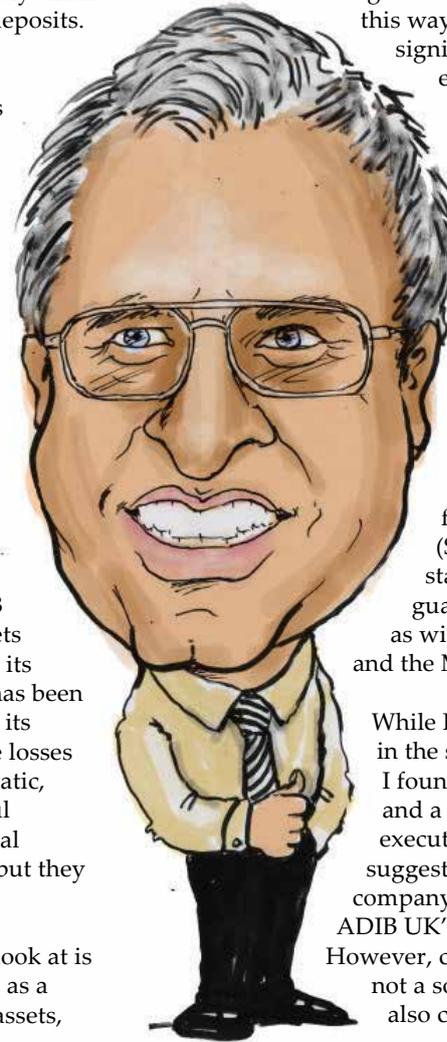


Table 1: ADIB UK's historic results by calendar year

Year ended 31 st December	Profit (loss) after tax (GBP million)	Year-end shareholders funds (GBP million)	Year-end total assets (GBP million)	Year-end customer financings before impairments (GBP million)	Liability to customers (GBP million)	Share capital increase during year (GBP million)	Year-end shareholders funds to assets, unweighted (%)
2012	2.5	7.5	68	-	13	10	11
2013	2.3	27.6	81.6	7	21	21.9	34
2014	3.7	23.6	94	15.9	26.5	-	25
2015	4	45.3	75.6	-	28	26.1	60
2016	4	41.5	156.9	71	37.2	-	26
2017	3.3	37.9	149.3	77.9	30.8	-	25
2018	2.1	32.3	223.4	153.7	41.6	-	14
	21.9					58	

Source: ADIB (UK)

Making moral and religious investment decisions is right, but it does not change the world

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I have long been a stock market investor. I have never thought of myself as an 'ethical investor', but quite some time ago I realized that I had never bought shares in a tobacco company. Subconsciously, I had avoided investing in companies which made profits by selling a product that ruins people's health and shortens their lives.

More intentionally, I have never bought shares in casinos or companies whose main business is producing and selling alcoholic drinks, because of my Muslim religious beliefs.

If I would never want to own 100% of a brewery, why would I buy a fraction of a brewery?

At the same time, I oppose bans. The experience of prohibition (of alcohol) in the US or the more recent failure of the so-called 'war on drugs' demonstrates how harmful such bans can be.

There is also a straightforward religious freedom question. If you believe that drinking alcohol is religiously acceptable, or have no religious beliefs at all, what right do I have to prohibit you from drinking alcohol?

An increasingly live political issue today concerns fossil fuel companies, especially oil companies.

Students at major universities which have large endowments, and members of churches (such as the Church of England) which also have large endowments, are pressing the trustees of such investment funds to divest themselves of their shares in oil companies.

There are two distinct questions:

1. Is divestment the correct investment decision? If so, divestment is obviously highly desirable.
2. If divestment is not warranted on pure investment grounds, will divesting help to change the world, for example by reducing greenhouse gas emissions?

The first question is a difficult one.

For example, I own shares in oil company BP. As countries reduce their use of fossil fuels, there is a risk that BP may end up owning large amounts of underground oil which it will never be able to extract because there is no market for it — so-called 'stranded assets'.

As an investor, I need to weigh this risk against the current high profitability of the business, which results in significant cash flows to investors.

I have not reached a conclusion but at present have not divested.

However, the second question has a clear answer.

If I sell my BP shares, someone else will obviously

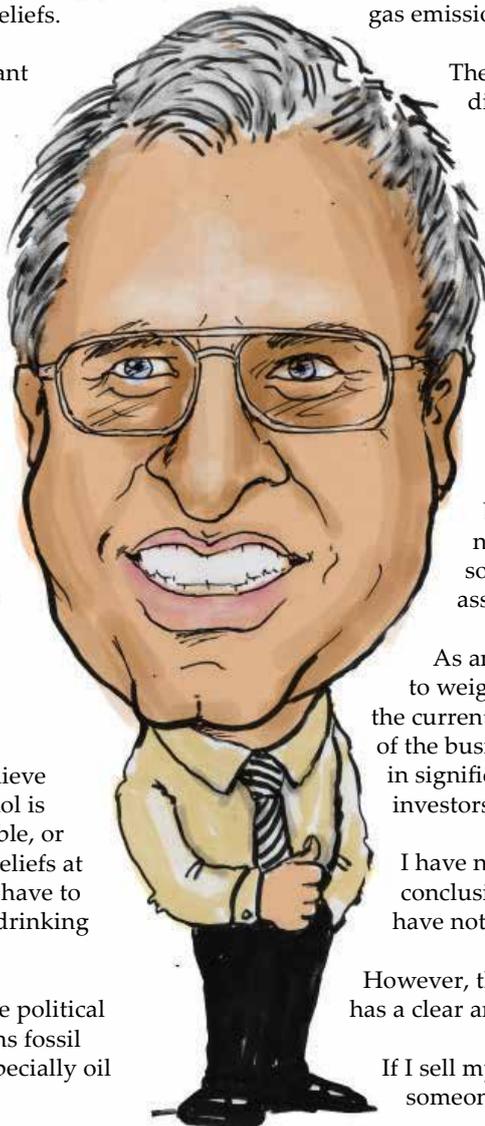
buy them. That is how stock markets operate. My selling has no impact on BP's oil extraction operations. Even if there is divestment by larger shareholders than me (my holding is relatively tiny), at most this will cause some downward pressure on the share price. Even if it causes the share price to be permanently lower, and therefore the dividend yield to be permanently higher, at most this causes an increase in BP's cost of equity capital.

“ If you believe that drinking alcohol is religiously acceptable, or have no religious beliefs at all, what right do I have to prohibit you from drinking alcohol? ”

However, like most major oil companies, BP does not need any additional equity from new investors, so the theoretical cost of equity is irrelevant to it. Indeed, major oil companies pay big dividends and often have additional cash flow which they use to buy back existing issued shares. They simply do not need to raise any additional equity.

Accordingly, I believe that this divestment campaign represents a misdirected effort, because it will not reduce climate change.

The same arguments apply, with appropriate adaptations, to Shariah compliant screening of stock market investments. Screening enables investors to invest in accordance with their religious beliefs, but that is all it does. To combat the harm from alcohol, for example, requires other policies. ☹



When is a bank not a bank?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Since 2005, I have watched the UK Islamic banking scene very closely, and was heavily involved professionally while at PwC.

Accordingly, when someone recently asked me what I thought about a particular UK Islamic bank, Rosette, I was dismayed to have to confess that I had never heard of it. Was I about to lose any credibility as a guru on UK Islamic banking?

I have since researched it. The bank's full name is Rosette Merchant Bank. The reason why I have never heard of this 'Islamic bank' before is very simple. It is not a bank! Because the UK has very good public registries, finding the information I needed was relatively straightforward, if you know where to look.

On its website www.rosette.co.uk which I accessed on the 28th March 2020, Rosette describes its business as follows: "Rosette Merchant Bank LLP is an independent investment advisory and asset management firm specialising in commercial real estate, capital markets, and bespoke family office services."

This provides the first clue.

In my opinion, the essence of banking is that a bank borrows money from one set of people (depositors) who then have a debt claim against the bank. It lends that money to another set of people (borrowers). Islamic banks typically also take deposits but for Shariah compliance reasons do not lend money to borrowers. Instead, they provide finance to customers normally using transactions which

are economically equivalent to lending money. Rosette does not claim to do that.

On its 'About Us' page, Rosette states that: "The firm is regulated by the United Kingdom's Financial Conduct Authority (FCA), has a wide range of FCA permissions, and is authorised to act as a UK Alternative Investment Fund Manager (sub-threshold)." However, it does not say what its wide range of FCA permissions are.

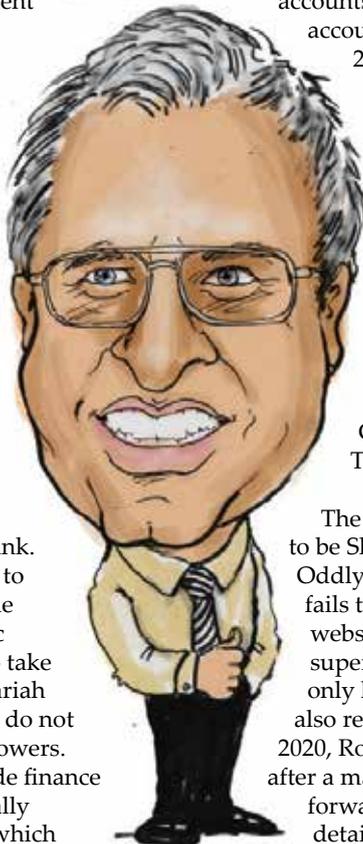
I went to the FCA's public register and saw what I regard as the most important limitation on Rosette's FCA permissions: "Client Money: This firm cannot hold client money. It may be able to control client money if it has the necessary requirements."

If a firm cannot hold client money, obviously there is no way that it can engage in a banking business. Rosette Merchant Bank contains the word 'Bank' as part of its name, but it is not a bank.

I was curious about Rosette's results. As a limited liability partnership, it is registered at England and Wales's Companies House, where it must file accounts. The most recent available accounts are for the calendar year 2018. They paint a sorry picture.

Rosette lost GBP1.9 million (US\$2.36 million) in 2018 and lost GBP1.2 million (US\$1.49 million) in the previous year. By the 31st December 2018, it had lost (cumulatively) GBP11.8 million (US\$14.69 million) of its members' capital of GBP12.8 million (US\$15.93 million), so its members' equity was down to GBP1 million (US\$1.24 million). That does not look sustainable.

The accounts state that Rosette aims to be Shariah compliant at all times. Oddly enough, the Rosette website fails to say that, although there is a website page about its Shariah supervisory board which currently only has one member. The website also reports that from the 17th February 2020, Rosette is under new management after a management buyout. I look forward to Rosette publishing more details eventually. ☺



IFN FORUMS 2020

JUNE	8	IFN World Leaders Summit <i>Dubai, UAE</i>
JUNE	8	IFN iINNOVATE MENA <i>Dubai, UAE</i>
JUNE	8	IFN Dubai Awards Dinner <i>Dubai, UAE</i>
JUNE	10	IFN Oman Forum <i>Muscat, Oman</i>
JUNE	15	IFN Asia Forum — Capital Raising Day <i>Kuala Lumpur, Malaysia</i>
JUNE	15	IFN Asia Awards Dinner <i>Kuala Lumpur, Malaysia</i>
JUNE	16	IFN Asia Forum — Investors Day <i>Kuala Lumpur, Malaysia</i>
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AUG	24	IFN Asia Halal Financing Forum <i>Kuala Lumpur, Malaysia</i>
AUG	26	IFN Indonesia Forum <i>Jakarta, Indonesia</i>
AUG	27	IFN Singapore Forum <i>Singapore</i>
<hr/>		
SEPT	1	IFN UK Forum <i>London, UK</i>
SEPT	3	IFN Turkey Forum <i>Istanbul, Turkey</i>
SEPT	7-11	IFN WAMU Forum & Dialogue <i>Dakar</i>
SEPT	7-11	IFN Nigeria Forum & Dialogue <i>Lagos, Nigeria</i>
SEPT	7-11	IFN Kenya Forum & Dialogue <i>Nairobi, Kenya</i>
<hr/>		
NOV	8	IFN Saudi Dialogues <i>Riyadh, Saudi Arabia</i>
NOV	11	IFN Kuwait Dialogues <i>Kuwait City</i>
NOV	11	Private Investors' Forum <i>Kuwait City</i>
NOV	23	IFN Green & Sustainable Finance Forum <i>Kuala Lumpur, Malaysia</i>

Why has UK retail Takaful never taken off?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The UK retail Islamic banking market is small but real. Indeed, meeting the demand for retail Islamic banking motivated the creation of the first Islamic bank in the UK. I expect the UK's retail Islamic banking industry to endure and to grow steadily.

Conversely, I know of only one attempt to provide retail Takaful in the UK, and that was a complete failure for its shareholders.

Takaful companies of course simply provide insurance as everyone understands it, but in a Shariah compliant manner, just as Islamic banks provide banking that is Shariah compliant.

Retail Takaful is widely found in Muslim-majority countries. It is obviously sustained there by the much larger potential market (compared with the UK) and in some countries benefits from state support.

However, there are multiple reasons which together make the UK extremely unattractive for potential retail Takaful providers.

Firstly, setting up a small insurance company in the

UK is much harder than setting up a small bank.

I consider that the skills required to price insurance risk successfully are much higher than those required for the provision of basic retail banking services.

Also, in my view, the regulatory burden for providing insurance, especially if you wish to provide life insurance, is greater than if you wish to provide banking.

Secondly, in general, individuals are reluctant to buy insurance. Of course, they are often compelled to do so, for example taking out home fire insurance is demanded by mortgage lenders.

Even more strongly, it is a criminal offence to drive without motor insurance. That is why about a decade ago Salaam Halal Insurance made motor insurance its first Takaful product.

Unfortunately, the UK's motor insurance market is intensely competitive, and the company was subscale and had to close down after suffering significant losses.

Thirdly, I believe that, on average, Muslims are even more reluctant than non-Muslim individuals to buy insurance. Quite apart from UK Muslims being poorer than non-Muslims (the propensity to buy insurance increases with income and wealth), there is a religious factor which causes some Muslims to be fatalistic,

discouraging them from buying insurance.

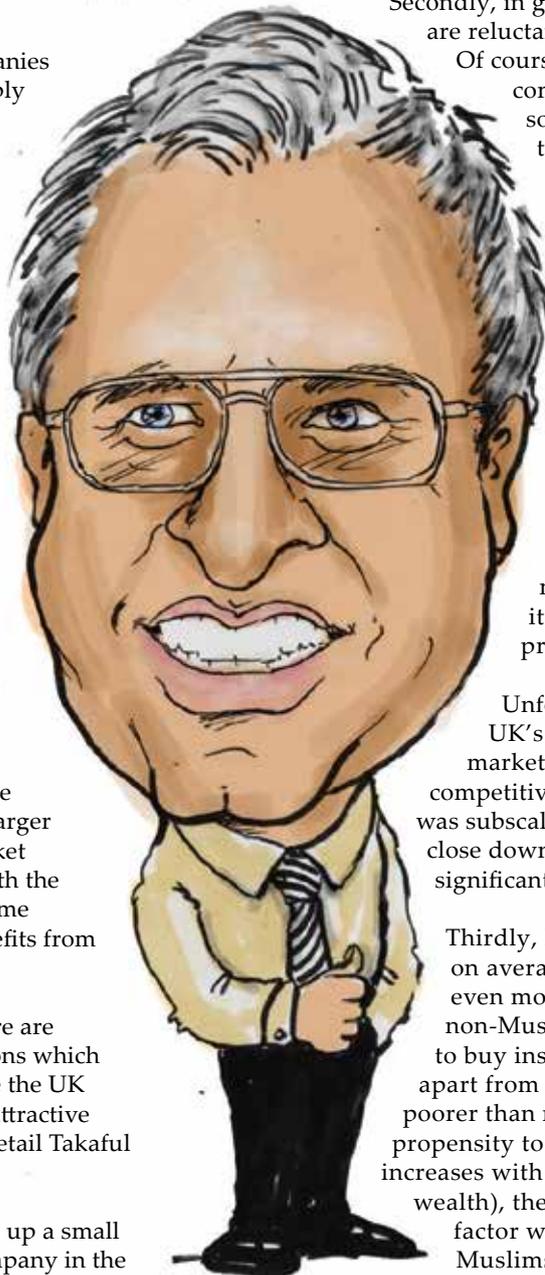
I have been unable to find meaningful statistics on fatalism among Muslims in the UK.

However, in 2012, the Pew Research Centre found very high levels among Muslims in most Muslim-majority countries. That is consistent with my intuition that fatalism is much higher among UK Muslims than among non-Muslims.

“ Quite apart from UK Muslims being poorer than non-Muslims (the propensity to buy insurance increases with income and wealth), there is a religious factor which causes some Muslims to be fatalistic, discouraging them from buying insurance ”

In my February 2017 **column**, I explained the need for life Takaful provision in the UK and pointed out its absence.

Three years later, the situation has not changed and for the aforementioned reasons, I think it is unrealistic to expect retail Takaful, especially life Takaful, to become available in the UK any time soon. ☹



VAT increase hits Saudi Islamic financial institutions

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Last month, The Times of London reported that Saudi Arabia is tripling the value-added tax (VAT) from 5% to 15% due to budgetary pressures. Low oil prices have cut government revenues drastically while plans to diversify the economy away from oil are still at an early stage. With high levels of government expenditure, to quote the time-honored phrase: "Something has got to give."

What does this mean for the country's Islamic finance industry?

Never forget that Islamic finance is finance, albeit conducted in a Shariah compliant way. From the inception of VAT in the EU, financial services have been almost entirely exempt from VAT.

While VAT in Saudi Arabia is only a couple of years old, the Saudi VAT law follows widespread international precedents by also exempting financial services.

“ Never forget that Islamic finance is finance, albeit conducted in a Shariah compliant way ”

Since they provide exempt services, financial institutions do not charge their customers VAT. The problem this creates is that, because they make no taxable supplies, financial institutions cannot recover input VAT on the goods and services that they purchase from others.

For example, to a bicycle-maker spending US\$100 on telephone services (billed as US\$105 including VAT), the actual cost is only US\$100 because the US\$5 input VAT it pays within the US\$105 is recoverable.

However, when a bank spends US\$100 on telephone services (also billed as US\$105 including VAT), the bank's actual cost is US\$105 because it cannot recover the US\$5 VAT.

After the VAT rate increase from 5% to 15%, that same telephone service will cost the bank US\$115.

Accordingly, all financial institutions will suffer a hit to their profit and loss account. All purchases of goods and services which are subject to VAT (for example, telecommunications, computing, consultancy services, purchases of stationery, office equipment, etc) will increase in cost by 9.5%, by rising from US\$105 to US\$115.

This reduction in profitability comes at a difficult time for banks. The low price of oil does not just harm the profitability of oil-extraction companies.

It also damages the prospects of those many businesses which supply oil companies with goods and services, and the profitability of businesses whose customers are the employees of oil services firms.

Accordingly, I expect an increase in bad debts in the Saudi banking sector.

The other question is whether there is a specifically Islamic financial

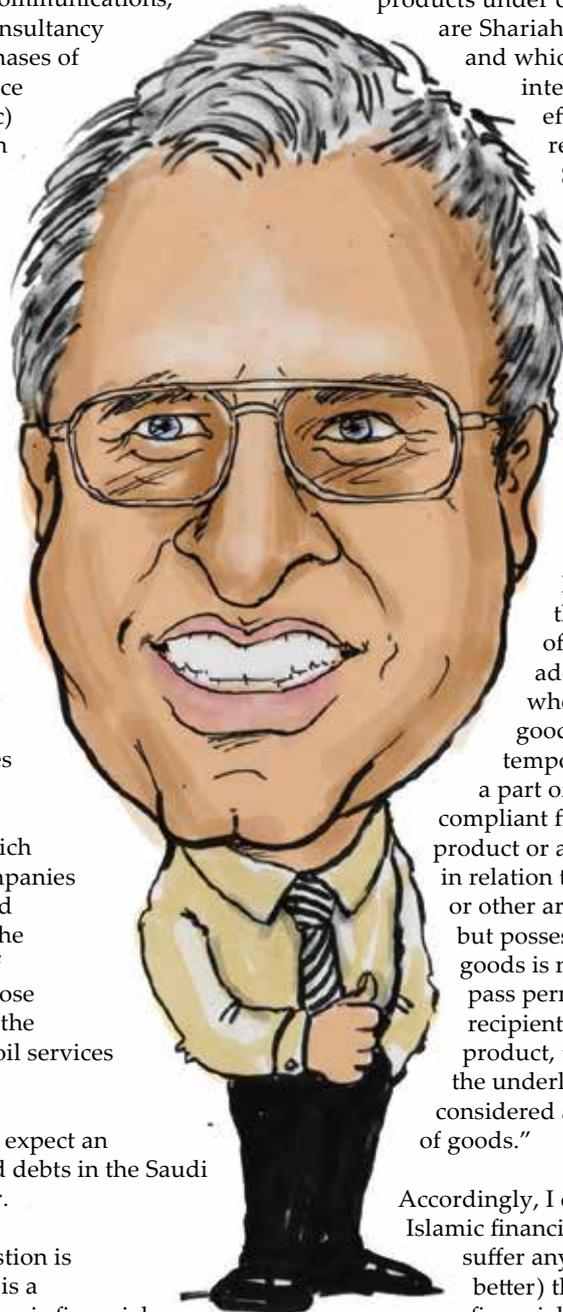
services aspect. By and large, I would not expect there to be. As well as making it clear that financial services generally are exempt supplies, the detailed Saudi VAT regulations aim to ensure that Islamic financial services are similarly exempt.

The Saudi 'Value Added Tax — Implementing Regulations' were issued on the 12th January 2018. Financial services are covered in Article 29, paragraph 3 which says: "Islamic finance products, being financial

products under contract which are Shariah compliant and which simulate the intention and achieve effectively the same result as a non-Shariah compliant financial product will be treated in the same manner as the equivalent non-Shariah financial product for the purpose of applying exemption from tax."

Furthermore, the first half of paragraph 4 adds: "In cases where ownership of goods is transferred temporarily as a part of a Shariah compliant financial product or as collateral in relation to a financing or other arrangement, but possession of those goods is not intended to pass permanently to the recipient of the financial product, the transfer of the underlying goods is not considered a separate supply of goods."

Accordingly, I do not expect Islamic financial services to suffer any worse (or any better) than conventional financial services. ☺



Another conventional/Islamic bank comparison

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

In my 6th August 2019 column, I compared the 2018 results of CIMB Bank and CIMB Islamic Bank. My expectation was: "Given common ownership, both should have the same management culture, and achieve similar financial results apart from differences due to size." As CIMB Islamic was much smaller, I expected it to be less profitable, due to lacking economies of scale.

To my surprise, I found that CIMB Islamic was noticeably more profitable. Its return on equity (ROE) (profit post-tax and Zakat divided by shareholders' funds) was 15.1%. That was compared with CIMB Bank's ROE of 10.4%, after adjusting out the equity financing its ownership of the Islamic subsidiary (before the adjustment, CIMB Bank's ROE was only 8.4%).

The key explanation was that CIMB Islamic was operating with a much higher leverage ratio (total assets, not weighted for risk, divided by shareholders' funds). It was 19.57, which struck me as very high in today's regulatory environment. By comparison, CIMB Bank was operating with a much lower leverage ratio of 11.7.

A few months ago, I was asked about Maybank, where my interlocutor expected a different outcome from the calculations. I have now computed the figures, using the calendar 2018 results to maintain comparability with CIMB.

Malayan Banking (MBB) describes itself as the largest financial services group in Malaysia, and is the parent company of the Maybank Group whose consolidated assets of RM807 billion (US\$188.31 billion) are significantly larger than CIMB Group's consolidated assets

of RM534 billion (US\$124.61 billion).

As well as owning many subsidiaries, MBB runs a conventional banking business, and its financial statements disclose both the group results and the conventional bank results.

Maybank Group's Islamic banking activities are carried out through Maybank Islamic (MIB) (in Malaysia) and Bank Maybank Syariah Indonesia in Indonesia. By comparing the total Islamic banking income shown in MBB's consolidated results with MIB's figures, one sees that most of the Maybank Group's Islamic banking business is within MIB.

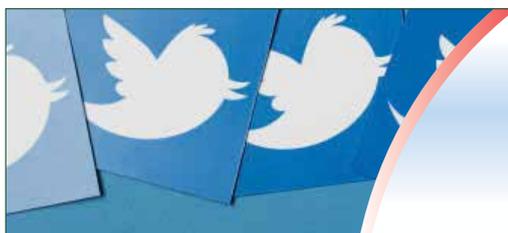
MIB's ROE was 18.9% (profit for the year was RM1.98 billion (US\$462.03 million), and shareholder's equity was RM10.48 billion (US\$2.45

billion)). That is almost four percentage points higher than CIMB Islamic's ROE for the same period, which is a commendable achievement.

However, MBB's ROE (after adjusting for equity used to finance investments in subsidiaries) was only 14.4%. This was computed by reducing the RM7.3 billion (US\$1.7 billion) published MBB Bank post-tax and Zakat profit by eliminating the RM2.4 billion (US\$560.03 million) dividends from subsidiaries, and similarly eliminating from the RM65.6 billion (US\$15.31 billion) equity a figure of RM31.4 billion (US\$7.33 billion) representing equity financing the investment in subsidiaries. Again, MBB's conventional banking ROE was significantly higher than CIMB Bank's ROE of 10.4%, but well behind the ROE of MIB.

As with CIMB Islamic, a key part of the explanation for MIB being more profitable than its conventional parent can be found in the balance sheet. MIB has total assets of RM225 billion (US\$52.5 billion), giving an unweighted leverage ratio of 21.5 (even if one excludes assets financed by the customers' investment accounts of RM23.5 billion (US\$5.48 billion), the unweighted leverage ratio would still be 19.2). In comparison, the MBB leverage ratio is only 12.4 computed after excluding investments in subsidiaries from the assets with a matching reduction in shareholders' equity.

Accordingly, while the Maybank Group is more profitable than the CIMB Group, both in conventional banking and in Islamic banking, we see the same pattern as with CIMB. Contrary to what one would expect, the Islamic banking subsidiary is much more profitable than its conventional banking parent company. ☺



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AAOIFI exposure draft on financial reporting for Zakat

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

On the 8th July 2020, AAOIFI issued Exposure Draft (F5/2019) v 5.1 'Financial reporting for Zakah' with feedback to be sent by email to accounting@aoofi.com by the 30th October 2020.

When adopted as an AAOIFI Financial Accounting Standard (FAS), it will replace AAOIFI FAS 9 'Zakah'. That was developed in 1998, before AAOIFI Shariah Standard 35 'Zakah' was issued in 2009. Later, AAOIFI recognized that there were "several contradictions" (all quotations are from ED F5/2019) between FAS 9 and SS 35.

ED F5/2019 focuses on "recognition, presentation and disclosure". Paragraph 4(b) of the proposed FAS contains the following key definition:

"4(b) Institutions obliged to pay Zakah — are such institutions that are required to pay Zakah on net assets pertaining to certain or all relevant stakeholders whereby one or more of the following conditions is/are met:

- i. when the law requires the institution to pay the Zakah obligation;
- ii. when the institution by virtue of its constitution documents is required to pay the Zakah obligation;
- iii. when the general assembly of shareholders has passed a resolution requiring the institution to pay the Zakah obligation; or
- iv. where the contract with certain stakeholders require

the institution to pay the Zakah obligation."

Specific treatments are then prescribed, separately for cases (i) and (ii), and for cases (iii) and (iv).

"5 An institution obliged to pay Zakah by law or by virtue of its constitution documents shall recognize current Zakah expense in its financial statements..." — this covers cases (i) and (ii).

"8 Where Zakah is not required to be paid by law or by virtue of its constitution documents, and where the institution is considered as an agent to pay Zakah on behalf of stakeholders, any amount paid in respect of Zakah shall be adjusted with the equity of the relevant stakeholders." — this covers cases (iii) and (iv).

ED F5/2019 does not specify the position of the Zakah expense in the income statement. Islamic bank accounts usually report the Zakah expense below the annual profit before taxation and Zakat. To ensure consistency between institutions, the standard should have mandated this presentation.

More importantly, in my opinion, category (ii) should have been treated like category (iii) and not like category (i).

In some countries, Islamic banks are required by law to pay Zakat. It is clearly right that in category (i), Zakat payable by law is an expense, as is corporate income tax.

In the UK, the law does not require Zakat payments so case (i) is irrelevant.

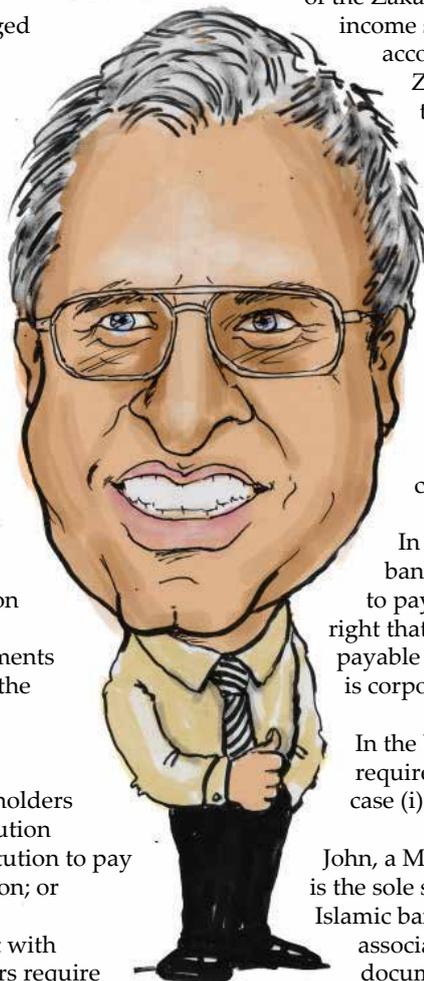
John, a Muslim, creates — and is the sole shareholder of — an Islamic bank. Its initial articles of association (the incorporation document of a UK company)

oblige it to pay Zakat. ED F5/2019 requires John's bank to treat Zakat payments as an expense since category (ii) applies.

Jane also creates — and is the sole shareholder of — a UK Islamic bank. Its articles of association do not mention Zakat. However, rather than paying Zakat herself (Jane is also a Muslim), Jane passes a shareholder resolution each year requiring the bank to pay Zakat to avoid her having to. ED F5/2019 classifies the Zakat as a reduction in equity since this is category (iii).

“ At any time, as the sole shareholder, John could amend the articles of association, removing its Zakat obligation, to move from category (ii) to category (iii) to boost its earnings per share. In substance, the two banks are identical ”

If both banks have identical financial results, they will nevertheless report different earnings per share because John's bank treats Zakat as an expense. That is illogical. At any time, as the sole shareholder, John could amend the articles of association, removing its Zakat obligation, to move from category (ii) to category (iii) to boost its earnings per share. In substance, the two banks are identical. ☺



Corruption, beneficial ownership registers and Islamic finance

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

People with illicit wealth, often called 'black money', whether obtained through major theft, corruption or tax evasion, have a practical problem. What do you do with the money? Buying real estate or company shares is hazardous, since their ownership is registered. As a poor person, how do you explain where you got the money to buy the assets?

Keeping black money hidden in a cave or a safe deposit box is pretty unproductive. Quite often, people buy valuable real estate or shares in companies, not in their own names but in the names of relatives or friends.

The practical risk they take is of the relative or friend deciding one day to just keep the asset, since they are legally its owner!

A common solution has been to use trusts. You find a highly reputable law firm and create a trust with some of the partners as trustees, handing over your black money to them for investment.

The registered owners of any assets that the trust purchases will be the law firm partners.

In most jurisdictions (prior to the following developments), trusts were secret and required no public disclosure.

While you might be the only real beneficiary of the trust, and therefore the 'beneficial owner' of the assets, nobody can discover this without breaking into the law firm and copying its files.

To counter such abuse of trusts, there has been major pressure around the world for public registers which would disclose not just the

legal ownership of assets but also their beneficial ownership.

Countries whose citizens often hide undisclosed wealth in trusts set up overseas have applied great pressure to locations such as Jersey and the Cayman Islands where trusts are set up to introduce public registers of beneficial ownership.

What is not well known is that some major countries, in particular the US, have no such transparency requirements.

In the US, crooks still have plenty of scope for hiding their wealth in trusts and similar entities without having to take it out of the US.

There is of course pressure for law changes. In 2019, the Democrat-controlled House of Representatives passed the Corporate Transparency Act of 2019.

However, the parallel legislation, the 'Improving Laundering Laws and Increasing Comprehensive Information Tracking of Criminal Activity in Shell Holdings (ILLICIT CASH) Act' is stuck in the Republican-controlled Senate.

I do not expect it to pass at all, and certainly not before the presidential election in November.

Since new laws require both the House and the Senate to approve them, that means no change yet.

I am also sceptical that US President Donald Trump would sign such legislation instead of vetoing it.

I was asked whether such transparency legislation

would negatively impact upon Islamic finance in the US. I see no reason why it should.

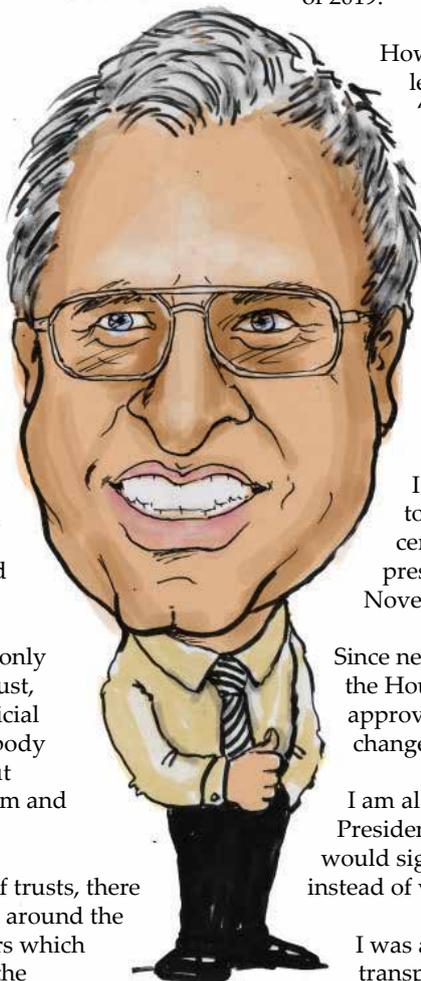
However, that leads me to ask a related question. When do Islamic finance transactions that involve a change in legal ownership also involve a change in beneficial ownership?

“ In the US, crooks still have plenty of scope for hiding their wealth in trusts and similar entities without having to take it out of the US ”

For example, you own a building. To raise finance, you sell the building to a bank, and rent it back under a diminishing Musharakah transaction. Are you or the bank the beneficial owner?

In my view, if you are paying rent at market rental rates, and your repurchase of the building, whether in slices or all at once, will be at the open market price on repurchase, then the bank clearly has beneficial ownership.

Conversely, if your rent is fixed (or set by reference to market interest rates) and your repurchase will be at a pre-specified price, then you have retained beneficial ownership. ☺



A closer look at the NQ Minerals Sukuk

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

In the 23rd September 2020 issue of Islamic Finance news, I read about a recent Sukuk issuance to finance P1 Capital, issued by Al Waseelah (AW) and managed by Bedford Row Capital Advisers (BRCAL). The article also mentioned a 2019 Sukuk issuance by AW and BRCAL to finance mining group NQ Minerals (NQ). I had missed the original story about this Sukuk in the IFN issue of the 11th September 2019.

As corporate Sukuk have been very slow to take off in the UK, I decided to take a closer look at the 2019 Sukuk. This was in the form of 'up to US\$50 million 10% secured certificates due 2026' listed on the Frankfurt Stock Exchange.

After trying and failing to find the Sukuk prospectus on the internet, I contacted BRCAL. They graciously sent me a copy. I also had a Zoom call with BRCAL's CEO, Dr Scott Levy; this was about the company and his career rather than the details of the NQ Sukuk.

The following description of the Sukuk issuance is entirely based

upon my reading of the prospectus and the relevant published accounts which are publicly available from the UK government's website. Any errors are mine, and BRCAL has no responsibility for my text.

Very briefly, AW raised (if all the notes were issued which I have not been able to check) US\$50 million by issuing the Sukuk certificates to investors. The prospectus states that 10% of the issue proceeds would be retained by AW "to cover the ongoing operating expenses as part of the relevant Issuer Collateral Account for the purposes of the creation of an expense and liquidity reserve".

The balance was used to enter into a commodity Murabahah transaction with NQ. Under this, NQ bought the commodity from AW with deferred payments starting six months later and running through to the 2026 redemption date. While some Shariah scholars frown on commodity Murabahah transactions, they are a convenient way for one party to provide cash finance to another party.

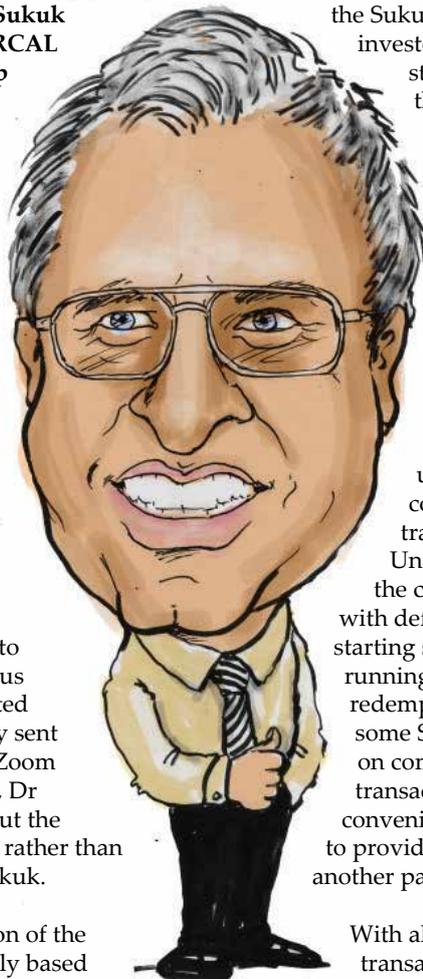
With all Islamic finance transactions, it helps to ask

what conventional finance transaction the Islamic one is replicating. Here, the Sukuk issuance is replicating a fixed rate debt issued by NQ. There are some unresolved points of detail.

The certificates are described as secured. However, it is clear from the prospectus that they are only secured on the assets of AW. The asset of AW in connection with this transaction is simply the right to be paid the deferred consideration due from NQ for the commodity Murabahah transaction.

Accordingly, unless there is additional security created under the terms of the commodity Murabahah agreement (a document I have not seen), what the Sukuk investor owns is, in economic terms, an unsecured liability of NQ, via the AW certificates. It is of course possible that, under the terms of the commodity Murabahah agreement, NQ may have given security for its deferred payment obligations by granting security over its assets. I do not know. Moreover, NQ's assets are the shares in the Australian mining subsidiaries, rather than the Australian mines themselves.

Peculiarly, in the 31st December 2019 balance sheet of NQ, I could not find the liability for deferred payments due to AW under the commodity Murabahah agreement. Accordingly, it is not clear how many of the 2026 certificates were successfully issued. The AW accounts do not help to resolve this, as the most recent published accounts ended on the 31st July 2019, pre-dating the Sukuk issuance. ☹️



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Muslims' views on religious questions vary

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

When Muslims address religious questions by analyzing the sources and then giving their opinion (ie write a Fatwa), they traditionally conclude with the phrase "and Allah knows best". That acknowledges God as the ultimate arbiter of religious questions.

Despite that, I encounter many Muslims who believe that Islam has a monolithic set of rules. Last month, an article titled 'A simple introduction to Islamic mortgages' received a website comment about the future price when the Islamic financial institution owning the property sells it in stages to the occupier, specifically asking about falls in value. The reader stated: "In my mind the 'Owner' [the Islamic financial institution] of the property has to bear this risk."

There are many ways of financing a property acquisition including:

- 1) A fixed rate conventional loan.
- 2) A floating rate conventional loan.
- 3) A one-off Murabahah transaction with the purchase price paid over a long period of time. This is economically equivalent to (1).
- 4) A diminishing Musharakah transaction, which can take several alternative forms:
 - a) the rate of rent is fixed, and the dates and future prices of the property acquisition in stages by the occupier are also specified. Economically, this is equivalent to (1) and (3).
 - b) The rent is periodically reset, with the future price being fixed. Economically, this is equivalent to (2).
 - c) The rate of rent is periodically reset, with the future price being:
 - i) Market value.
 - ii) The lower of cost or market value.

In 4(b) and (c), the reset could be:

- A. By reference to prevailing short-term property rental rates for transactions where the tenant acquires no rights of any kind to purchase the property.
- B. By reference to market interest rates.

In practice, (A) is never (or almost never) done. The reason is that comparing the economics of such a diminishing Musharakah transaction with a conventional mortgage would then become much more complex for both financial institutions and their customers. I have not attempted to exhaustively list all possible alternatives. Instead, I have focused only on those which I consider most relevant.

There are Muslims who consider every one of the aforementioned alternatives to be religiously permitted within Islam. Conversely, some Muslims will reject every alternative, at least where the rent is explicitly reset by reference to market interest rates, which is the norm.

Within diminishing Musharakah, I regularly come across Muslims who consider that only scenario 4(c)(i) is religiously permitted.

My view is straightforward.

Religious freedom requires the state to stay out of religious questions, and to allow citizens to enter into the economic arrangements that they wish. Accordingly, provided there is clear disclosure of the contractual terms, with deceptive advertising being prohibited, financial institutions and individuals should be free to structure mortgages as they wish. Obviously, it is important that financial institutions are adequately capitalized and take into account the economic risks of the contractual structures used, and also important that individuals are not misled.

In the UK, the tax law was revised in 2006 to make diminishing Musharakah mortgages possible. This was done by introducing a UK tax law concept called Diminishing Shared Ownership (DSO). Qualifying DSO contracts exclude 4(c)(i) but permit 4(c)(ii). I cannot see any logical reason for this, except perhaps protecting consumers from agreeing to 'give away' to the financial institution future price increases without understanding the financial implications of doing so. ☹️



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Futures trading: Economically beneficial. Religiously permissible?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

An American Muslim recently asked me about commodity futures trading. He understood its purpose, as explained in my column published in IFN Volume 12 Issue 45.

However, he was concerned that the exchange matches trades irrespective of whether the party is a speculator or a hedger. Accordingly, many contracts may involve a speculator trading with another speculator. Was this religiously permissible?

As always, empirical questions and religious questions need to be kept separate.

Empirically, it is clear that markets function better when speculators are freely able to take part in the market alongside commodity producers and commodity users. Arguments to the contrary come only from people who are economically naive.

For religious questions, each Muslim needs to decide for themselves, as each of us is individually answerable to God. My view is that since futures markets are clearly empirically

beneficial, one would need to find very strong religious arguments against them before concluding they were impermissible.

Those Shariah scholars who oppose futures trading rely upon the Hadith where Prophet Muhammad prohibited the sale of what you do not own, with the Hadith prohibiting the sale of goods where there was no opportunity to inspect them. For the purposes of discussion, it is simplest to treat these Hadiths as authentic.

These Hadiths prevent problems arising in normal life when you contract to sell something which you do not presently own and then are unable to supply it to the buyer. Similarly, requiring a customer to buy something without having the opportunity to inspect it creates significant scope for fraud, misrepresentation, unhappiness and conflict. When it comes to futures trading, none of the problems that these Hadiths seek to prevent is relevant.

The arrangements for posting margin and closing out

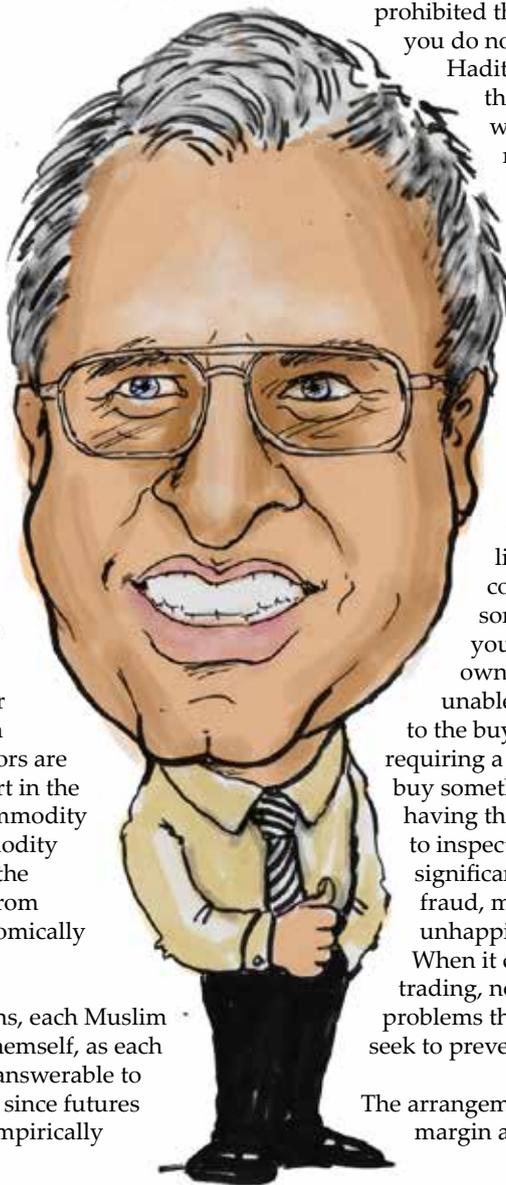
transactions ensure that even if you contract to sell cotton (in the case of a cotton futures exchange) and then are unable to supply that cotton on the closeout date, there will be no economic harm to your counterparty. In practice, even if your counterparty is a cotton user, they are unlikely to be waiting for the delivery of bales of cotton from the central warehouse; users enter into futures transactions primarily to hedge price variation risk, while acquiring the cotton that they actually use from other sources. (For physical commodities, the central counterparty often maintains an inventory of the commodity, to enable delivery to take place if the user really requires physical delivery.)

Similarly, the absence of the ability to inspect is irrelevant. Each commodity exchange meticulously specifies the subject matter of the contract, so that neither the seller nor the buyer is left in any doubt regarding what they are contracting to deliver or receive should the contract proceed to physical delivery instead of being closed out by entering into an equal and opposite contract.

Accordingly, my opinion is that there is no religious impediment to futures trading as conducted in the world today through organized futures exchanges with central counterparties.

That is also the view expressed in the book 'Islamic Commercial Law: An Analysis of Futures and Options' by Mohammad Hashim Kamali, who is the emeritus professor, founding chairman and CEO of the International Institute of Advanced Islamic Studies, Kuala Lumpur.

This was one of the first books I read on Islamic finance many years ago. If you have not read it, I recommend it highly. ☺





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My new year perspective on the future of Islamic finance

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

With the start of 2021 (Happy New Year), I have been thinking about how Islamic finance has developed and where it is going.

When lecturing, I often stress that, speaking mathematically, Islamic finance is a strict subset of conventional finance. What that means is:

1. Anything which can be done in Islamic finance can also be done in conventional finance. (If necessary, by copying the Islamic finance transaction's structure and contractual documents exactly.)
2. However, some conventional finance products will never be available in Islamic finance. A trivial example to prove the point is a mutual fund investing only in the shares of casino companies.

Who should decide what financial arrangements are religiously permissible for Muslims?

Where individual action is concerned, it must be the persons themselves, since each of us is individually answerable to God on the Day of Judgment. While some countries legally prohibit conventional finance transactions, I regard that as an unwarranted infringement of religious freedom.

Where collective action is concerned, there is an obvious need for a religious opinion that will command wide acceptance. There is no point in starting an Islamic bank if almost all potential customers might refuse to accept that it is

actually Islamic — hence, the need for supervisory boards of Shariah scholars, whose views will command broad (even if not universal) acceptance among Muslims. Indeed, some countries specify legislative requirements for Shariah supervisory boards.

In the earliest days of Islamic finance, finding people who had a deep education in the study of Quran, Hadith and Fiqh (Islamic jurisprudence), and who also understood banking and finance, was essentially impossible. The two are very different intellectual disciplines, and there had historically been zero need for religious scholars to study banking!

Over the intervening decades, a growing number of religious scholars have gained an understanding of banking and finance, initially by simple exposure to the subject and later by formal study. Today, many who understand both subjects are referred to as Shariah scholars. (The more exact name of 'Religious Scholars Who Also Understand Finance' would be far too long to find acceptance!)

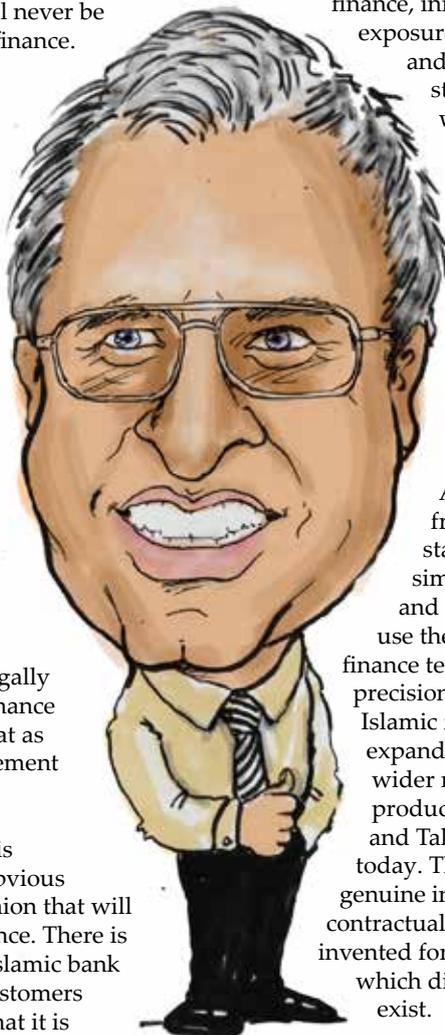
As a consequence, from a very narrow start, with banks simply taking deposits and making loans (to use the conventional finance terminology for precision and conciseness), Islamic finance has expanded to the much wider range of financial products such as Sukuk and Takaful available today. This represents genuine innovation, where contractual structures were invented for Islamic finance which did not previously exist.

All such advances require Shariah scholars to interpret the original sources of the Quran and Hadith to decide how historic rules apply to new situations that simply did not exist at the time of Prophet Muhammad.

“ My key question is whether Islamic finance is innovating rapidly enough. At present, there are still important gaps in Islamic finance, where conventional finance has products that meet real human needs, and Islamic finance does not ”

For example, in IFN Volume 13 Issue 28, I discussed the International Swaps and Derivatives Association and the International Islamic Financial Market publishing innovative template documentation for Islamic foreign exchange forwards. There were no foreign exchange forward transactions when Islam arose. Creating this documentation required original thinking about how old rules apply in new situations.

My key question is whether Islamic finance is innovating rapidly enough. At present, there are still important gaps in Islamic finance, where conventional finance has products that meet real human needs, and Islamic finance does not. ☺



A close look at short-selling from an Islamic finance perspective

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The widespread media coverage of the GameStop Corp story motivated me to explain short-selling, since I find that it is widely misunderstood.

Imagine XYZ, listed on the stock exchange, priced at US\$20 per share. (I ignore bid-offer spreads for simplicity.) The price of a share is always clear; here it is US\$20. What a share is 'really worth', known as the 'value', is a guess. (Theoretically, it is the net present value of all its future distributions discounted at appropriate rates. All matters of opinion.)

If you believe the value of an XYZ share far exceeds its US\$20 price, you should buy it. (Known as 'buying long'.) However, what if you believe the value of an XYZ share is, say US\$5? Can you make money?

You can, by selling XYZ shares even though you do not own any. (Known as 'selling short'.) You first borrow shares from an existing owner; explained in the following for 1,000 shares.

You now sell the 1,000 borrowed shares for US\$20 each. The US\$20,000 proceeds restore the cash you paid to the escrow agent as collateral.

When XYZ shares fall, say to US\$10, you can buy 1,000 shares for US\$10,000, return them to the owner, recover your US\$20,000 collateral, and you will have made a profit of US\$10,000. Conversely, if the share price rises, you will lose money. For every US\$10 price rise, you must post another US\$10,000 collateral until you run out of money.

In my view, short-sellers perform a worthwhile social function by steering share prices downwards back into line with value.

Islamic finance scholars disallow short-selling based on some Hadith prohibiting the sale of what you do not already own. As explained in IFN Volume 17 Issue 48, I do not regard those Hadith as relevant when the legal mechanisms eliminate any risk of the sale defrauding anyone.

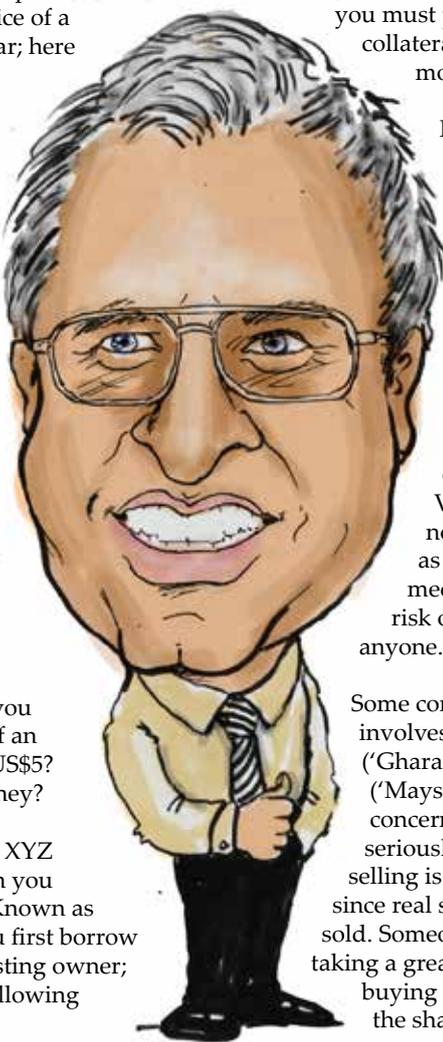
Some contend short-selling involves excessive uncertainty ('Gharar' in Arabic) or gambling ('Maysir' in Arabic). These concerns need to be taken seriously. In my view, short-selling is clearly not gambling since real shares are bought and sold. Someone selling short is indeed taking a greater risk than someone buying long and then holding the share, but whether that

uncertainty is excessive is a matter of their risk tolerance. The transactions are clear-cut, and there is no meaningful default risk.

“ Ultimately of course, each Muslim needs to decide for himself or herself what they consider to be the correct religious position since they are accountable to God for their own individual actions ”

Ultimately of course, each Muslim needs to decide for himself or herself what they consider to be the correct religious position since they are accountable to God for their own individual actions.

Despite being an investor for over 45 years, I have never sold short. I prefer to invest over long timescales, while short-selling is inherently short-term. For the same reason, I have never been a (long only) day trader. Also, I regard the downside risks, which are theoretically infinite, as not worth the finite upside. ☺



Issue	Resolution
Why should the owner lend you the shares?	You agree to pay rent of say five US cents per share per week.
Will you abscond and fail to return the shares?	You deliver US\$20,000 cash collateral to an escrow agent.
What happens to the dividends XYZ pays while the shares are lent out?	You undertake to pay cash to the owner equal to the amount of those dividends.
What happens if the share price increases, say to US\$30?	When prices rise, you deliver additional cash collateral; here it is US\$10,000.

Which locations will lead Islamic finance innovation?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I recently had a long conversation in which a senior executive of a Shariah compliant investment management firm briefed me about the firm and its product offerings.

In exchange, I suggested some additional products that I consider the Islamic finance market needs, even if customers were not actively asking for them.

I never promote individual businesses, so his firm will remain nameless. However, its main operations are in North America and the UK.

While I do not claim universal knowledge, my perception is that while Islamic finance was originally developed in Muslim-majority countries such as Egypt, with the main centers being the Gulf states and Malaysia, as time has gone on, an increasing share of innovation has come from the UK and North America. I appreciate that some will find that statement controversial!

Stepping back, assuming I am right, the obvious question is why? When there are so many more Muslim Islamic finance customers in OIC countries, why should the pace of innovation be greater outside the OIC where there are far fewer customers?

In my opinion, there are a number of factors.

Firstly, non-OIC countries have been in a 'catch up' situation. Initially, Islamic finance developed within the OIC countries as mentioned previously, while there were no offerings, certainly at a retail level, in countries like the UK until the mid-2000s.

Accordingly, significant innovation was needed simply to make Islamic finance products feasible in the complex regulatory and tax environment of the UK and North America.

Secondly, although the regulatory environment in the UK and North America is more complex than within the OIC generally, it is typically also easier to 'do business'. I have never forgotten the experience of a client about 14 years ago who was seeking to register a simple company in Bahrain.

After about six months the client abandoned Bahrain as a location, and was able to incorporate within one day in the UK. OIC environments that make it hard to do business generally are obviously not conducive to innovation.

With regard to Islamic finance, this may be even more significant. Many OIC countries have state Shariah boards which specify what is Shariah compliant in their territory.

This would obviously make it more challenging to obtain approval for new and innovative Shariah compliant products.

Conversely, in the UK and North America, the governments have no wish

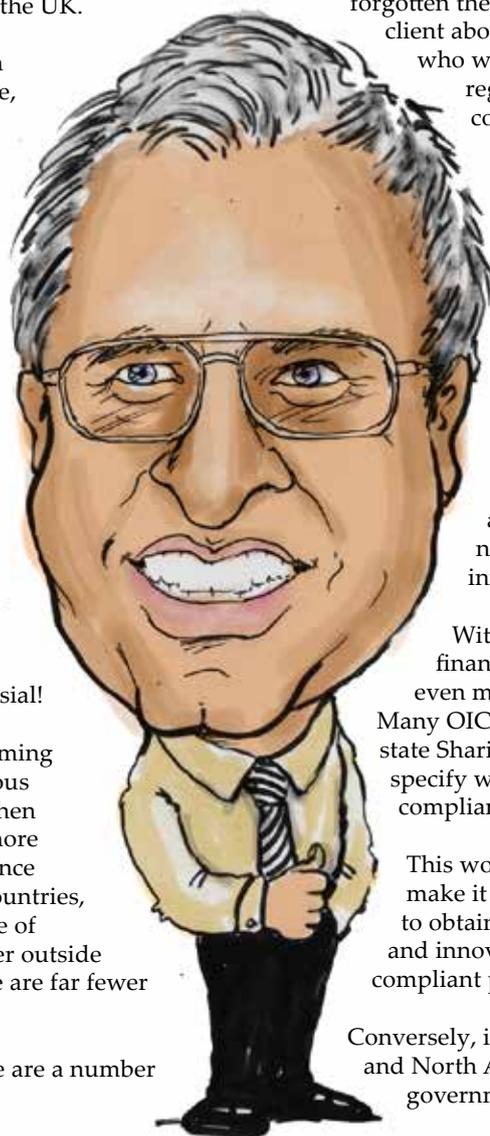
to say what is Shariah compliant. An innovator simply needs to ensure that their Shariah supervisory board (SSB) approves the new product, and that their SSB has credibility with potential Muslim customers.

“ While OIC countries have enormous populations, and therefore produce very large numbers of new graduates each year, I am skeptical about the quality of their education ”

Finally, and most controversially, in my view the mental skills and habits required for innovation are not evenly distributed. While OIC countries have enormous populations, and therefore produce very large numbers of new graduates each year, I am skeptical about the quality of their education.

In particular, in my opinion, education in OIC countries puts great emphasis on rote learning, respect for the opinions of the teacher, respect for the rules of the government and negligible emphasis on critical thinking and challenging what one is being taught. None of these are consistent with developing the ability to innovate.

In contrast, the entire educational model of the UK and North America is to develop individuals who can think independently and who will challenge received wisdom. ☺



Why Islamic finance contracts do not use traditional Islamic law (Fiqh)

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The foundation of Islamic finance is complying with Shariah requirements as interpreted by Shariah scholars. Accordingly, newcomers to Islamic finance are often surprised to discover that Islamic finance contracts are almost never governed by Fiqh.

Obviously, nobody should be surprised that UK Islamic banks use English law contracts subject to the jurisdiction of the courts of England and Wales. Much more remarkable is that most Muslim-majority countries rely upon commercial laws created by their legislators and subject to the jurisdiction of the courts established by the state. From time to time, courts in Muslim-majority countries do apply religious interpretations on top of state law; the instances vary from country to country and such religious deviations from state law often create commercial uncertainty.

The reasons why Fiqh is not used for commercial transactions as an exclusive free-standing law are a combination of individual countries' history and legal practicality.

The practical obstacles to relying exclusively on Fiqh are very real. In my view, the obstacles arise from a gap of many centuries when Fiqh failed to keep up with changes in the world.

Most obviously, and perhaps trivially, there is not a single

Fiqh but multiple ones, represented by the different schools of Islamic law. I call this obstacle trivial because both parties to the contract could specify the school of law whose Fiqh should govern the contract.

More seriously, even within the individual schools of law, Fiqh is not codified, either in the form of a binding precedent from previous judicial decisions or in statute. Indeed, there is no way of legislating in Fiqh given the underlying concept that Fiqh is derived from the original Islamic sources using the tools historically established for developing Islamic jurisprudence. (I recommend the book 'Principles of Islamic Jurisprudence' by Mohammad Hashim Kamali, founding CEO of the International Institute of Advanced Islamic Studies, Malaysia.)

As a simple example of the problems created by the inability to legislate for Fiqh, how would one derive an Islamic law of patents and specify what the standard life of a patent should be? The choice of any particular number of years is an entirely arbitrary political and economic decision.

There is simply no way of deriving a binding number of years for the life of a patent from the original Islamic sources and having that universally agreed.

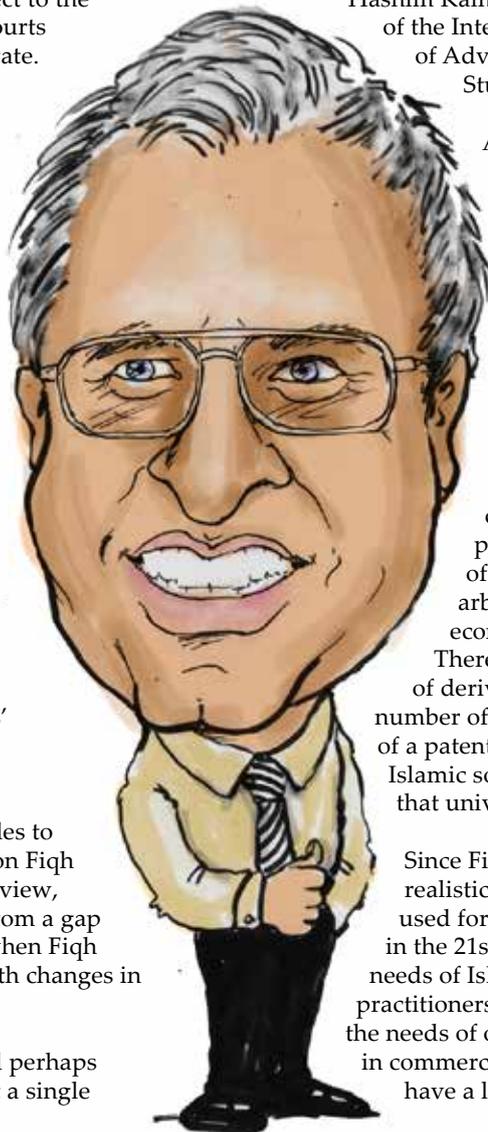
Since Fiqh is not, and realistically cannot, be used for commercial law in the 21st century, the needs of Islamic finance practitioners are the same as the needs of other participants in commercial life. That is to have a legislature which

enacts high-quality commercial law in their country which caters for modern commercial requirements, and is well drafted and unambiguous. Similarly, when it comes to legal disputes, the key requirement is to have state courts which function well, avoid backlogs of cases, with judges who understand commercial law statutes and previous case law, and who are incorruptible.

“ More seriously, even within the individual schools of law, Fiqh is not codified, either in the form of a binding precedent from previous judicial decisions or in statute ”

None of this requires the judge to have any particular religious views. The role of the judge is to interpret the contract, written under state law, and to ensure that the contract is properly applied.

It is for each contracting party to determine for themselves, at the time they sign the contract, whether it is Shariah compliant and at that time to obtain the approval of their Shariah supervisory board if so required. ☺



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Can the price of money in Islamic finance and conventional finance differ?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

When a UK Islamic bank finances you, whether short-term or long-term, the bank will always price the finance by:

- Looking up the sterling market interest rate for that term.
- Adding on a margin which reflects your circumstances and the bank's.

The same approach is used wherever Islamic finance and conventional finance exist side by side.

This way of pricing Islamic finance irritates many new to the subject. They ask: "Why does Islamic finance not have its own basic price for money, instead of being based on conventional interest rates?"

(My article 'Murabahah and the time value of money in Islamic finance' in the 11th January 2017 issue of IFN showed that Islamic finance incorporates the time value of money in the same way as conventional finance. Accordingly, when writing I use plain language such as the 'price for money'.)

The answer to the aforementioned question is very simple — arbitrage.

In any country where Islamic finance and conventional finance exist side by side, the population can be divided into two groups:

1. Islamic finance-only users: they will only deposit in, and borrow from, Islamic banks.

2. Conventional finance users: they are happy to transact with both Islamic banks and conventional banks, depending upon price. (For simplicity, I ignore entity-specific factors such as the credit risk of particular institutions or particular customers.)

While I would expect Islamic finance-only-users to all be Muslims, the conventional finance users will comprise both non-Muslims and Muslims who do not object to conventional finance.

Deposit rates: if an Islamic bank offers higher deposit rates than conventional banks, it will be flooded with deposits, attracting them from both Islamic

finance-only users and conventional finance users. Excess deposits that cannot be profitably lent are a nuisance for a bank. Accordingly, the Islamic bank would reduce its deposit rate until it no longer exceeded the conventional deposit rate.

The Islamic bank could however offer lower deposit rates than conventional banks, since the Islamic finance-only users have no alternative place to deposit.

Lending rates: a mirror image situation arises. An Islamic bank offering to lend money more cheaply than conventional banks will be flooded with a loan demand which will rapidly exhaust its available lending funds. It could only attract enough extra deposits to meet the loan demand by offering higher deposit rates than conventional banks, but the combined effect of its lending and deposit rates would be to seriously squeeze its profitability.

Again, the Islamic bank could offer lending rates higher than conventional banks, since the Islamic finance-only users have no alternative source to borrow from.

To summarize, Islamic banks' rates can differ from conventional banks' rates, but only in certain ways:

“ The Islamic bank could offer lending rates higher than conventional banks, since the Islamic finance-only users have no alternative source to borrow from ”

Deposit rates: these can be lower, but not higher.

Lending rates: these can be higher, but not lower.

This is probably not the scenario that advocates for a separate price for Islamic money are seeking!

It helps to consider how one might prevent the arbitrage as discussed. That would require the Islamic financial system to be hermetically sealed off, so that anyone willing to use conventional finance was prohibited from depositing money in, or borrowing from, an Islamic bank.

I do not regard such a sealing-off of the Islamic finance sector as feasible. Even if the country concerned had laws permitting discrimination on the grounds of religion, Islamic banks would still need to find a way of identifying and excluding those Muslims who were willing to use conventional finance. I do not see that as realistic in a free society. ☹



How is the UK Islamic banking scene?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Despite all the talk about innovation, most Islamic finance remains plain vanilla Islamic banking, either retail or corporate.

I was conscious that although I had written about their individual, generally lamentable, financial histories, I had not looked at the UK's Islamic banks collectively for a while. However, I was shocked to find I last did this in the **15th July 2015 issue**, when I looked at their 2014 accounts. Six years ago!

The UK has always been the leader in Islamic banking outside the OIC. In my view it still is. During the 2000s, new Islamic banks almost raced to be established, and eventually there were six.

Like all other banks, they struggled during the global financial crisis. Despite the crisis ending over a decade ago, they still struggle. The biggest reason is probably the one that affects all banks. That is the low interest rate environment due to quantitative easing in the dollar, euro and sterling. However, Islamic banks have also suffered from being subscale, combined with bad banking decisions.

Two have exited the UK banking market: European Islamic Investment Bank, later renamed Rasmala, and ADIB (UK). The four remaining divide naturally into the 'Big 2' and the 'Little 2'.

The largest is the UK's only retail Islamic bank, Al Rayan Bank. Until the 2014 takeover by Masraf Al Rayan of Qatar, it was called Islamic Bank of Britain and was

heading for failure due to making losses every year and being unsustainably small. The injection of new capital by its Qatari parent allowed it to begin financing home purchases.

Al Rayan's 2020 calendar year accounts confirm it as the largest Islamic bank in the UK, with assets of GBP2.34 billion (US\$3.32 billion), equity of GBP150 million (US\$212.75 million) and profits of GBP3.8 million (US\$5.39 million). The return on equity of 2.5% is nothing to be proud of. However, 2020 was overshadowed by the coronavirus pandemic, so staying profitable is an achievement.

Not far behind is corporate/investment bank Bank of London and the Middle East (BLME) with assets of GBP1.74 billion (US\$2.47 billion),

equity of GBP234 million (US\$331.89 million) and profits of GBP900,000 (US\$1.28 million).

The return on equity of 0.4% should not please anyone at the bank.

Comparing the change of Al Rayan's 2019 profits of GBP6.1 million (US\$8.65 million) to 2020 profits of GBP3.8 million with BLME's change from 2019 profits of GBP8.7 million (US\$12.34 million) to 2020 profits of GBP900,000 shows just how much greater the impact of the pandemic was on corporate banking compared with retail banking.

The first thing distinguishing the 'Little 2' from the 'Big 2' is that they have not published their 2020 accounts on their websites!

Each has their 2019 accounts published on its website but gives no reason why,

five months after the end of the year, the 2020 accounts are not yet published. The 2019 accounts of course tell us nothing about how the bank fared with the 2020 pandemic. However, they do show how much smaller these banks are than the 'Big 2'. Gatehouse Bank had 2019 assets of GBP685 million (US\$971.54 million), equity of GBP108 million (US\$153.18 million) and a loss of GBP3 million (US\$4.25 million). As this 2019 loss preceded any impact from the pandemic, I am not optimistic about its 2020 results.

“ The remaining bank, QIB (UK), had 2019 assets of GBP676 million (US\$958.78 million), equity of GBP67 million (US\$95.03 million) and 2019 profits of GBP4.4 million (US\$6.24 million). Again, I wonder how it found 2020 ”

The remaining bank, QIB (UK), had 2019 assets of GBP676 million (US\$958.78 million), equity of GBP67 million (US\$95.03 million) and 2019 profits of GBP4.4 million (US\$6.24 million). Again, I wonder how it found 2020. ☹️



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Why Islamic finance needs accounting standards

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The apparently obvious should occasionally be questioned. Why does Islamic finance need accounting standards and Shariah standards? These are distinct questions meriting separate columns.

The accounting profession began to develop modern accounting standards during the 19th century, driven by the multiplication of joint stock companies with publicly traded shares. Gradually, the accounts of different companies within the same country became more standardized. The pressure to standardize increased each time there was a major scandal involving distorted accounting.

International comparability came much more slowly. As recently as 1991, in Geneva, I gave participants at an international course the accounts of four giant bulk chemicals companies to review; one each from the US, the UK, Germany and Japan. Despite being very similar businesses, their accounts were dramatically different because accounting standards differed so much between their countries. That is why we needed international standardization!

Today, Islamic financial institutions account on a planet divided into four parts:

1. The US which ignores the rest of the world and uses its own Financial Accounting Standards as promulgated by the Financial Accounting Standards Board. As the world's largest economy, this separatism by the US matters, but with every year that passes, the US is a slightly smaller part of the global economy.
2. Almost all of the rest of the world uses International Financial Reporting Standards (IFRS) promulgated by the International Accounting Standards Board (IASB).
3. A tiny number of countries (when I last checked only Bahrain and Qatar) which require Islamic financial institutions to account using



- Financial Accounting Standards promulgated by AAOIFI.
4. A few isolated countries such as Iran where Islamic financial institutions account using local country accounting standards.

The IASB has an Islamic Finance Consultative Group to ensure that it takes account of Islamic finance. However, the most recent meeting I could trace was as long ago as the 27th March 2018, chaired by PwC Partner Mohammad Faiz Azmi of Malaysia.

Overall, I would say that users of Islamic financial institutions' accounts have basically the same needs as the users of accounts prepared by other financial institutions. They want to assess the profitability of the entity, and its viability and exposure to risks. However, they also have some additional needs. For example:

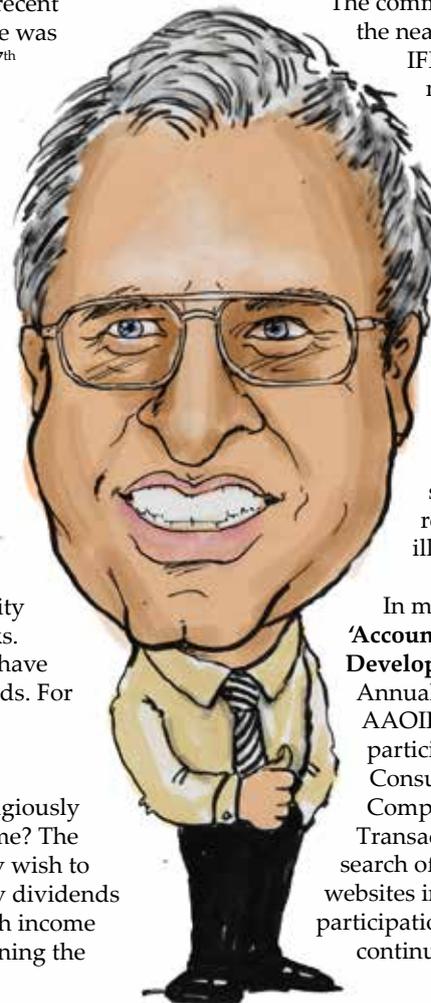
- Has the entity received any religiously prohibited income? The shareholder may wish to donate to charity dividends arising from such income rather than retaining the money.

- Has the entity paid Zakat on behalf of the shareholder? If not, what is the amount on which shareholders should pay Zakat?

However, apart from the aforementioned religious needs, the remaining needs of accounts users are the same, regardless of whether the financial institution is Islamic or not.

The commonality of needs and the near-universal adoption of IFRS are the reasons why my 9th February 2011 IFN article titled 'AAOIFI's Proper Accounting Standards Role' recommended that AAOIFI should stop issuing accounting standards and instead partner with the IASB to ensure that IFRS mandated disclosures which would help Islamic financial institutions' shareholders address religious needs like those illustrated previously.

In my contribution titled 'Accounting and Tax Developments' in the IFN 2015 Annual Guide, I noted that AAOIFI had agreed to participate in the IASB's Consultative Group on Shariah Compliant Instruments and Transactions. However, my search of the IASB and AAOIFI websites indicates that this participation appears not to have continued. (2)



Reflections on AAOIFI roundtable

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Last month, I was one of about 35 participants in a three-hour, invitation-only, experts roundtable (using Zoom) convened by AAOIFI. We discussed AAOIFI's Exposure Draft F2/2020 proposing changes to AAOIFI's Financial Accounting Standard 1 'General Presentation and Disclosures in the Financial Statements of Islamic Banks and Financial Institutions'.

By now, unless accounting for Islamic financial institutions is your speciality, your eyes may be glazing over! However, I realized afterwards that there were some important messages from the roundtable.

“ My conclusion is that AAOIFI now has greater self-confidence than when it first started, and no longer feels the need to demonstrate that it is different from, and independent of, the IFRS ”

For international meetings, video is the new default

Multinational corporations, Big 4 accounting firms and similar organizations have increasingly used videoconferencing since the mid-1990s. Although smaller organizations and individuals have had facilities such as Skype, usage has been relatively low and mainly by technically literate 'early adopters'. However, the explosion of Zoom usage during the coronavirus pandemic has transformed the scene.

While in-person conferences will resume (I am looking forward to attending the IFN UK Forum 2021 in London), I expect that discussions like July's AAOIFI roundtable will almost always be conducted online in future, even when there are no travel restrictions.

The lingua franca of Muslims is English

The workshop brought together people from the Gulf states, the UK, Pakistan, Malaysia and other locations. As readers would expect, it was conducted entirely in English, being the common language of the participants, just as Islamic Finance news has always been published in English.

Why not Arabic? After all, Arabic is the language of the Quran, of the Hadith collections and of almost all Islamic intellectual writing for the first six or seven centuries of Islam. However, the reality is that for non-Arabs the in-depth study of Arabic is only personally worthwhile for those seeking a career in academic Islamic studies. For everyone else, the career-enhancing move is mastering English.

AAOIFI has decided to stop duplicating IFRS

Various comments from the AAOIFI

participants left me with a clear, and very encouraging, personal impression. I stress that the following opinion is very much my own, formed from attending the roundtable. It should not be attributed to AAOIFI.

I believe that AAOIFI has decided that where International Financial Reporting Standards (IFRS) cover something well, and there are no Shariah issues, AAOIFI does not need to issue different standards, but instead will simply follow the IFRS, even to the extent of adopting the same language as the IFRS.

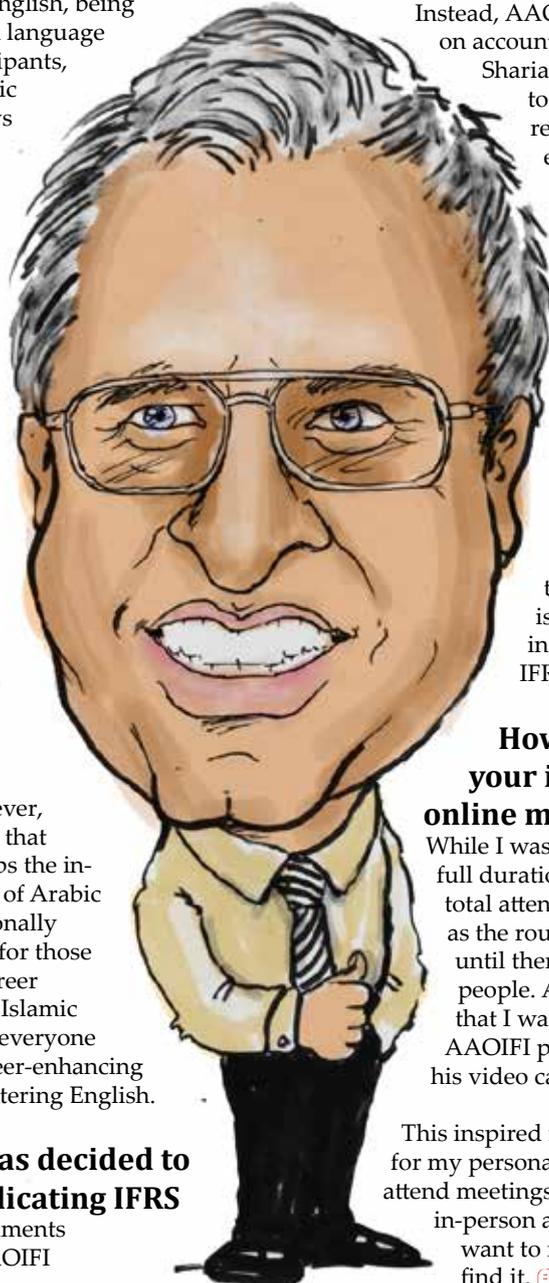
Instead, AAOIFI will concentrate on accounting matters where Shariah issues give rise to specific guidance requirements. For example, the treatment of assets financed by different types of profit-sharing investment accounts.

My conclusion is that AAOIFI now has greater self-confidence than when it first started, and no longer feels the need to demonstrate that it is different from, and independent of, the IFRS.

How to maximize your impact in an online meeting

While I was able to attend for the full duration of the meeting, the total attendance did decline as the roundtable progressed until there were only about 15 people. At one point, I noticed that I was the only non-AAOIFI participant who had his video camera on!

This inspired me to write an article for my personal website on how to attend meetings effectively, both in-person and online. If you want to read it, you will easily find it. ☺



The hard question in Islamic bank accounting

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Broadly speaking, Islamic banks do what conventional banks do, while complying with the requirements of Shariah scholars. The main economic difference is that Islamic banks offer profit-sharing investment accounts (PSIAs) where the PSIA's return is linked to the return on the Islamic bank's assets.

There is no uniform practice, and PSIAs take many forms. To list just two examples chosen to be at opposite extremes:

A. The bank's board considers the overall return on all of the bank's assets and decides how much to allocate to the PSIA holders. The allocation never exceeds a rate equivalent to market interest rates. The bank operates a profit equalization reserve, intended to allow it to pay PSIA account holders a positive return even in years when asset returns are low or negative.

B. The bank segregates all assets acquired with funds from PSIA account holders, using a legal structure which isolates those assets from the bank's creditors. While the bank charges a fixed percentage fee for managing the assets, 100%

of the asset return (after deducting the management charge), whether positive or negative, is allocated to PSIA account holders, with precise accounting to ensure that each account holder receives their exact share of the assets' returns.

Many intermediate scenarios are possible. For example, in the UK, the regulatory authority does not allow banks to allocate negative returns to PSIA holders, so PSIA accounts are always repayable in full except in the event of bank insolvency.

Scenario B of course replicates conventional asset management. Conventional banks often act as managers of collective investment schemes, which are structured to ensure that creditors of the asset managing bank have no claim against the scheme assets, which are located in a vehicle owned entirely by the investors.

Conventional banks with asset management businesses almost always disclose in their accounts the total value of such assets under management, since increasing them is normally an important business goal.

However, the assets are not included on the conventional bank's balance sheet, since they do not belong to the bank, either legally or economically.

Conversely, in scenario A, my view is that the bank has full legal and economic ownership of the assets, and they clearly belong on the bank's balance sheet. While the PSIA accounts have the characteristics of a liability, if the bank is legally able to allocate some asset losses to PSIA account holders, that needs proper reporting since it makes the bank's other liabilities less risky.

“Historically, Islamic banks have been very inconsistent in how they report PSIA accounts”

Historically, Islamic banks have been very inconsistent in how they report PSIA accounts. Occasionally, banks have excluded PSIA accounts from their balance sheet entirely (even in circumstances similar to scenario A), and also excluded an equivalent amount of the bank's assets from the balance sheet. This, of course, gives an unrealistically optimistic picture of the bank's ratio of equity/total assets.

I regard accounting for PSIAs as the most important question addressed in AAOIFI's Exposure Draft (F2/2020) v11.5 which I mentioned in my 3rd August 2021 column.

At the risk of extreme oversimplification, in circumstances similar to scenario A, the PSIA accounts appear on the balance sheet as 'quasi-equity' with disclosure in the balance sheet of the amount of assets financed jointly by quasi-equity and the bank's own equity.

Conversely, in scenario B, the assets concerned are off the balance sheet but with very full disclosure. I regard the overall recommendations as sensible and hope that they are implemented. ☺



The long-term future for global Shariah standards

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

When lecturing I often point out that Islamic finance is, in mathematical terms, a strict subset of conventional finance. Everything Islamic financiers can do, conventional financiers can also do if they wish. Conversely, many conventional finance transactions cannot be done by Islamic financiers, because they are prohibited for Shariah reasons.

Muslims' views on what complies with Shariah vary. One Muslim may regard Transaction X as permissible, while another regards it as prohibited. In the same way that governments set standards for some consumer products, such as bottled milk, governments in Muslim-majority countries typically specify rules for determining what financial products can be labeled as Shariah compliant in that country.

“ We should expect continuing differences in Shariah standards, with some geographies continuing to permit transactions that other geographies prohibit ”

For example, Malaysia requires all Islamic financial institutions to follow the views of the central bank's Shariah board. Muslim-minority governments such as the UK leave it to market

practice, since the UK government has no wish to regulate religion.

There is no reason to expect the governments of Muslim-majority countries to converge on a common set of Shariah standards. Views about Shariah vary not just between individual Muslims but also between geographies. The reason is that the different schools of Islamic law are not evenly spread; instead, different schools predominate in different geographies.

Against this background, AAOIFI has done a commendable job in promulgating a growing set of Shariah standards that have been approved by Shariah scholars from all geographies. Islamic financial products that comply with the AAOIFI Shariah standards should logically be acceptable to Muslim consumers in all jurisdictions.

I used to believe that this process would continue until full harmonization was achieved with two factors driving it:

A. Even if they cannot agree on all Shariah issues, scholars from all schools of Islamic law should be able to agree upon a core set of narrow and relatively restrictive Shariah standards acceptable to all of them.

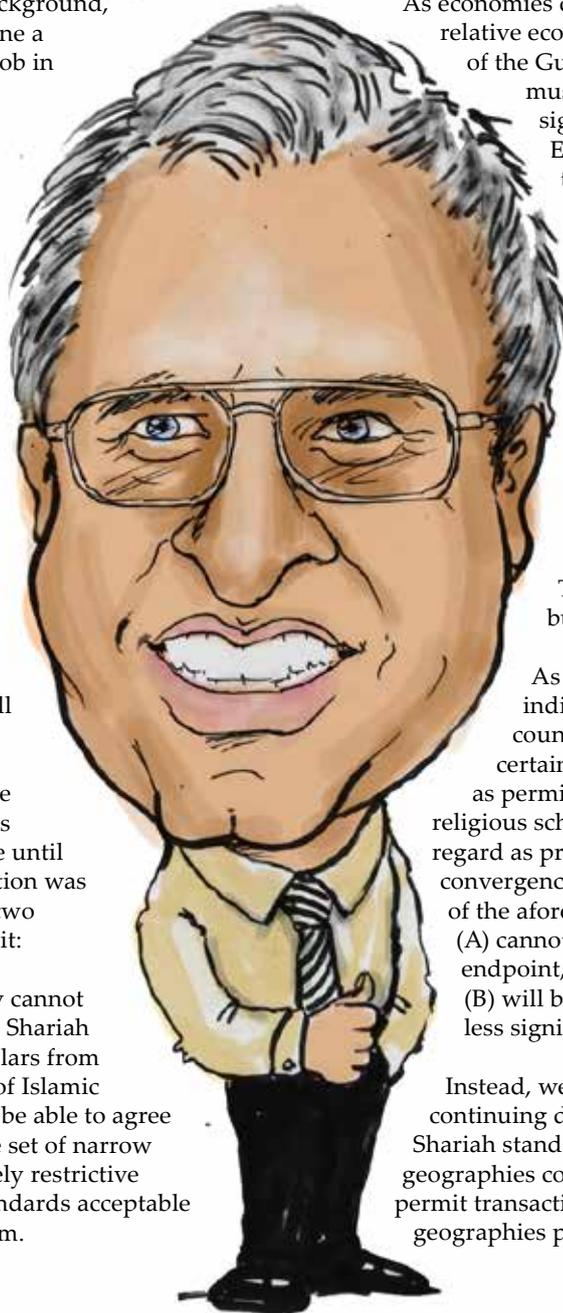
B. The geographies with the most restrictive views on Shariah compliance are the oil-rich Gulf states, which are the major capital exporters among Muslims. Accordingly, capital-importing countries would have to offer financial products complying with these narrow standards as in (A) above in order to sell those products to the capital exporters.

Now I am not so sure.

As economies develop, the relative economic weight of the Gulf oil states must diminish significantly. Eventually, as their economies grow, the GDP of Muslim-majority countries in aggregate will increasingly be represented by large-population countries such as Indonesia, Pakistan, Bangladesh and Turkey, to name but a few.

As long as individuals in those countries regard certain transactions as permissible which religious scholars elsewhere regard as prohibited, convergence along the lines of the aforementioned (A) cannot proceed to an endpoint, because factor (B) will become less and less significant over time.

Instead, we should expect continuing differences in Shariah standards, with some geographies continuing to permit transactions that other geographies prohibit. ☺



A personal perspective on cryptocurrency

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Almost every issue of IFN mentions new cryptocurrency offerings aimed at Muslim investors. The people's desire to speculate in cryptocurrencies like Bitcoin is perfectly understandable when you look at its price history.

Shortly after its launch, the price of one Bitcoin was well under one US cent. I read that on the 22nd May 2010 Laszlo Hanyecz made the first real-world transaction by buying two pizzas in Jacksonville, Florida, for 10,000 Bitcoins. Compared to that, by October 2021 the price of one Bitcoin has exceeded US\$66,000.

“ My fundamental question is that if conventional insurance has too much Gharar to be Shariah compliant, how does one justify Bitcoin being a Shariah compliant asset? ”

If you can successfully predict how the price of Bitcoin will fluctuate, you can of course make enormous amounts of money. Or lose it if your predictions are wrong!

The fact that owning Bitcoin can be promoted as Shariah compliant poses a very acute form of a wider question. Does the Shariah permissibility of Islamic finance derive just from its legal form, or is there a deeper underlying religious and moral principle? For example, the economics of a diminishing Musharakah home purchase plan are essentially identical to the economics of a conventional mortgage. Shariah scholars say that one is permissible, while the other is not permissible.

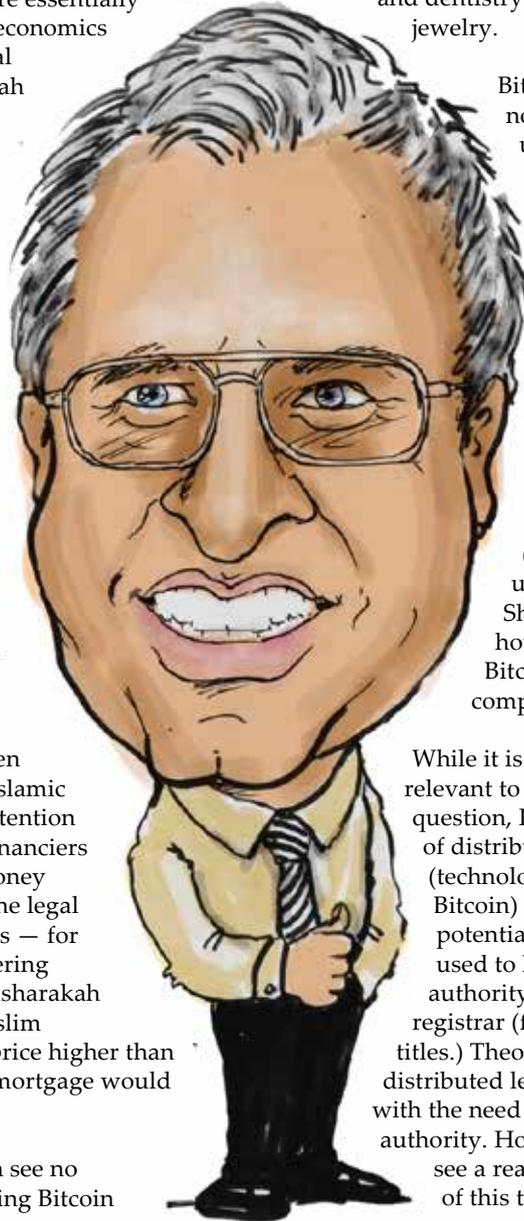
For many years, US scholar Mahmoud El-Gamal, the professor of economics and statistics and holder of the chair in Islamic economics, finance and management at Rice University in Texas, has been very critical of Islamic finance. His contention is that Islamic financiers simply make money by arbitraging the legal form of contracts – for example, by offering diminishing Musharakah contracts to Muslim customers at a price higher than a conventional mortgage would cost them.

Personally, I can see no purpose in owning Bitcoin

apart from speculating on its price fluctuations. It is not a useful medium of exchange because its price changes too quickly. While it is sometimes compared to gold or other commodities since their prices also fluctuate, the fundamental difference is that all other commodities are used to make things, even gold which has uses in electronics and dentistry quite apart from jewelry.

Bitcoin simply has no alternative use, unless you count paying ransom demands to terrorists as a valid use. Instead, the only reason for buying it is to speculate. My fundamental question is that if conventional insurance has too much Gharar (Arabic for risk and uncertainty) to be Shariah compliant, how does one justify Bitcoin being a Shariah compliant asset?

While it is not directly relevant to the aforementioned question, I do find the concept of distributed ledgers (technology which underlies Bitcoin) interesting and potentially useful. We are used to having a trusted authority as a central registrar (for example of land titles.) Theoretically, distributed ledgers can do away with the need for such a trusted authority. However, I have yet to see a real world application of this take off. ☺



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Why can't I find a Shariah compliant retirement annuity?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

My 'Letter from Amin' report in the 13th April 2016 issue of Islamic Finance news explained the need for Shariah compliant retirement annuities that you could purchase with your accumulated pension fund once you retire. As I wrote:

"Annuities are particularly appropriate for individuals with relatively lower pension fund amounts or other savings who cannot afford to have the continuing investment risk throughout retirement which the second alternative [leaving the pension fund invested and making periodic cash withdrawals as the retiree requires money to spend] entails."

“ Unless the retirement annuity provider is very well capitalized, it cannot afford the risks of holding equities or short-term Sukuk as investments while selling long period annuities ”

Almost six years later, when I searched, I could not find anyone actually offering such annuities. Why is this?

The most obvious answer is the challenge of devising a Shariah compliant structure. On the face of it, handing over money in exchange for the promise to pay you a fixed income each year until you die looks like a contract of

Riba (impermissible increase). Riba is of course prohibited in Islam.

However, many people have proposed structures for providing retirement annuities that would be Shariah compliant. I could even construct one myself, using a Takaful model. In the same way that a Takaful fund can pay you if the unfortunate event of dying occurs, it should be able to pay you every 12 months if you are suffering from still being alive! One is the mirror image of the other, and both create financial needs you need protecting against.

Indeed, commercially a Takaful operator which already provides death cover is a natural provider of annuities, since the two products have naturally offsetting risks if there is a change in mortality experience. If people live longer than expected, the extra losses on the annuity business should be matched by greater profits on the death cover business.

Instead, I believe that the absence of annuity providers arises from a number of commercial factors:

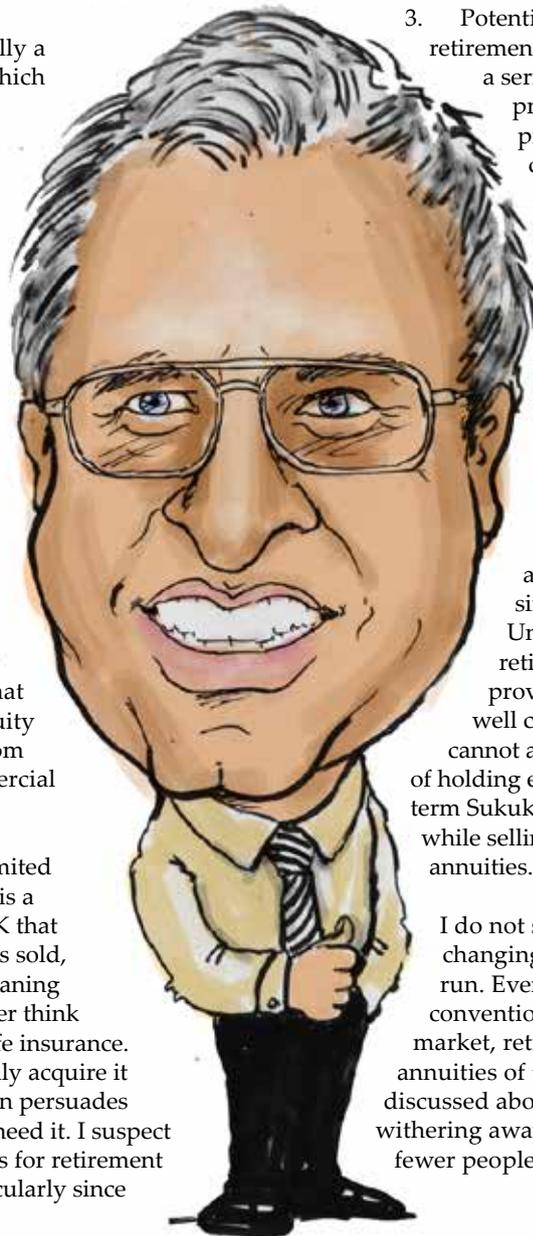
1. There is very limited demand. There is a saying in the UK that "life insurance is sold, not bought" meaning that people never think about buying life insurance. Instead, they only acquire it when a salesman persuades them that they need it. I suspect the same applies for retirement annuities, particularly since

Muslim-majority countries typically have very underdeveloped markets for long-term savings products. (You need the accumulated fund with which to buy the annuity.)

2. Market interest rates have been very low almost everywhere since the global financial crisis. That feeds through into lower yields on Sukuk, and therefore a lower yearly annuity payment for each US\$1,000 of purchase price. In turn, potential buyers decide annuities are not 'value for money'.

3. Potential providers of retirement annuities have a serious mismatch problem. At present, they cannot buy the long-term Sukuk that would match the long duration of annuity liabilities. If you are selling annuities that may last 20-plus years, you need income-generating assets with a similar duration. Unless the retirement annuity provider is very well capitalized, it cannot afford the risks of holding equities or short-term Sukuk as investments while selling long period annuities.

I do not see this changing in the short run. Even in the conventional finance market, retirement annuities of the type discussed above are withering away as fewer and fewer people buy them.☹



A day spent virtually in the GCC

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The widespread adoption of videoconferencing as a result of the coronavirus pandemic has made it much easier to pool widely dispersed expertise at minimal cost. The way I spent the 22nd December 2021 is a good example.

The morning was devoted to an online three-hour invitation-only roundtable meeting convened from Bahrain by AAOIFI. As I mentioned in my 3rd August 2021 column, AAOIFI has been consulting industry participants about Exposure Draft F2/2020 proposing changes to AAOIFI's Financial Accounting Standard 1 (FAS 1) 'General Presentation and Disclosures in the Financial Statements of Islamic Banks and Financial Institutions'.

“ Islamic financial institutions face the same governance challenges as conventional ones, compounded by the fact that most are based in OIC countries with underdeveloped governance codes and practices ”

To continue that process, AAOIFI has produced illustrative financial statements for Islamic banks and similar institutions to show how they would look under the proposed revisions to

FAS 1. They are extremely detailed; the draft version 27.4 supplied to roundtable participants was 57 pages long, even though it does not yet contain all of the risk disclosures normally needed in banks' accounts.

While Exposure Draft F2/2020 is on the **AAOIFI website**, as far as I can tell the illustrative financial statements were available only to roundtable participants.

As Islamic banks perform the same economic function as conventional banks (intermediating money between customers who have surplus funds which they wish to deposit/invest for shorter or longer periods with various risk profiles and customers who require short-term or long-term finance), I consider that Islamic banks' accounts should:

1. Look just like the accounts of conventional banks, since readers have the same information needs in both cases.
2. In addition, contain disclosures which enable readers to understand how the bank has complied with the requirements of its Shariah supervisory board.

My personal perception is that AAOIFI has a similar view, and that this can be seen in the illustrative financial statements which any reader of conventional banks' accounts would find very familiar.

In the afternoon, I attended the 3rd International Corporate Governance Conference organized by the Corporate Governance Centre

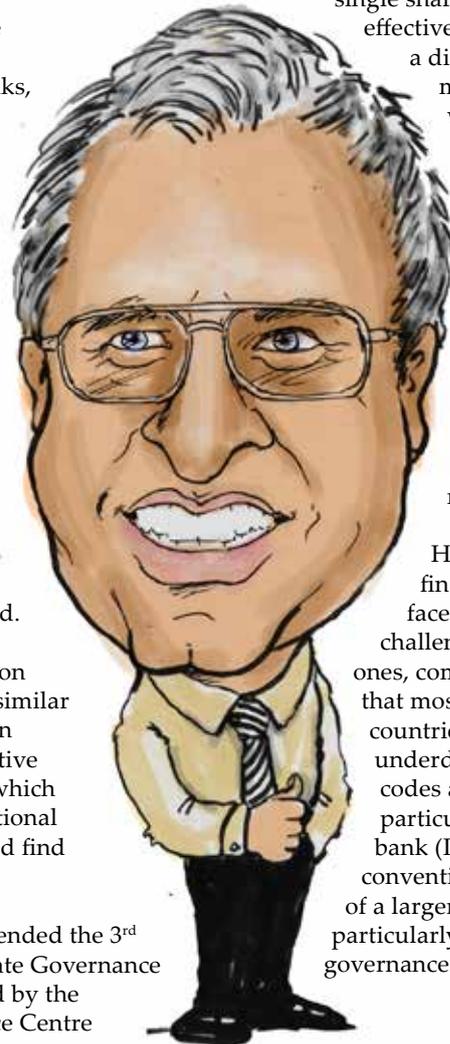
of Alfaisal University in Riyadh, Saudi Arabia, whose subject was 'Effective Corporate Governance and the Independence of the Board Audit Committee'. It was a hybrid conference, with an auditorium but with some of the audience online, as were I and the other keynote speaker.

The way I came to speak illustrates the modern world. The executive director of the Corporate Governance Centre, Assistant Professor Dr Mashhour Mourad, read my material on the internet, connected with me via LinkedIn, and then we got to know each other in a one-to-one Zoom meeting.

In my presentation, which is now available on my personal website, I set out to demystify corporate governance, and emphasized the major governance challenges that arise when there is a single shareholder who has effective control alongside a dispersed body of minority shareholders who have invested via a stock exchange.

The conference was not about Islamic finance, although I did answer a question from Dr Mashhour about how UK tax law has changed to facilitate Islamic mortgages.

However, Islamic financial institutions face the same governance challenges as conventional ones, compounded by the fact that most are based in OIC countries with underdeveloped governance codes and practices. In particular, when you see a bank (Islamic or conventional) which is part of a larger ownership group be particularly cautious about governance.☺



A quick look at Emirates Islamic Bank

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

To avoid missing mentions of myself in the media, several years ago I set up a Google alert on “Mohammed Amin” so that Google’s search engine would automatically tell me about any mentions in the previous 24 hours.

The unavoidable consequence is that most days I receive an alert because some random person with “Mohammed Amin” as part of his name is in the media. Usually they are politicians, but sadly I also see too many stories about criminals called Mohammed Amin!

Recently, for three days running, Google alerts told me about the 2021 preliminary results of Emirates Islamic Bank PJSC because its CEO is Salah Mohammed Amin. Those press reports led me to take a closer look.

“ This is a reminder of high levels of state ownership of business in the UAE and most other OIC countries. In my view, this is always a bad idea ”

Emirates Islamic Bank is the third-largest Islamic bank in the UAE, although it is much smaller than the largest, Dubai

Islamic Bank, which has about four times the assets. It has just announced the preliminary results for the year ended the 31st December 2021 as a profit of AED823 million (US\$224.04 million).

Obviously, the full 2021 financials are not yet available. However, from the bank’s website I had no problems downloading the 2020 annual report, financial statements and Basel II Pillar III disclosures.

Overall, I found the reports excellently informative. In my view the main reason is international standardization.

The accounts are of course prepared under International Financial Reporting Standards. As I have often said, the accounting standards promulgated by AAOIFI are used by very few countries and I see negligible likelihood of that changing.

The 2020 financial result was a significant loss of AED425 million (US\$115.69 million). That was no surprise given the impact of COVID-19 on economies everywhere, including the UAE. (The financial statements disclose the geographical distribution of the bank’s assets and show that its business is overwhelmingly domestic, both retail and corporate.)

The previous year, 2019, was presumably normal and the bank reported a profit of AED1.06

billion (US\$288.56 million). That represents a return of 12.7% on its 31st December 2019 shareholders’ equity of AED8,305 (US\$2,260.8). That return on equity is much higher than the figures I see for UK Islamic banks or indeed large UK conventional banks. Perhaps the UAE Islamic banking market is not particularly competitive. I may look more closely in a future article.

I had two other thoughts while looking at the report and accounts.

Firstly, the bank is a subsidiary of Emirates NBD Bank of Dubai which is a conventional bank. That replicates the pattern which I see very commonly around the world (except where it is legally prohibited) of conventional banks having an Islamic subsidiary. There is obvious scope for shared expertise and movements of personnel, compared with the challenges of running a small standalone Islamic bank.

Secondly, the ultimate parent company of Emirates NBD Bank is Investment Corporation of Dubai, a company in which the government of Dubai is the major shareholder. This is a reminder of high levels of state ownership of business in the UAE and most other OIC countries. In my view, this is always a bad idea. ☹️





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A closer look at the Bank of England's alternative liquidity facility

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I was very pleased to see the article 'Bank of England debuts much-awaited alternative liquidity facility for UK Islamic banks' in the 8th December 2021 issue of *Islamic Finance news* (IFN).

For many years, Islamic financial institutions in the UK have been pointing out that the absence of highly liquid, virtually risk-free, short maturity, sterling-denominated financial assets has made managing their treasury operations much more difficult. That has been particularly problematical because modern bank regulations require all banks to hold significant amounts of liquid risk-free assets.

The launch of the facility in December 2021 is another demonstration of the fact that achieving change always takes much longer than most might expect.

I raised the need for a liquidity facility as long ago as in the 4th July 2012 issue of IFN when responding to the following question which IFN posed to its Islamic finance experts panel: "What are the challenges that still exist among Islamic banks in relation to their treasury requirements and what should be done to further its development?"

Six years ago, my 9th March 2016 IFN column mentioned the February 2016 Bank of England consultation paper about such a liquidity facility. I subsequently responded to the consultation.

My 9th May 2017 IFN column reported that the Bank of England had issued a second consultation document in April 2017, to which I also responded. The consultation paper issued at that time, which is still available from the Bank of England website page, titled 'Shari'ah compliant liquidity facilities: establishing a fund based deposit facility' explains the Wakalah-based fund structure the Bank of England had in mind.

The Bank of England's Quarterly Bulletin for the third quarter of 2017 contained a very informative article titled 'Islamic banks and central banking'

by Arshadur Rahman of the bank's Sterling Markets Division.

It explained in excellent detail both the background issues summarized in my IFN columns and the detailed operations of the structure the Bank of England had in mind.

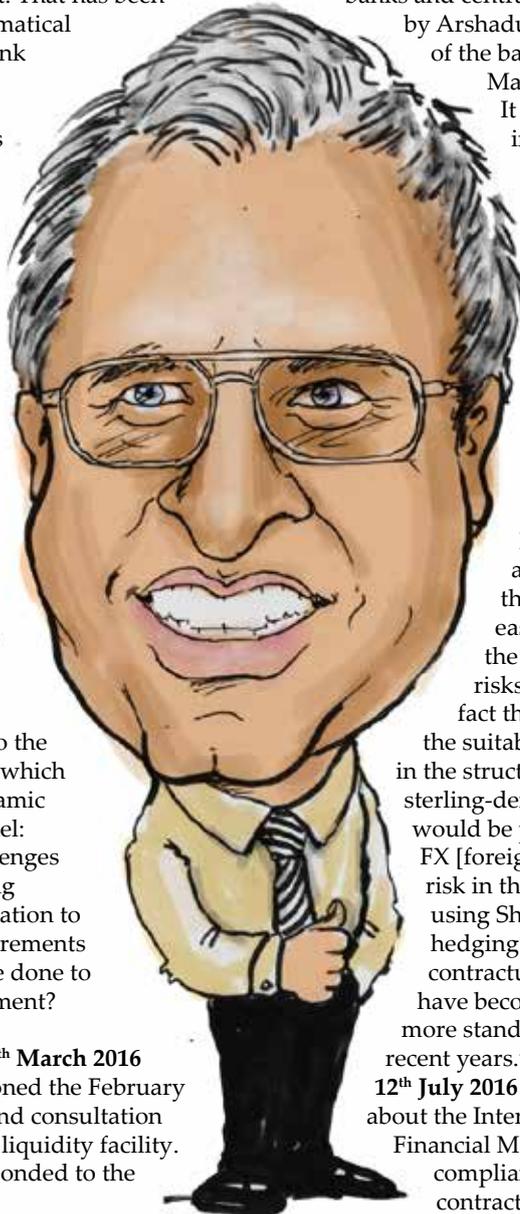
In particular, the article pointed out that it had become easier to address the foreign exchange risks arising from the fact that virtually all of the suitable Sukuk to hold in the structure were not sterling-denominated: "It would be possible to hedge FX [foreign exchange] risk in the portfolio using Shariah compliant hedging instruments, the contractual terms of which have become increasingly more standardised over recent years." See also my 12th July 2016 IFN column about the International Islamic Financial Market's Shariah compliant forward contracts.

When it launched the alternative liquidity facility, the Bank of England also published 22 pages of 'Terms and Conditions for Participation in the Bank of England's Alternative Liquidity Facility'. When you read these, it is quite clear that the arrangement is based on Wakalah, as presaged in the consultation papers and Arshadur Rahman's article.

“ What the Bank of England now needs to devise are Shariah compliant arrangements to enable it to make 'lender of last resort' loans to Islamic banks. That challenge has been deferred for the last six years! ”

However, consistent with long-standing UK government policy, the term 'Wakalah' or 'Islamic' appear nowhere in the terms and conditions document. As always, the text only uses standard English terminology, and religious language or issues are never mentioned. That has been the approach of the government for over 20 years, with commendable consistency.

Finally, the alternative liquidity facility only tackles one side of the balance sheet. What the Bank of England now needs to devise are Shariah compliant arrangements to enable it to make 'lender of last resort' loans to Islamic banks. That challenge has been deferred for the last six years! ☺



Low interest rates and the search for yield

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The global financial crisis was followed by a long period of very low, sometimes negative, interest rates in the major currencies such as the US dollar, euro, pound sterling and yen. The consequent derisory return on bank deposits led many to seek higher returns by investing in other assets.

Investing beyond bank deposits is of course reasonable. In my own case, 75% of my family's net worth is in equities. However, problems arise when someone unhappy with bank deposit returns fails to fully appreciate the risks of other investments.

I regularly meet people who directly compare bank deposit returns with the rental yield on property investment. While they formally acknowledge the risk that the property might fall in value, or that the tenant may cease paying the rent, their behavior indicates that in practice they disregard such risks.

The issues here are identical for conventional and Islamic finance. In both cases, investment in real estate should never be compared with bank deposits or profit-sharing investment accounts.

I met Irfan Khan, the founder and then-CEO of Yielders in mid-2018 when we both spoke in London on a panel about Shariah compliant fintech. He explained that his company organizes investment in real estate in fractional units. As its website www.yielders.co.uk



yielders.co.uk explains, you can invest as little as GBP100 (US\$131.11).

The website contains the standard risk disclosures. The pages describing how its offering works have the following line at the end, between the text and the footer: “*Past performance isn’t a reliable indicator of future performance.”

The footer on every page reads as follows:

“RISK WARNING:
Investments in property and unlisted shares carry risk and you may not receive the anticipated returns and your capital may be at risk. Yielders Limited is directly authorised and regulated by the Financial Conduct Authority (745636) Yielders Ltd. Company Number: 09757611 ‘Yielders Read More..’

Clicking “Read More” reveals the following additional text:

“Yielders does not provide any advice in relation to investments and you must rely on your own due diligence before investing. Please remember that property prices can go down as well as up and that all figures, rates and yields are projections only and should not be relied on. If in doubt, please seek the advice of a financial adviser.

Yielders Investments are only available to certain specified persons who are sufficiently sophisticated to understand the risks.’ Close.”

I assume these disclosures satisfy the UK regulatory requirements. However, my personal opinion is that the website has too much focus on returns, and not enough focus on risks, compared with what I consider appropriate.

I could not see any information about how many customer transactions (either by number or by value) Yielders has undertaken.

From the UK’s Companies House registry, I downloaded the accounts to the 31st December 2020. The available exemptions allow the accounts to not disclose a profit and loss account for the year. The accounts are unaudited since the company is not large enough for an audit to be mandatory and the shareholders have not required an audit.

I was dismayed by the balance sheet. There are accumulated losses of GBP753,000 (US\$987,288). Although shareholders’ funds are positive at GBP880,000 (US\$1.15 million), the largest single asset is a debt receivable of GBP579,000 (US\$759,150) for share capital issued but not paid, which is unusual to see on a balance sheet. There have also been several recent management changes, including the departure of Irfan as a director in August 2021. ☹️



When governments draft tax laws badly

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Taxation is the government legally taking your money to fund itself. In most countries, the legislature creates tax laws, which are administered by the executive part of the government. Subject to any constitutional constraints, the legislature can enact any tax laws that it wishes.

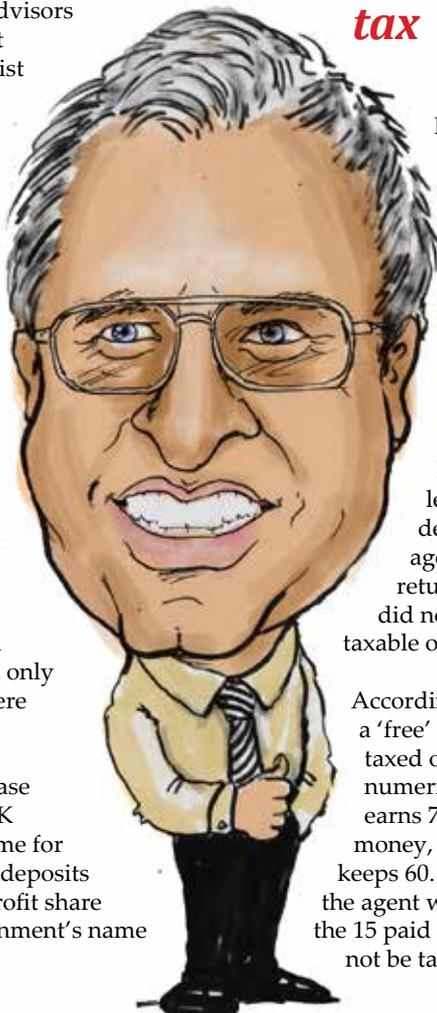
In my view, the sole obligation of the taxpayer is to pay those taxes which the law requires, and no more. If the tax law is badly drafted so taxpayers can rearrange their affairs to pay less tax, there is no moral impediment to them doing that. (Some countries do have specific laws to deny tax reductions arising from rearrangements that lack commercial justification.)

Similarly, I see no moral objection to tax advisors using their expert knowledge to assist taxpayers in reducing their tax liabilities if the relevant tax law is badly drafted.

However, there are exceptions. I had a very good example about 15 years ago.

When the UK first legislated for the direct tax consequences of Islamic finance in Finance Act 2005, only two structures were covered.

They were purchase and resale (the UK government's name for Murabahah) and deposits giving rise to a profit share return (the government's name for Mudarabah).



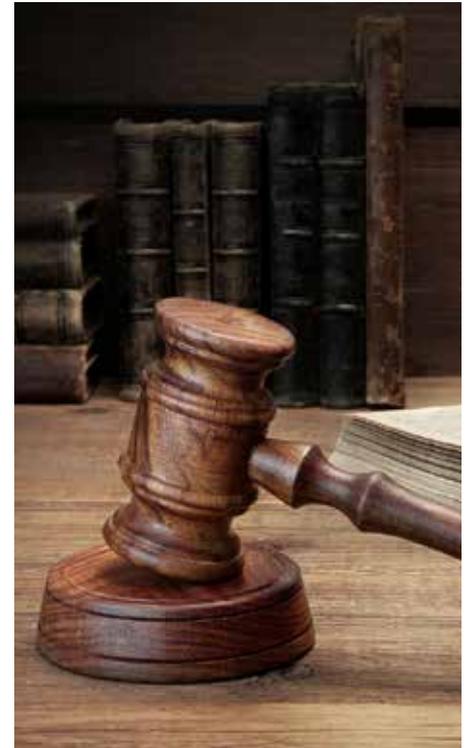
In Finance Act 2006, the law was extended to cover two more structures, diminishing shared ownership (the government's name for diminishing Musharakah), and profit share agency (the government's name for Wakalah).

“ Given my desire for the UK to adapt its laws to facilitate Islamic finance, the last thing I wanted was for the new legislation to be used to avoid tax ”

In a Wakalah transaction, the agent (Wakeel) uses the principal's money to earn a commercial return, part of which is then paid to the principal and part retained by the agent.

As soon as I saw the published text of Finance Bill 2006 (which became Finance Act 2006 once legislated), I identified a defect. The text gave the agent a deduction for the return paid to the principal, but did not make the agent initially taxable on that return.

Accordingly, the agent would get a 'free' tax deduction while being taxed on nothing. (To explain numerically, assume the agent earns 75 using the principal's money, pays 15 to the principal and keeps 60. Under the law as drafted, the agent would get a deduction for the 15 paid to the principal, but would not be taxed on anything!)



Given my desire for the UK to adapt its laws to facilitate Islamic finance, the last thing I wanted was for the new legislation to be used to avoid tax. This could damage the reputation of Islamic finance, and make the government less willing to legislate for it in future.

Accordingly, after consulting with colleagues at PwC, I wrote to HM Treasury to point out the drafting error in the Finance Bill.

The HM Treasury never accepted that the law was badly drafted.

However, two years later in Finance Act 2007 (governments are often slow closing tax loopholes), the law was revised to state explicitly that the agent was taxable on all of the commercial profits generated.

This succeeds in leaving the agent with the correct taxable income after deducting the return paid to the principal. Using the earlier figures, the agent's taxable income is 75 less a deduction for the 15 paid to the principal, making 60. That is the amount of the agent's net profit, so the agent is now taxed on the right amount.☺

Governments should stop privileging debt over equity

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Islamic banking is often described as banking without interest. Since finance is not free, Islamic banks charge in other ways for providing finance such as using Murabahah contracts. (Buying something for the customer and selling it on at a higher price with a disclosed markup.)

The UK and some other countries have rewritten their tax laws to ensure that the party being financed (the 'borrower') gets tax relief for such quasi-interest, provided that it corresponds to a charge for finance at market interest rates.

A wider question often arises in tax policy discussions. Is it sensible that interest (the cost of debt) is tax-deductible when there is no tax relief for the cost of equity capital? Especially since such tax relief for interest expense often leads to companies taking on more debt than they should, making financial distress more likely.

Simply abolishing tax relief for interest expense is not easy, even putting to one side the predictable howls of outrage from corporate borrowers.

The reason is that 'lenders' and 'borrowers' will, instead of having explicit interest provisions in their finance agreements,

devise workarounds. For examples of such workarounds, look at the range of contracts used in Islamic finance.

There would then follow a game of 'whack a mole'. Tax advisors would devise innovative ways of paying for quasi-debt finance in ways that obtained tax relief, while tax authorities regularly changed their tax laws to shut down such tax relief.

When you consider the likely political outcry if governments try to simply abolish tax relief for interest expense, and the extensive tax avoidance efforts that would follow on the part of corporate borrowers, it is more realistic to consider an alternative way of removing the current privilege that debt enjoys.

That is to introduce a new tax relief for the cost of equity, normally called an 'Allowance for Corporate Equity'.

The concept is very simple. Paid-in share capital and retained earnings would receive tax relief each year at a specified interest rate.

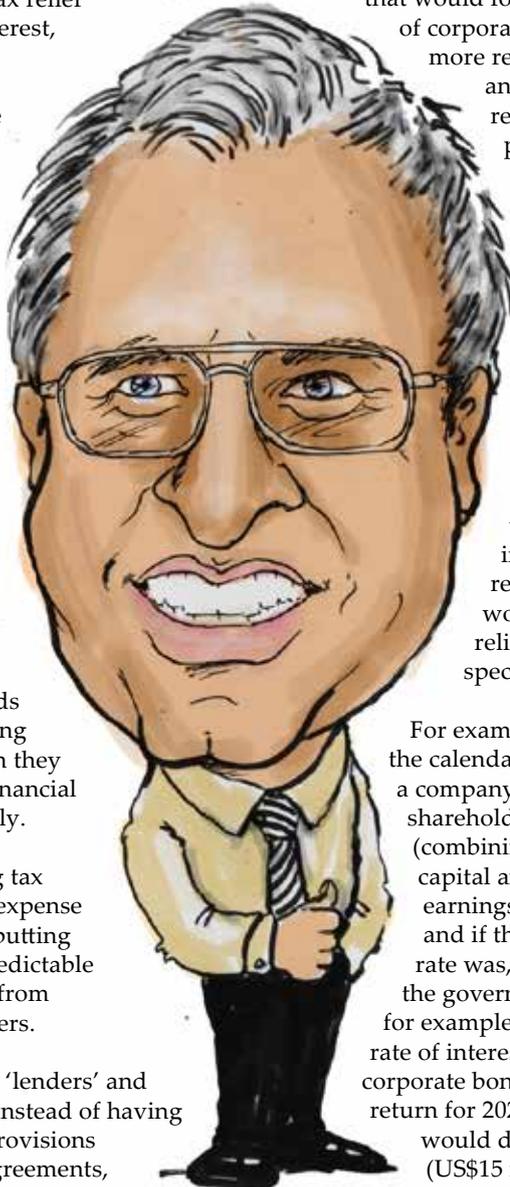
For example, if over the calendar year of 2022 a company had average shareholders' funds (combining paid-in share capital and retained earnings) of US\$15 million, and if the specified interest rate was, say, 3% (set by the government and based, for example, on the average rate of interest paid on 10-year corporate bonds), then on its tax return for 2022 the company would deduct US\$450,000 (US\$15 million x 3%).

Tax relief for interest expense would remain unchanged, but there would no longer be an artificial privilege for raising finance in the form of debt compared with raising finance in the form of equity capital.

“ Tax relief for interest expense would remain unchanged, but there would no longer be an artificial privilege for raising finance in the form of debt compared with raising finance in the form of equity capital ”

Since the introduction of tax relief for corporate equity would increase the total tax deductions available to the corporate sector, the way to compensate the government is to raise corporate tax rates so that, overall, the corporate sector pays the same amount of corporate tax after the change as it did before.

A small number of countries, such as Italy, Portugal and Latvia, have introduced schemes of this kind. However, I am not aware of any OIC country having done so, perhaps illustrating the general lack of policy innovation in the OIC. Logically, an allowance for corporate equity should be particularly appealing to OIC countries given many Muslims' distaste for interest-paying finance. (2)



Is trading KuCoin futures Halal or Haram?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I regularly receive Islamic finance questions from visitors to my website. An email last month asked me about something I had never previously heard of, KuCoin. The incoming text below has been edited for clarity and brevity.

"I have read your article about futures trading and the recommendation of Muhammed Hashim Kamali's book ['Islamic Commercial Law: An Analysis of Futures and Options.'] As most Islamic scholars consider cryptocurrencies Halal, will trading KuCoin futures perpetual be Halal or Haram?"

Some criticize it as based on gambling and excessive speculation. Will it be Halal to take leverage for such commodity because as per my knowledge leverage is Halal if there is no fixed interest on it and KuCoin does not charge a fixed interest; it adjusts profit depending on market in trading fees. Also, every eight hours KuCoin imposes a funding rate between long traders and short traders which includes interest that is not fixed but is calculated every time and varies every time. Is it Halal or Haram?"

I was able to reply without needing to even look at the KuCoin website because the enquirer had in my view gone through entirely the wrong thought process.

I began by reminding the enquirer that each Muslim has to decide for themselves what God



requires of them, since each of us is individually accountable to God on the Day of Judgment. Having made that preliminary point, I was willing to share my views.

In my opinion, fundamental factors make something Halal or Haram. It is not a question to be decided by applying a set of legalistic tests that can be, and often are, 'gamed' or 'maneuvered around'.

The starting point of the analysis is that buying and selling physical commodities is beneficial for society and therefore desirable. It is the very essence of trade, allowing producers to be more efficient by specializing. What then makes futures trading religiously acceptable is that futures trading has benefits for society by supporting the physical commodities market. For example, it enables farmers to plant with confidence, because they can know the future selling prices of what they will harvest.

Futures were invented for practical reasons, and only the ignorant believe they were invented primarily to enable speculation. However, speculators (people who have no need to buy or sell the underlying commodity) do play a useful role in futures markets by making

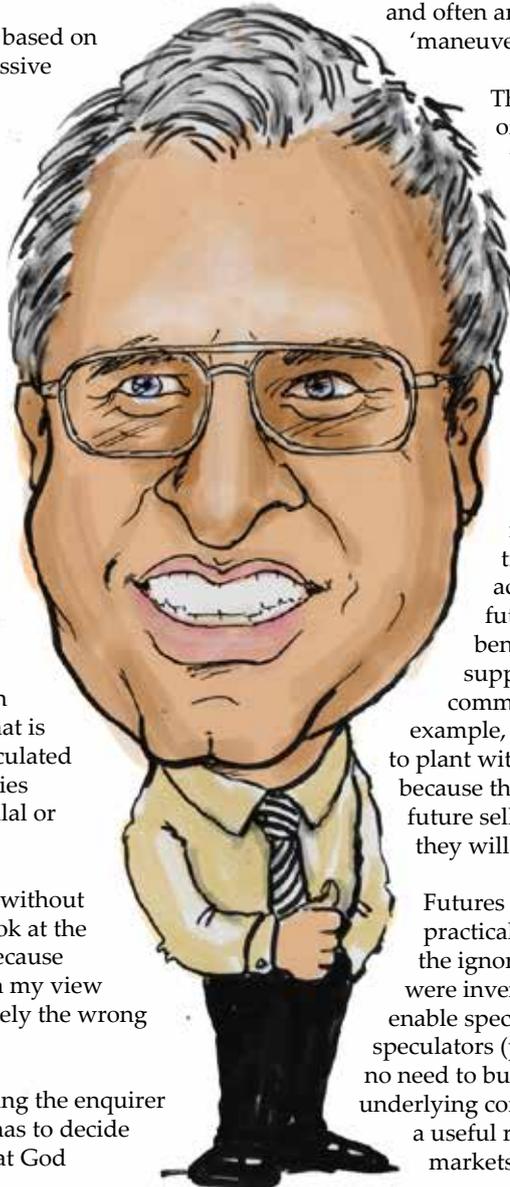
them more liquid, validating their involvement.

As I explained in *Islamic Finance news*, volume 18 issue 44, I see no social purpose in Bitcoin, or indeed other cryptocurrencies. If there is no social purpose in cryptocurrency itself, then there can also be no social purpose in trading cryptocurrency futures, whether Bitcoin, KuCoin or any other cryptocurrency.

“ If there is no social purpose in cryptocurrency itself, then there can also be no social purpose in trading cryptocurrency futures, whether Bitcoin, KuCoin or any other cryptocurrency ”

When writing this article, I spent some time on the KuCoin website. It provides both a spot and futures market. There are explanations for beginners which I had no trouble following but given my professional background, I start with a significant knowledge advantage.

I am not convinced that genuine beginners would understand what they are about to get into when they start trading futures on the platform. They should ask themselves honestly why they want to do it. ☹️



The UK government needs to tackle Shariah compliant refinancing

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

In my [column](#) of the 30th April 2018, I explained how a tax charge can arise if a UK taxpayer refinances a building that has appreciated in value, using a Shariah compliant structure such as diminishing Musharakah. Very briefly, unless the asset is exempt from capital gains tax (in most cases your principal private residence is exempt), you can end up triggering a taxable capital gain, even though your economic interest in the property has not changed.

I illustrated this by assuming that you had bought a building for US\$100,000, that it was now worth US\$1 million, and you were raising US\$750,000 by selling the building to an Islamic bank for US\$750,000 and buying it back using diminishing Musharakah.

Obviously, if you were using conventional finance, you would simply have taken out a US\$750,000 loan secured on the appreciated property, with no tax consequences. The diminishing Musharakah transaction triggers a taxable gain of US\$650,000.

That article mentioned that, with my help, the UK's Chartered

Institute of Taxation had raised the problem with HM Revenue & Customs (HMRC), proposing a change in the tax law to ensure equal treatment for Shariah compliant refinancing and conventional refinancing. HMRC eventually agreed that there was a problem, agreed that the tax treatment was unequal, but declined to ask the government to change the law. Effectively, they considered other priorities were more important — my words not theirs!

It is a growing problem. I was recently contacted by a tax advisor who has several clients in this situation.

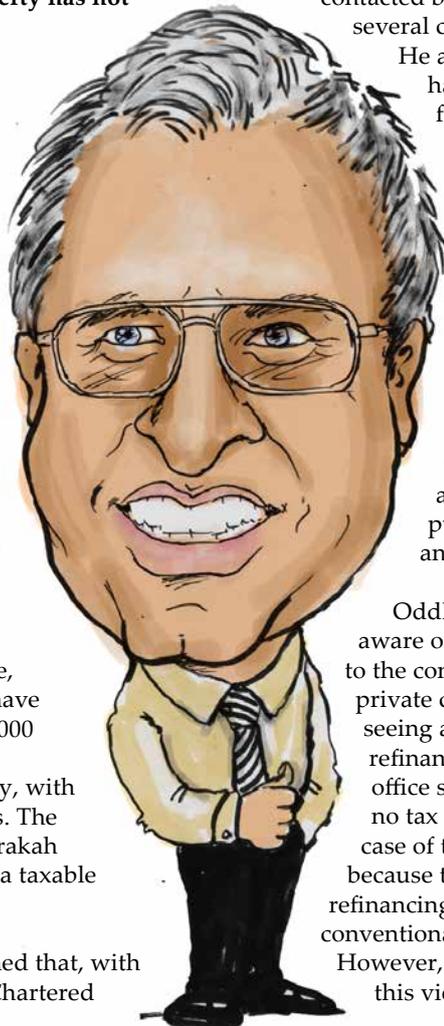
He asked me if HMRC had announced any form of concessional treatment to avoid the tax charge arising. I was not aware of any published concession, and a search of the government website while writing this article has failed to find anything. I will be pleased rather than embarrassed if any reader does find a published concession and sends it on to me!

Oddly enough, I am aware of one specific case to the contrary as a result of private correspondence. After seeing all the details of the refinancing, a HMRC head office specialist decided that no tax charges arose in the case of that specific taxpayer because the Shariah compliant refinancing was equivalent to a conventional refinancing. However, as mentioned above, this view in that one case has

not led to a published concession that I can find. Furthermore, while the head office specialist's decision is clearly fair and sensible, in the absence of a formal decision by HMRC to consciously not apply the existing tax law, I consider that his decision was unique as a simple matter of legal interpretation of the transactions undertaken in a diminishing Musharakah refinancing, and therefore open to further scrutiny and testing.

“ As there are more such transactions with every year that goes by, the UK needs a proper solution, preferably in the form of legislation, or otherwise in the form of a published HMRC concession that all taxpayers can rely upon ”

As there are more such transactions with every year that goes by, the UK needs a proper solution, preferably in the form of legislation, or otherwise in the form of a published HMRC concession that all taxpayers can rely upon. ☺







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Retail Islamic banks need to become internet-only

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I have written about the UK's first (and so far only) retail Islamic bank, originally called Islamic Bank of Britain (IBB) and now called Al Rayan Bank, on a number of occasions. Most recently, in the 2nd June 2021 issue, I looked at the calendar 2020 results. In that year, it made a profit of GBP3.8 million (US\$4.39 million).

“ Obviously, some customers will be lost as there are always some individuals who cannot cope with internet banking ”

I wrote: “The return on equity of 2.5% is nothing to be proud of. However, 2020 was overshadowed by the coronavirus pandemic, so staying profitable is an achievement.”

I have been looking at the bank again, in particular because a journalist asked me for my opinion on the closure of its last branch serving regular retail customers. (It has retained a branch in the upmarket area of Knightsbridge, London, to serve

high-net-worth individuals and GCC customers.)

My reaction can be summarized as: “About time!”

I recall several conversations only a few years after the establishment of IBB with the then-CEO. The bank was losing money heavily (see my historical summary of the results in the 6th February 2019 issue.) I explained that branches were just an expensive way to incur costs, and that being internet-only would be a much more cost-effective approach. While internet usage was not as widespread then as it is today, there were already internet-only banks such as Smile (a separate brand of The Co-operative Bank) and telephone-only banks such as First Direct (a separate brand of HSBC) as well as ING Direct which was a dedicated internet-only deposit-gathering bank.

IBB's view was that retail Muslim customers wanted physical branches. However, over the last few years, Al Rayan has recognized that branches are both expensive and unnecessary, and step-by-step it has closed its retail branches.

Obviously, some customers will be lost as there are always some individuals who cannot cope with internet banking. (While older people are often classified that way, as someone who has been an intensive internet user

since the mid-1990s and who is aged 71, I have no sympathy with anyone who claims they cannot use the internet due to their age!)

I was also asked why Al Rayan's assets were only GBP2.26 billion (US\$2.61 billion) (as reported in the 31st December 2021 balance sheet) when it states on its website that it has 90,000 customers.

My reaction was to do a comparison. Al Rayan's GBP2.26 billion of assets spread over 90,000 customers mean that assets per customer average about GBP25,000 (US\$28,908.5). Nationwide Building Society is much larger but has a similar retail banking focus. Its 2022 accounts report that Nationwide has 16.3 million members, and total assets of GBP272 billion (US\$314.52 billion), which is an average per member of GBP16,700 (US\$ 19,310.9). This makes the Al Rayan numbers look much more reasonable.

Looking at the wider picture, in 2021 Al Rayan made a profit of GBP9.6 million (US\$11.1 million), which is more than double the 2020 figure, and which represents a return on equity of 6.12%. Given that 2021 was still a very low interest rate environment (which always makes it hard for retail banks to make money), I consider 6.12% a very creditable rate of return on equity.

With the closure of its last branch serving regular retail customers, in my view Al Rayan finally has the right strategy for a retail Islamic bank in the UK. I look forward to seeing the future results. ☺



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Another look at the UK's largest Islamic investment bank

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

From shortly after it opened for business, Bank of London and the Middle East (BLME) has been the largest stand-alone Islamic investment bank in the UK.

In my 8th January 2019 column, 'Making money in UK Islamic banking is tough', I listed year by year the results for BLME's first 11 years. There were seven years when it made small profits, interspersed by four years of large losses, resulting in a cumulative loss by the 31st December 2017 of GBP31.6 million (US\$35.27 million).

I mentioned its 2020 results in my 2nd June 2021 column, 'How is the UK Islamic banking scene?' which was a first look at the UK Islamic banking sector after the COVID-19 pandemic. I reported that BLME made profits of GBP900,000 (US\$1 million) in 2020, commenting that: "The return on equity of 0.4% should not please anyone at the bank."

“ It was credit impairment losses that primarily led to the poor results in the first 11 years ”

Today, instead of just looking at 2021, I am updating my cumulative table of BLME's results as shown in Table 1.

The profits made in 2018 and 2019 were the largest in BLME's history, since the highest profit in the first 11 years of operation was GBP4.3 million (US\$4.8 million) in the year ended the 31st December 2013.

The much-reduced profit in 2020 was understandable given the COVID-19 pandemic, and I would commend BLME in avoiding a loss that year. Sadly in 2021, BLME seems to have reverted to its previous history by reporting a significant loss.

Comparing the 2021 income statement with that for 2020 indicates that the main reasons for the worsening result in 2021 are an increase in credit impairment losses and a significant increase in 'Other operating expenses', especially legal and professional fees. It was credit impairment losses that primarily led to the poor results in the first 11 years.

Since 2013, BLME has been a wholly-owned subsidiary

of BLME Holdings which was listed on NASDAQ Dubai. A controlling interest in BLME Holdings was acquired by its largest shareholder, Boubyan Bank of Kuwait, in 2020, after which the company delisted and is now called BLME Holdings.

Since BLME is by far the largest subsidiary of BLME Holdings, it is no surprise that BLME Holdings also reported a loss in 2021, of GBP8.6 million (US\$9.6 million) (after excluding results attributable to minority interests in subsidiaries).

Something that seems to go unremarked is that all four of the UK's Islamic banks are now owned by foreign parents, with Al Rayan Bank and QIB (UK) both being owned from Qatar, and BLME and Gatehouse owned from Kuwait.

It is striking that none of the other countries which aspire to lead Islamic finance consider it worthwhile establishing in the UK. This indicates that they may share my view that the UK is a very challenging place in which to establish new Islamic banks, particularly given the incumbency factor which will now favor those already established here.☺

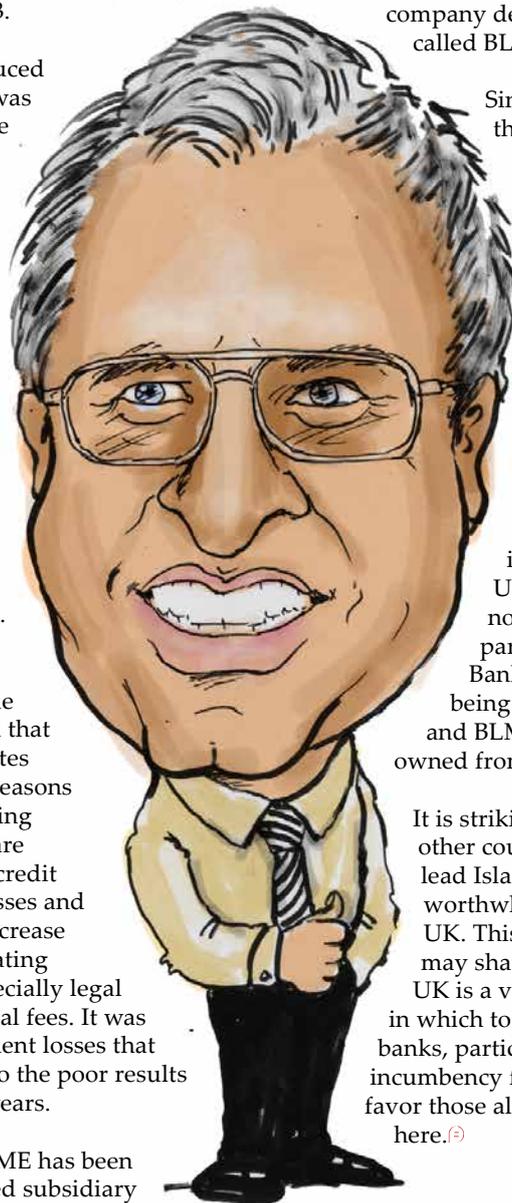


Table 1: Cumulative table of BLME's results

Calendar year	Profit/(loss) after tax (GBP million)	Shareholders' funds (GBP million)	Return on equity (%)
Cumulative to 31.12.2017	(31.6)		
2018	10.7	228.1	4.7
2019	8.7	233.5	3.7
2020	0.9	234.3	0.4
2021	(4.3)	229.7	(1.9)

Source: Author's own

Islamic banking is banking — with Shariah compliant contracts

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I was recently asked to speak at a conference with the theme: ‘The Role of Islamic Banking Towards Establishment of Socio-Economic Welfare: Potential, Challenges, Development & Future Prospects’. An Islamic finance acquaintance had recommended me based on my article titled ‘Governments should stop privileging debt over equity’ in the 1st June 2022 issue of IFN.

My 15-minute presentation will have the title of ‘Why companies prefer debt finance (whether conventional or Islamic) to equity finance. What could change this?’

The tax reasons were covered in my article mentioned above. However, there is a more fundamental point. As suggested by the conference title, many expect Islamic banking to produce different economic results to conventional banking. In my experience, they are regularly disappointed when it does not.

The early thinking about Islamic banking in the 1950s came from individuals with a religious background but limited understanding of economics. In my view, that is why ‘Islamic economics’ has gone nowhere as a subject. While being a Muslim should influence the way you see the world and your attitudes to fairness and justice, intellectually there is no more logic in talking

about ‘Islamic economics’ than ‘Islamic civil engineering’.

Over six years ago, my ‘A Letter from Amin’ in the 10th August 2016 issue of IFN explained why fixed return contracts predominate in Islamic banking.

People who put money into banks want to be able to get it back — in full. That is what regulators seek to ensure when setting the rules under which banks operate. In turn, that is why conventional banks make interest-bearing loans rather than equity investments, and why Islamic banks finance customers with fixed-return contracts rather than participating contracts such as Mudarabah.

Poor people who put money into banks simply cannot afford to lose it. That money may represent their only savings. Rich people can afford to lose money when investing, and often invest in equities and other risky investments. However, even rich people have some practical need to be able to hold money in a bank which they can rely upon in recovering in full. (They balance their equity investments’ risks by holding some safe investments such as bank deposits.)

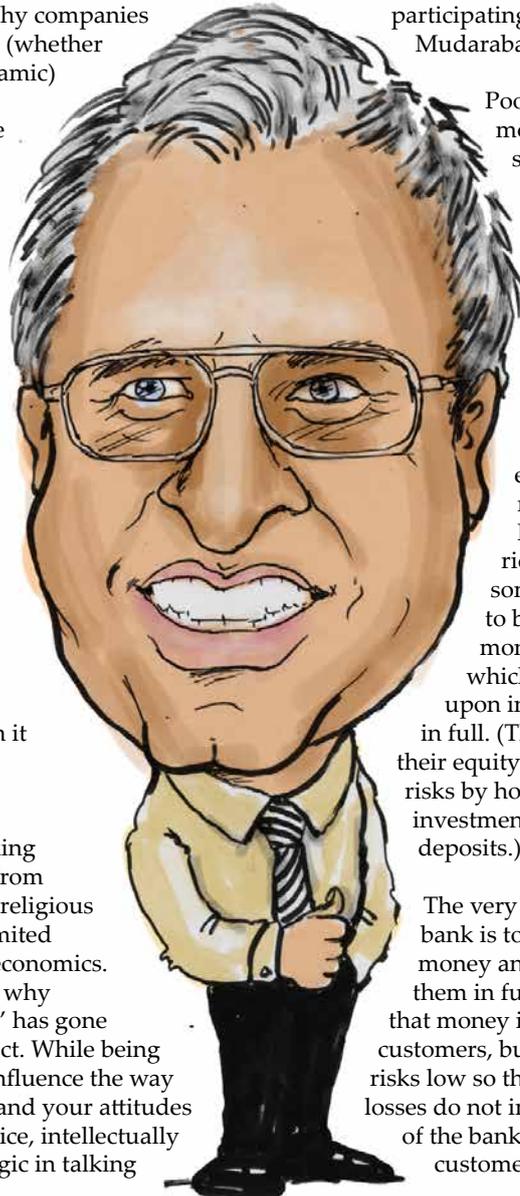
The very purpose of a bank is to hold customers’ money and return it to them in full. In between, that money is used to finance customers, but keeping the risks low so that any credit losses do not impair the ability of the bank to repay its customers in full.

In some countries, Islamic banks do engage in genuine participatory finance by operating Mudarabah funds. However, these are typically well segregated from their mainstream fixed-return financing, and funded by profit-sharing investment accounts where the customer is fully aware that they are taking on a genuine business risk and may lose part or all of their money. (Sadly, sometimes the disclosure may not be as good as it should be!)

“ While being a Muslim should influence the way you see the world and your attitudes to fairness and justice, intellectually there is no more logic in talking about ‘Islamic economics’ than ‘Islamic civil engineering’ ”

However, even when done by banks, such participatory financing activity is fundamentally different from mainstream fixed-return banking, just as conventional banks sometimes engage in operating equity investment funds for clients.

These distinctions between the mainstream banking operations and the running of equity-related investment funds apply equally strongly whether the bank concerned is conventional, using interest-based contracts or Islamic using Shariah compliant contracts. ☺



How are the UK's two smaller Islamic banks doing?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

My column 'How is the UK Islamic banking scene?' in the 1st June 2021 issue of IFN pointed out how the UK's remaining Islamic banks divided naturally into the 'Big 2' (Bank of London and the Middle East (BLME) and Al Rayan Bank) and the 'Little 2' (Gatehouse Bank and QIB (UK)).

At that time, neither of the 'Little 2' had published their 2020 accounts, so my column could only refer to their 2019 accounts to assess how they were doing. (All of the UK's Islamic banks produce accounts to the 31st December each year, which is helpful for comparability.)

My 6th September 2022 column included a look at Al Rayan's 2021 results, and the following month the 4th October 2022 column took a relatively detailed look at BLME's 2021 results. To close out the set, I want to cover how the 'Little 2' performed in both 2020 (when the coronavirus pandemic was at its height) and 2021.

Starting with QIB (UK), in 2019 it had reported assets of GBP676 million (US\$830.68 million), equity of GBP67 million (US\$82.33 million) and profits of GBP4.4 million (US\$5.41 million), giving a return on equity of 6.5%, which in a low interest rate environment is tolerable albeit unexciting.

The key figures for 2020 and 2021 are summarized below:

	2021 (GBP million)	2020 (GBP million)
Assets	894.7	732
Equity	78.8	71.9
Post-tax profits	6.9	4.7
Return on equity	8.7%	6.5%

QIB (UK) should be commended for maintaining its performance during the very difficult year of 2020, and for raising its return on equity to 8.7% in 2021.

Conversely, Gatehouse Bank had reported for 2019 assets of GBP685 million (US\$841.73 million), equity of GBP108 million (US\$132.71 million) and a loss of GBP3 million (US\$3.69 million), with obviously a negative return on equity. I wrote in my column: "As this 2019 loss preceded any impact from the pandemic, I am not optimistic about their 2020 results."

Accordingly, I was surprised when I summarized the 2020 and 2021 results for this column as shown below:

	2021 (GBP million)	2020 GBP (million)
Assets	1,026.4	824.8
Equity	112.7	109.3
Post-tax profits	3.4	2.1
Return on equity	3%	1.9%

Although the 2020 return on equity was only 1.9%, at least Gatehouse avoided making a loss during the pandemic.

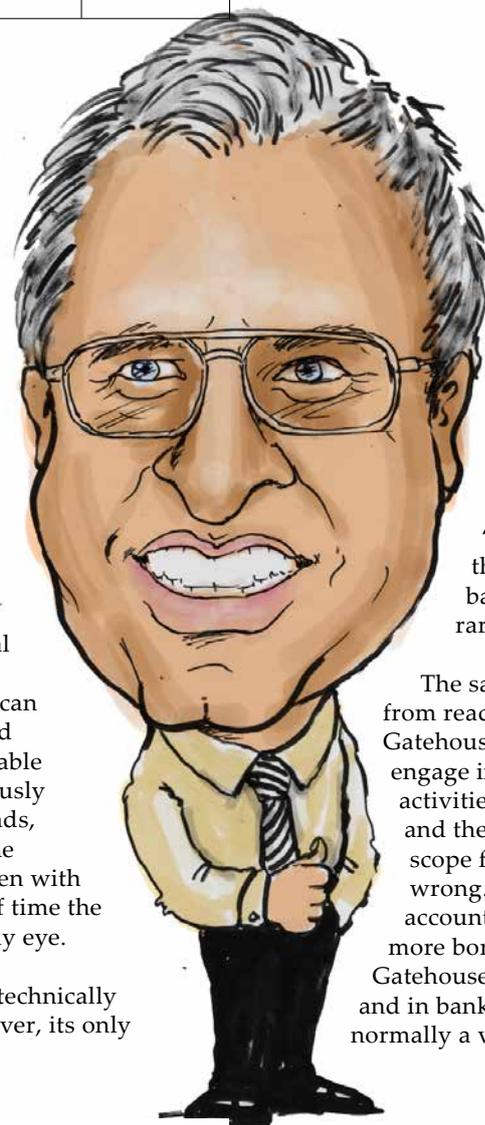
Given their similar sizes, the question I have been struggling with is why Gatehouse is doing so much worse than QIB (UK).

Even without access to confidential internal information, a significant amount can normally be gleaned from publicly available information. Obviously the longer one spends, the more reliable the conclusions, but even with a limited amount of time the following caught my eye.

Gatehouse Bank is technically a subsidiary. However, its only

parent company is Gatehouse Financial Group. That company has relatively few assets apart from Gatehouse Bank and overlapping directors, and I regard the two companies as essentially the same. Accordingly, Gatehouse does not have a single controlling shareholder.

“ Although the 2020 return on equity was only 1.9%, at least Gatehouse avoided making a loss during the pandemic ”



Conversely, QIB (UK) is a wholly-owned subsidiary of Qatar Islamic Bank, which presumably keeps a tight grip on its subsidiary. I would expect that to mean QIB (UK) does fewer 'exciting' things than Gatehouse. In banking, 'exciting' is rarely good!

The same picture arises from reading the accounts. Gatehouse Bank appears to engage in a wider range of activities than QIB (UK), and therefore has more scope for things to go wrong. The QIB (UK) accounts are significantly more boring than the Gatehouse Bank accounts, and in banking 'boring' is normally a virtue! ☺

How is Germany's first Islamic bank doing?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I recently shared my column 'Retail Islamic banks need to become internet-only' from IFN's 7th September 2022 issue on my website, and then publicized it via social media.

This led to a reader commenting: "Just to mention that KT Bank in Germany still has branches and seems to work." I have now been able to take a look at the bank mentioned by the reader.

KT Bank is a wholly-owned subsidiary of Kuveyt Turk Participation Bank (the English translation of its name) of Turkiye. The parent company's website tells readers that KT Bank is the first Islamic bank in Germany and the eurozone, having received a full banking license under German law for the provision of a deposit and credit business in March 2015 and started business in July 2015. It now has four branches, in the cities of Berlin, Frankfurt, Mannheim and Cologne.

Banks often publish their accounts on their own websites. Unfortunately, I could not find KT Bank's financial statements anywhere on its website. The German Business Register website states that KT Bank's financial statements are filed with the District Court in Frankfurt, but the effort of purchasing them from the court was excessive.

Fortunately, the website www.thebanks.eu contains summarized financial data on 9,000 EU banks, including

KT Bank. However, only the total assets and the profit/loss figure are reported. I have tabulated those below.

The assets have grown rapidly.

	EUR millions
31st December	Assets
2015	54.42
2016	108.3
2017	193.43
2018	373.94
2019	549.33
2020	700.73
2021	861.74

The asset growth is what I would have expected for a newly established Islamic bank in a market where Islamic banking was not previously available. After all, Germany has a Muslim population of about 4.7 million.

However, the absolute asset figure is relatively small, taking the Muslim population into account. It suggests that retail Islamic banking in Germany faces the same problem as in the UK, namely that most Muslim citizens are not motivated to adopt it, regardless of what response they may give to surveys.

What was the price of the aforementioned growth?

	EUR millions
Year to 31st December	Profit/(Loss)
2015	-9.43
2016	-20.84
2017	-28.46
2018	-29.02
2019	-2.48
2020	0.28
2021	-0.71

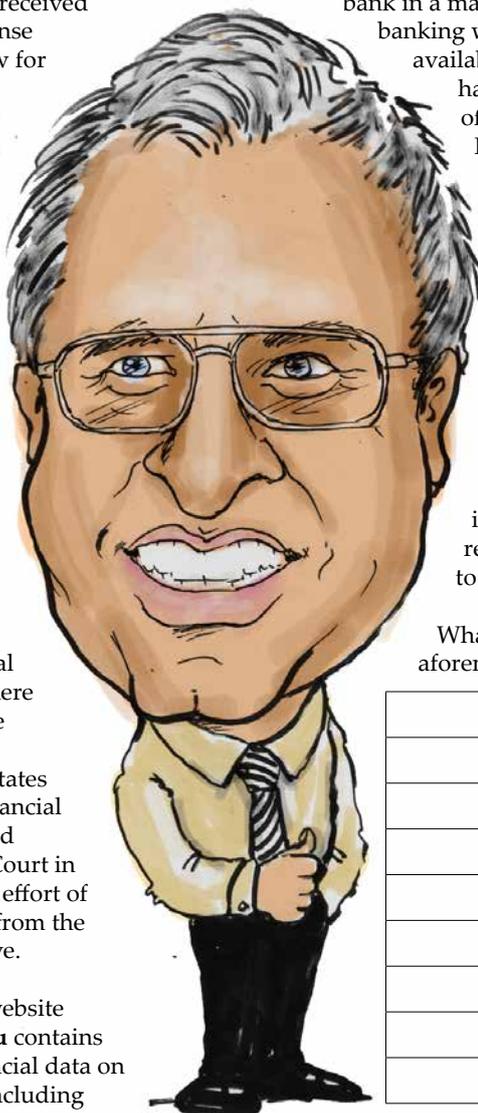
The profit and loss figures for each year are below.

The losses are no surprise, since new growing businesses often lose money.

“ It suggests that retail Islamic banking in Germany faces the same problem as in the UK, namely that most Muslim citizens are not motivated to adopt it ”

A useful way to understand these losses is to compare the aforementioned results with those of the UK's only retail Islamic bank, Islamic Bank of Britain (IBB) (now called Al Rayan Bank) which I listed in my 6th February 2019 column. IBB never lost as much money in any one year as KT Bank did in the years 2016–18, but IBB lost money for a longer period. I suspect that KT Bank has benefited from the experience and knowledge its parent company provided to get to a stable position more quickly than did IBB.

However, KT Bank is not generating anything like an acceptable return on equity. Using my reader's word above, it is not "working"! ☹️



What is the extra cost of Islamic equity investing?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Having spent the day drafting a response to the UK Financial Conduct Authority's Consultation Document CP22/24 'Broadening access to financial advice for mainstream investments', I cannot stop thinking about low-cost global market capitalization weighted ETFs (exchange-traded funds).

Very briefly, I believe that unless they are particularly knowledgeable about investing, such an ETF is the only equity investment that individuals should buy.

Extensive research shows that over the long run, most active investment managers (meaning investment managers running funds that seek to select shares they expect to outperform) fail to beat stock market indices once the higher charges of the active manager are taken into account. (ETFs of this type have low charges since all of their processes can be computerized, and they engage in relatively few buying and selling transactions.) While some managers do beat the market index, the problem is identifying them in advance rather than retrospectively.

“ Conventional ETF has a total expense ratio of 0.24% per year, while Islamic ETF's total expense ratio is 0.3% per year ”

In my 6th June 2018 IFN column titled 'Does having principles make you poorer or richer?', I asked whether a Shariah compliant investor should be expected to do better or worse than a conventional investor. (The data in the article was only about stock market indices because data on the universes of all Shariah compliant/conventional active managers is not available.)



Today, I want to tackle a different, but related issue. How do the costs of conventional and Shariah compliant ETFs compare? (It is well known that Islamic banking is typically more expensive than conventional banking. See my 8th March 2017 IFN column titled 'The relative costs of conventional and Islamic mortgages'.)

To make this comparison fairly, you need to look at two ETFs that are otherwise as similar as possible. I compared the following, which come from the same ETF provider, Blackrock, and which track similar indices:

- iShares MSCI World ETF ('Conventional ETF'), and
- iShares MSCI World Islamic UCITS ETF USD ('Islamic ETF').

Both track global developed market indices compiled by MSCI, and both use the technology and business infrastructure of their provider, Blackrock, which makes them as comparable as possible. As I expected, their sizes are very different. As at the 31st December 2022, Conventional ETF had total assets in 2022 of US\$2.5 billion while Islamic ETF had total assets of only US\$375 million.

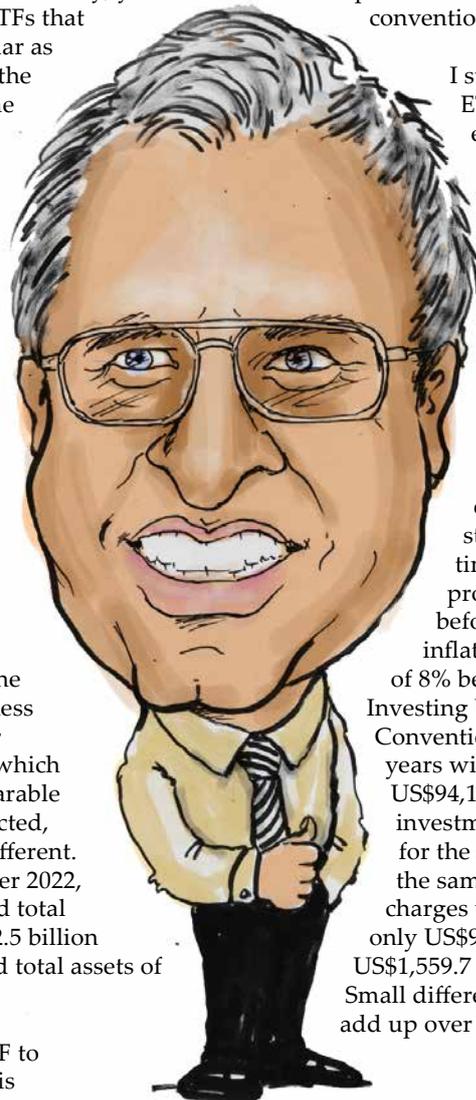
I expected Islamic ETF to cost more, because it is

much smaller, and because Shariah screening entails costs that conventional investing does not. Accordingly, I was pleasantly surprised to find that the cost differential is smaller than I expected. Conventional ETF has a total expense ratio of 0.24% per year, while Islamic ETF's total expense ratio is 0.3% per year. The extra cost, 0.06% per year, may not seem much, but it means Islamic is a quarter more expensive than conventional.

I suspect that Islamic ETF receives an effective cross-subsidy, since if it had to replicate Blackrock's computer technology just for itself, the costs would be prohibitive with assets of only US\$375 million.

The effect of the extra charges is still significant over time. I always use a projected nominal (ie before allowing for inflation) rate of return of 8% before charges.

Investing US\$10,000 in Conventional ETF for 30 years will leave you with US\$94,129.87 whereas an investment in Islamic ETF for the same 30 years with the same 8% return before charges will leave you with only US\$92,570.18, which is US\$1,559.7 or 1.68% less. Small differences in charges add up over time! ☹️



How a transaction is done normally changes its tax treatment

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Like many previous columns, this one was inspired by an enquiry from a website reader.

This person has diminishing Musharakah finance provided by a UK Islamic bank on some UK real estate that is not the person's principal private residence. (A gain realized by selling a principal private residence is normally exempt from capital gains tax.) The real estate is let by the person to some tenants, who are legally the person's subtenants since the person is renting from the bank the share of the property which is not owned by the person. There is more than one property involved.

This real estate needs to be refinanced for two possible reasons:

- In the case of some properties because the nature of the person's subtenants is going to change.
- In the case of some properties because the finance was at a fixed finance rate for a fixed period which is about to expire, and floating rate finance would be too expensive so another fixed rate financing is desired.

As I have mentioned on several occasions, most recently in my column of the 3rd August 2022 titled 'The UK government needs to tackle Shariah compliant refinancing', there is no general relief from

capital gains tax when real estate is refinanced using Shariah compliant bank finance. That is unfair because no such tax charge arises on conventional real estate refinancing. The UK failure to correct this anomaly looks even more unreasonable once you are aware that there is relief from capital gains tax when real estate is sold to an SPV to enable the issue of Sukuk!

In this case, the existing Islamic bank may be willing to refinance the property. However, I understand from meeting the person that the bank wishes to carry out the refinancing as follows.

Assume for ease of understanding that the real estate originally cost GBP10,000 (US\$11,939.2), and that by now the person has paid GBP2,500 (US\$2,984.8) to the bank to purchase 25%, while the remaining 75% belongs to the bank and is being rented from the bank by the person under the diminishing Musharakah contract. Assume also that the property is now worth GBP100,000 (US\$119,392).

Step 1 – The bank sells its 75% to the person for GBP75,000 (US\$89,544).

Step 2 – The person immediately sells that 75% back to the bank for GBP75,000 and enters into a new diminishing Musharakah contract at the new fixed rental rate, with the appropriate subletting provisions.

While this seems logical to the bank's lawyers, the UK tax rules work as follows:

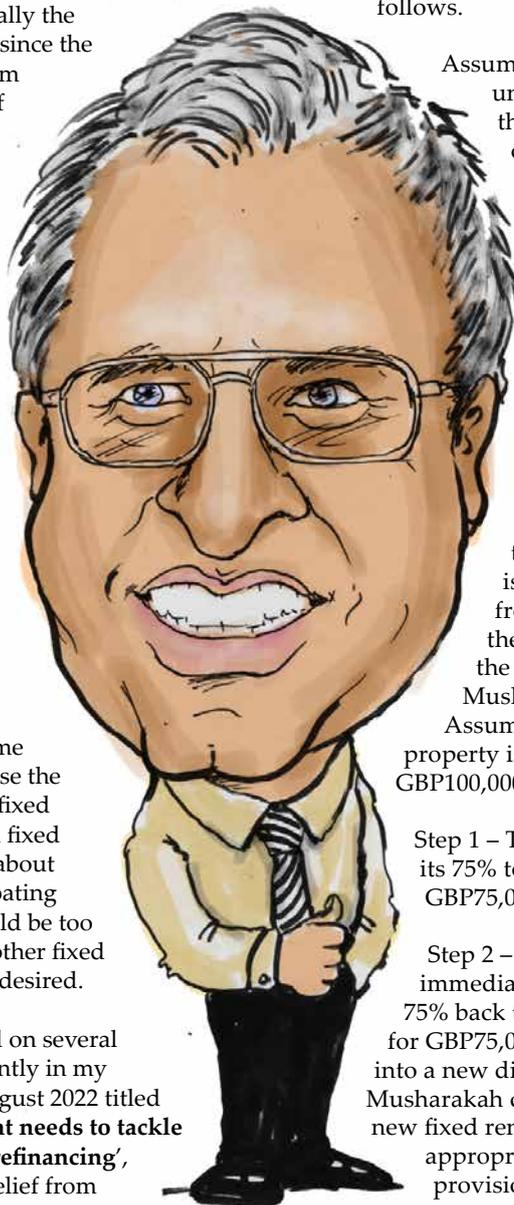
- After Step 1, the person owns 100% of the property, having paid GBP77,500 (US\$92,528.8) for it (namely GBP2,500 + GBP75,000).
- The person then sells 75% of the property to the bank for GBP75,000.
- 75% of the property cost the person only GBP58,125 (US\$69,396.6) (namely 75% of GBP77,500).
- The person has a taxable capital gain of GBP16,875 (US\$20,147.4) (GBP75,000 - GBP58,125).

“ While the UK needs to improve its tax law, in this case of refinancing with the bank being unchanged, the tax liability is entirely self-inflicted ”

While the UK needs to improve its tax law, in this case of refinancing with the bank being unchanged, the tax liability is entirely self-inflicted.

If the terms of the existing diminishing Musharakah contract were simply amended to vary the provisions determining the rent the person pay to the bank, and varying the subletting permissions, there would be no sale and sale-back of the bank's 75%, and no taxable gain should arise.

This example illustrates the general principle that there is often more than one way of carrying out a transaction, with different amounts of tax arising. (f)



Is buying shares gambling?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Every so often, family members and friends make the comment that buying shares is a form of gambling. However, last week I was very surprised to find the question being asked by someone who should know better – a friend who is a chartered accountant!

Gambling (in Arabic 'Maysir') is prohibited in Islam. That is the reason I do not gamble, even when it looks like a 'surefire bet' such as the money I could have made in 1997 by predicting the Labor Party's majority in that year's general election.

However, what is the essence of gambling that distinguishes it from other types of risks? For example, every time you drive your car from home to work, you might be killed in a car accident. You might even say that rush-hour driving is a 'gamble with your life'. However, it is clearly not gambling as prohibited by Islam.

In my view, the defining characteristic of gambling is that it involves the unnecessary and artificial creation of risk. The purest example is the game of roulette. When you stand beside a roulette table, there is absolutely no need to put

down a stake. Choosing to put down a stake which could be lost or conversely multiplied in your favor is a decision to create risk-based outcomes (depending upon the spin of the wheel) which are simply not needed.

Conversely, when you risk your life driving from home to work, you are doing so because you need to get to work.

With that preliminary background, we can now consider what happens when you buy shares in a stock market-listed company. You now own a very small percentage of the entire company. If the company makes a profit and chooses to distribute part of that profit to its shareholders, you will receive a cash dividend on your shares.

Even if the company is currently paying no dividends by retaining all its profits (as, for example, US company Apple did for many decades), those retained profits are being reinvested to expand the business and you hope to receive dividends in future years.

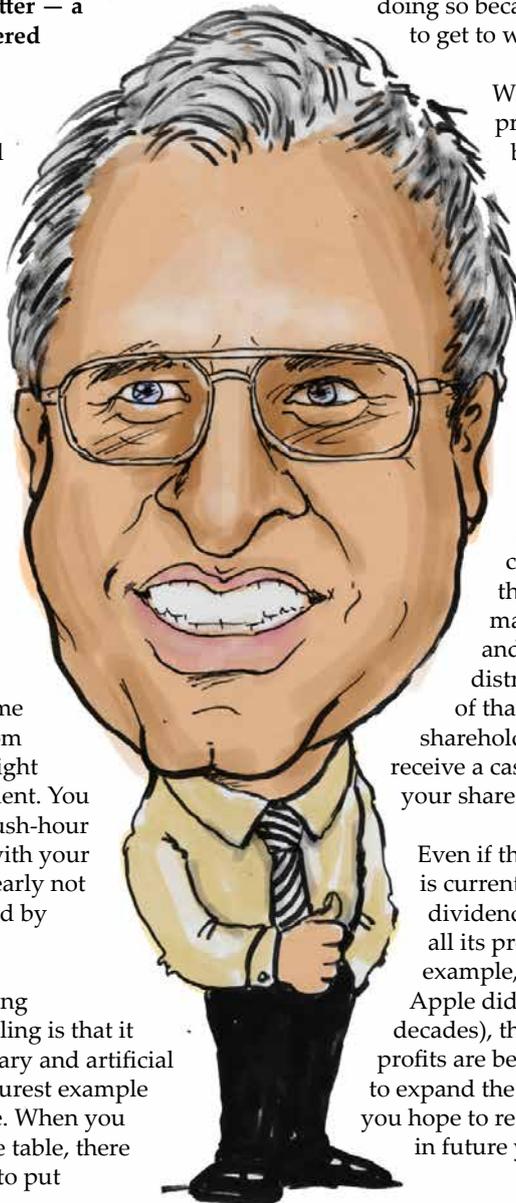
There are risks associated with your share ownership. The company may run its business so badly that it never pays a dividend. Indeed, the business may go downhill with the company becoming insolvent and being liquidated, with a total loss of your shareholding.

If you decide to sell your shares, you may receive more than you paid to buy them or you may receive less.

“ In my view, the defining characteristic of gambling is that it involves the unnecessary and artificial creation of risk. The purest example is the game of roulette ”

However, all of these risks and uncertainties arise from the inherent uncertainty of life when you own a small percentage of the real business being conducted by the company. They are not risks that have been artificially created purely to create variability of outcomes, unlike the aforementioned situation with the game of roulette.

Accordingly, although the buying of shares results in outcomes for you which are inherently uncertain, this has none of the qualities of gambling. Buying shares is categorically not gambling! (2)



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31st May 2023, Hamad Bin Khalifa University Auditorium

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A look at the US's first Shariah compliant bank

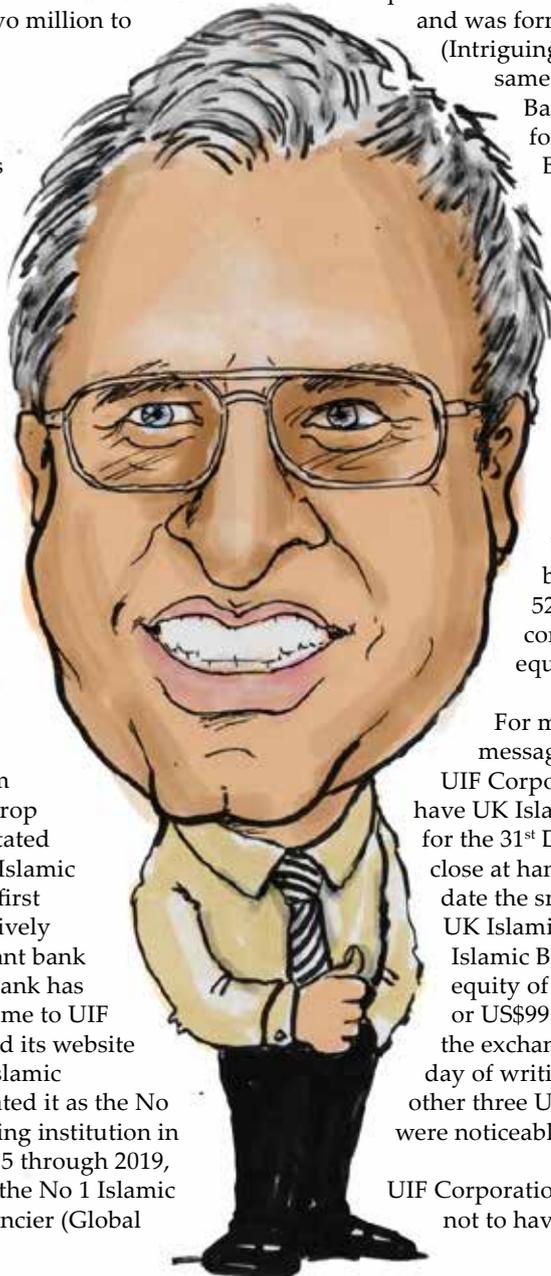
Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Despite following US business generally relatively closely, I have never written about the Islamic finance scene in the US.

It is hard getting reliable data on the number of Muslims in the US. Unlike the UK, the US national census does not ask about religion, consistent with its constitution's First Amendment's prohibition of the establishment of religion. I have seen estimates ranging from two million to six million.

The private sector 2020 US Religion Census surveyed a random sample of mosques and came up with an estimate of 4.45 million which seems reasonable. Research from Pew indicates that on average US Muslims have similar incomes to non-Muslim Americans.

In 2021, law firm Pillsbury Winthrop Shaw Pittman stated that University Islamic Financial is the first and only exclusively Shariah compliant bank in the US. The bank has shortened its name to UIF Corporation, and its website mentions that Islamic Finance news rated it as the No 1 Islamic financing institution in the US from 2015 through 2019, and awarded it the No 1 Islamic Real Estate Financier (Global



Award) in 2020 and 2021. Accordingly, I decided to take a closer look.

I could not find UIF Corporation's financial statements on its website. However, it reports that it is a subsidiary of University Bank (legal name University Bancorp) and that entity's website does have consolidated financial statements for the year ended the 31st December 2022.

University Bank is a conventional bank, and relatively small with total equity of only US\$88 million. UIF Corporation is its 80% subsidiary and was formed in 2005.

(Intriguingly, at about the same time that Islamic Bank of Britain was formed.) University Bank's accounts state that UIF Corporation's total equity as at the 31st December 2022 was US\$46 million. That makes UIF Corporation a relatively large part of University Bank's total business, about 52% if you just compare the two equity numbers.

For me, the key message is how small UIF Corporation is. I only have UK Islamic bank figures for the 31st December 2021 close at hand, but at that date the smallest of the UK Islamic banks, Qatar Islamic Bank (UK), had equity of GBP79 million, or US\$99 million applying the exchange rate on the day of writing, while the other three UK Islamic banks were noticeably larger.

UIF Corporation also appears not to have a full banking

license, since it discloses that it takes deposits as an agent of its parent, although those deposits are segregated so that they are only used for Shariah compliant purposes.

“ My view is that the small size of the US's Islamic banking industry indicates low 'effective demand' for Islamic banking from the US's Muslims, similar to the low 'effective demand' seen from Muslims in the UK, or Germany as discussed in my 3rd January 2023 article about KT Bank ”

My view is that the small size of the US's Islamic banking industry indicates low 'effective demand' for Islamic banking from the US's Muslims, similar to the low 'effective demand' seen from Muslims in the UK, or Germany as discussed in my 3rd January 2023 article about KT Bank.

By 'effective demand', I mean demand expressed by the actions of consumers (for example in depositing money), as opposed to 'expressed demand' when Muslims simply say that they would like to have Islamic banking. (☺)

Another look at US Islamic banking

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Last month, I wrote about University Islamic Financial (legal name UIF Corporation) which offers Shariah compliant banking services in the US, albeit as an agent of its parent company University Bank, since UIF Corporation appears not to have its own banking license. My key point was the small size of UIF Corporation.

Subsequently, someone suggested that I look at Devon Bank, based in Chicago, which is another well-known US Islamic bank.

As with UIF Corporation, finding publicly available financial data for Devon Bank of the same quality that one takes for granted in the UK proved to be impossible. (If my searching has been inadequate and any reader can find it, please could they send it to me!) In particular, Devon Bank's website publishes no financials as far as I can see, and its parent company Devon Bancorp appears not to have a website.

However, I did find relatively detailed financial information presented in a standardized manner on the website www.ibanknet.com but without the narrative reporting that normally accompanies financial accounts. Devon

Bank's 2020 Impact Report also contains an informative history.

Founded as Devon North Town State Bank in 1945, the bank was closed by regulators in 1953! The banking charter was bought by an investor group, with someone called Mason Loundy as CEO. Over time, the Loundy family acquired control. While I never assume what religion anyone practices, the pattern of given names in the Loundy family gives no reason to think that they are Muslims, and their religion is not mentioned in the sources I have seen.

Faith-based banking is a major section on Devon Bank's website, explaining that it has offered Islamic home financing since 2003. Its products were reviewed by the honorable Mufti Muhammad Nawal-ur-Rahman and the Shariah Supervisory Board of America which is based in Chicago. However, the bank does not appear to have its own Shariah supervisory board.

Devon Bank does not disclose how much of its business is Islamic. I did find an ABC News article, undated but I deduce from about 2010, indicating that 75% of Devon Bank's home mortgages were Shariah compliant. The bank itself is clearly a conventional bank, as it holds large amounts of interest-paying US government bonds. Its Islamic operations therefore constitute an Islamic window.

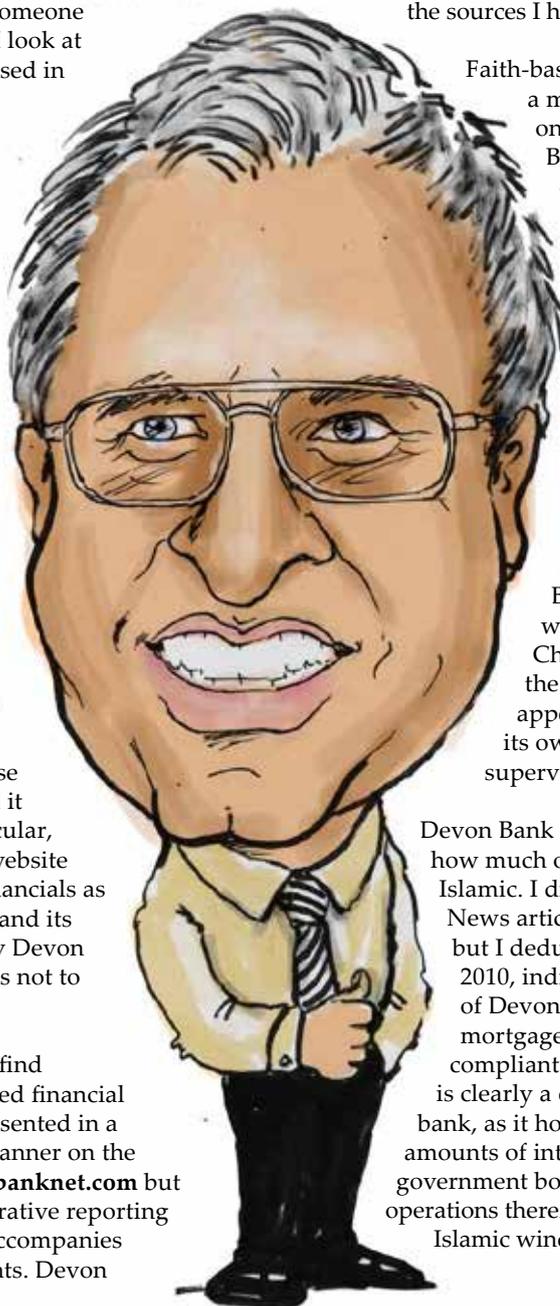
Like UIF Corporation, Devon Bank is relatively small. As at the 31st December 2022, its total equity was only US\$30.6 million, making it much smaller than any of the UK's Islamic banks. Its total loans and leases were US\$228.9 million. Since these include both Islamic financings and conventional lending, the Islamic figure will be less than US\$228.9 million but I have no data.

During the calendar year of 2022, Devon Bank's aggregate net income was US\$8.1 million. As the average of the opening and closing equity for the year was US\$30.4 million, this represents a return on equity of 26.6%.

“ A small, well-run, local bank can be very profitable. It may also indicate that its Muslim customers are willing to pay over the odds for Shariah compliant financial services because Shariah compliance is so important to them ”

That is an outstanding result.

I think the message is that a small, well-run, local bank can be very profitable. It may also indicate that its Muslim customers, though few in absolute numbers, are willing to pay over the odds for Shariah compliant financial services because Shariah compliance is so important to them. ☺



A look at American Finance House Lariba

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

This month I look again at the US Islamic finance scene, this time with American Finance House Lariba (LARIBA).

The LARIBA website www.lariba.com discloses that it is a California corporation but says nothing about its ownership. While I found its records on the California Secretary of State's website, no financial information is disclosed and extensive searching elsewhere also found nothing.

This exercise reminds me how fortunate we are in the UK that all companies have to file at least some publicly available accounting information with our Registrar of Companies.

As well as home financing, commercial and business financing, and new car finance, LARIBA's website also offers full-service Riba-free banking. Clicking that takes you from the LARIBA website to the website of Bank of Whittier which is a fully

licensed bank and an FDIC (Federal Deposit Insurance Corporation) member.

Bank of Whittier is a wholly-owned subsidiary of Greater Pacific Bancshares, a company which seems to do nothing else apart from own Bank of Whittier. It does publish accounts which for calendar year 2021 reported a net income of US\$1.3 million, and shareholders' equity as at the 31st December 2021 of US\$19.6 million. (Obviously, it is a relatively small bank.)

The return on closing equity of 6.6% I consider respectable given the pandemic circumstances of 2021. The accounts do not mention any of the words 'Riba', 'Islamic', 'Shariah' or 'LARIBA' although the Bank of Whittier website emphasizes its Riba-free banking offering.

LARIBA and Bank of Whittier share the same physical address in Whittier, California. Further research established that LARIBA was created in 1987 to enable Shariah compliant home purchasing.

LARIBA's operating model is described in detail on its website and involves diminishing Musharakah with fixed equal monthly purchases of slices of property from LARIBA by a customer, with LARIBA charging rent on its share of the property by reference to local rental rates, rather than by reference to market interest rates.

However, the transactions are legally structured to comply

with the requirements of the US mortgage agencies like Freddie Mac so that the home purchase plans can be sold by LARIBA to the agencies in the same way that conventional banks originate and then sell on mortgages.

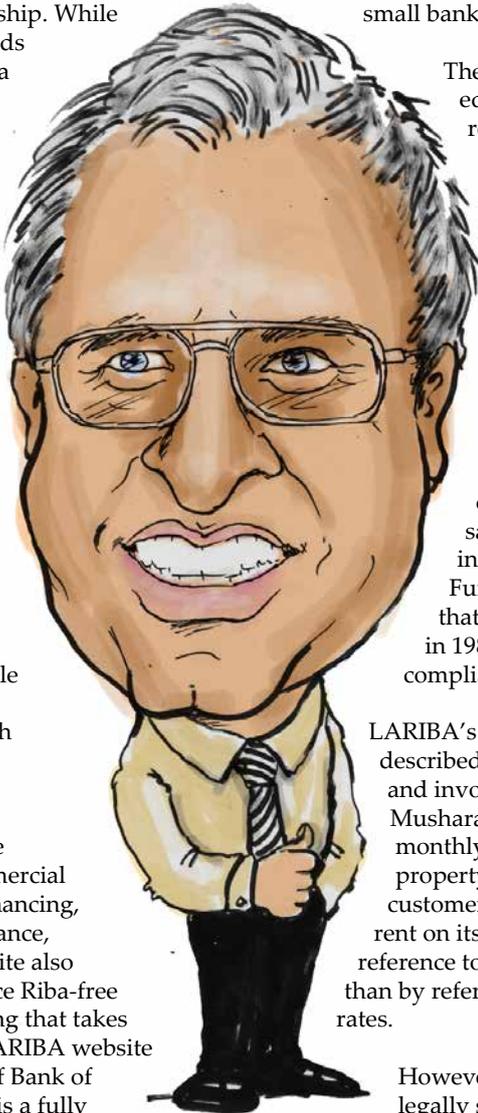
“ In the different tax environment of the US, it has been possible to practice Islamic finance without needing preliminary tax law changes ”

Bank of Whittier was set up by the same individuals who set up LARIBA, and there is significant overlap of management, despite the limited disclosure on the website.

Overall, this is another illustration of the kind of Muslim 'self-help' that has been possible in the US.

Due to the existence of a real estate transaction tax, and a tax regime where the legal form of a transaction largely dictates the tax treatment, the UK (and some other European countries) needed tax law changes before Islamic finance could take off.

However, in the different tax environment of the US, it has been possible to practice Islamic finance without needing preliminary tax law changes. ☺





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4th September 2023,
Mansion House, London

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Evidence of Pakistani Muslims' real usage of conventional finance

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

When reading 'A look at the US's UIF Corporation' in the 3rd May 2023 issue of *Islamic Finance news*, a Muslim economist was particularly struck by my concluding point. I had said that US Muslims' 'effective demand' for Islamic banking was low, as it was among UK and German Muslims. By 'effective demand', I meant demand expressed by action, rather than by just saying that they wanted Islamic banking — 'expressed demand'.

My reader sent me a 13-page academic paper published in February 2023 by Elsevier's *Journal of Behavioral and Experimental Finance*. The paper is titled 'Religion, social desirability bias and financial inclusion: Evidence from a list experiment on Islamic (micro)finance' by Syedah Ahmad, Robert Lensink and Annika Mueller from the Department of Economics, Econometrics and Finance, University of Groningen, The Netherlands.

Many survey problems, such as finding a representative sample to interview, are well known. However, one problem that receives insufficient discussion is 'Social desirability bias'. In every society, there are some questions which

respondents are reluctant to answer honestly, even if given anonymity.

I would expect social desirability bias to significantly affect what people are willing to say about Islamic finance. If someone is regularly told by their religious leaders that the

usage of conventional finance will send them to Hell, it is likely to affect their survey response!

The authors wrote: "In this paper, we propose a possible solution to this issue.

We conduct the first list experiment designed to measure attitudes towards the usage of non-Islamic financial products and services, with 2,145 poor Muslims from Multan, Pakistan."

The paper explains in simple terms what a list experiment is:

"List experiments are designed to provide the data necessary to estimate the proportion of respondents in the population who

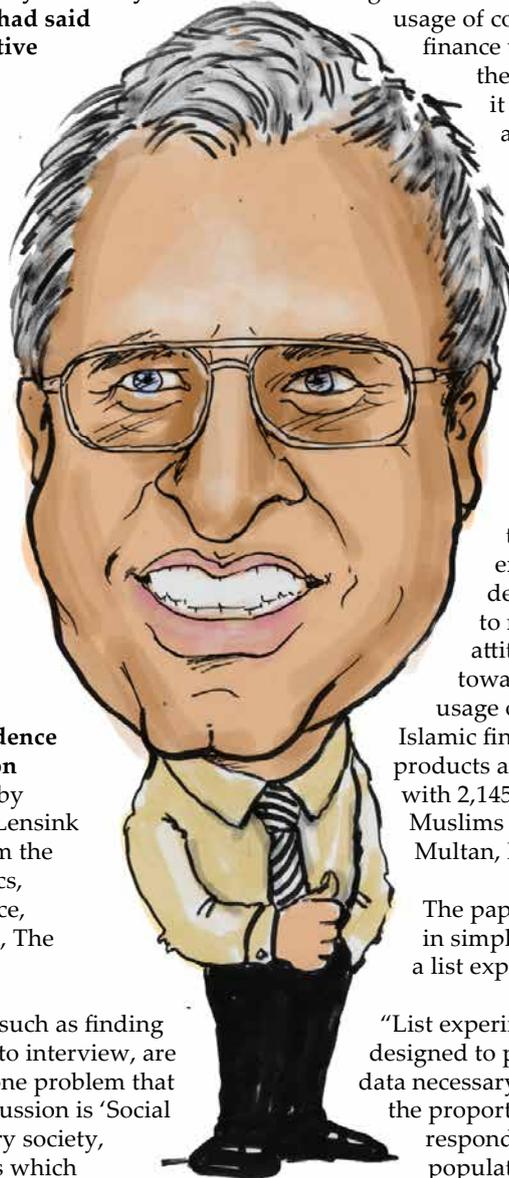
agree with a sensitive statement. They do so by presenting an identical set of non-sensitive statements to (randomly assigned) treatment and control groups of respondents, with the treatment group being shown an additional sensitive statement, which in our case concerned non-Islamic finance. The key principle behind a list experiment is that respondents need to report only the number of statements that they agree with, which guarantees a higher level of anonymity than direct survey questions and makes respondents more likely to answer truthfully."

If the treatment group and the control group are well matched, they should agree with the same number of non-sensitive statements. Accordingly, any difference in total responses arises from the inclusion of the sensitive statement in the list presented to the treatment group.

The authors found that approximately 37% of the sample (poor Muslims in Multan) used conventional finance as described in the statement: "I use formal or informal non-Islamic financial products or services from time to time, such as bringing jewelry or a vehicle to a pawn shop and retrieving it later by paying interest on the loan."

This 37% compares with only about half that number who said that they use conventional finance when responding to surveys directly asking them. This shows the very significant impact of social desirability bias.

I expect that surveys conducted in the UK or the US would show a similar, but weaker, effect because UK or US Muslims should face lower social pressures from other Muslims than do Pakistani Muslims. ☺





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4th September 2023,
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Would Islamic finance solve Australia's housing crisis?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

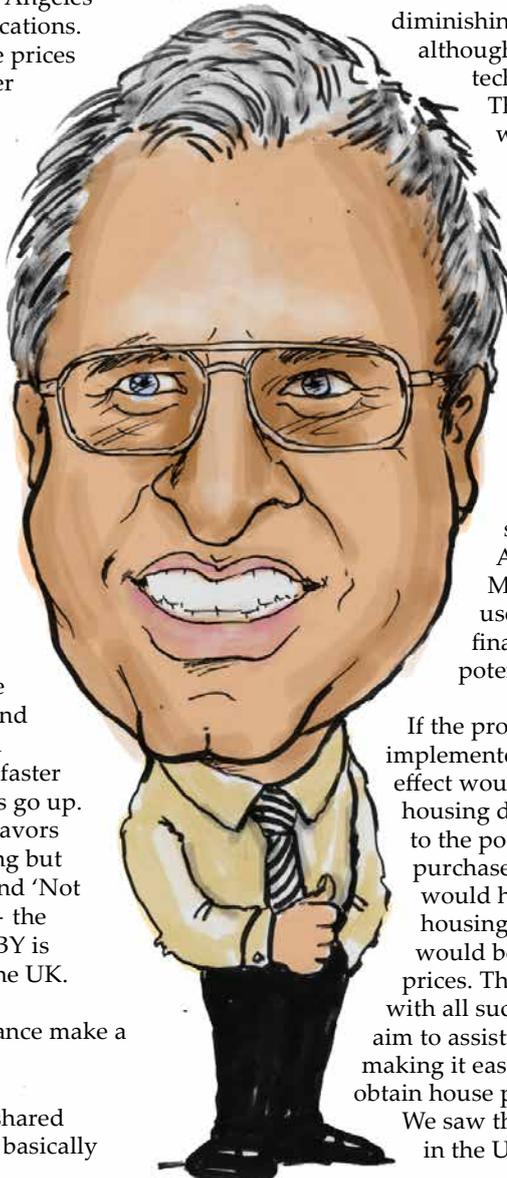
Some of my contacts shared an Australian article titled 'Australian businessman proposes bold solution to housing crisis' about a TEDxSydney talk by Professor Talal Yassine OAM, the managing director of Crescent Wealth. Professor Talal's talk is not online yet, so I can only comment on the article.

Without claiming to be an expert on Australia, I assume it has similar housing market problems to the UK, San Francisco, Los Angeles and many other locations. Very briefly, house prices have risen far faster than incomes. As a 27-year-old, I bought my first house in Manchester for, from memory, three times my then-income. Now, the average UK house price is a much higher multiple of the average UK income.

The reasons are the same around the world. The supply of housing has not risen at the same rate as demand for housing. When demand increases faster than supply, prices go up. Almost everyone favors more housebuilding but somewhere else, and 'Not in my backyard' — the abbreviation NIMBY is commonplace in the UK.

Would Islamic finance make a difference?

The proposal is a shared ownership model, basically



diminishing Musharakah, although the article avoids technical terms.

The goal is that it will enable more people to obtain home purchase finance — people who would be insufficiently good credit risks for conventional home purchase finance. In addition, it would of course enable the relatively small minority of Australians who are Muslims who won't use conventional finance to become potential house buyers.

If the proposal is implemented, the logical effect would be to boost housing demand by adding to the pool of potential purchasers. However, as it would have no effect on housing supply, the result would be to increase house prices. That is the problem with all such schemes, which aim to assist individuals by making it easier for them to obtain house purchase finance.

We saw the same effect in the UK with the

government's recent 'Help to Buy' scheme.

From the article, Professor Talal's proposal appears to involve a rental rate that is fixed for the life of the arrangement, unlike the normal practice in the UK where diminishing Musharakah rental rates are regularly reset by reference to market interest rates. Many customers may prefer a fixed rental rate, although the normal shape of the yield curve (upward sloping) means that fixed rates will be higher than floating rates.

There is nothing about conventional finance that requires floating mortgage rates. While in the UK most mortgage rates are floating, or fixed for relatively short periods such as five years, in the US it is standard practice to have long-term (eg 30 years) fixed rate mortgages. It simply requires the lending bank to either obtain fixed rate funding, or to sell the mortgage on to another entity, such as the Federal National Mortgage Association, which finances the purchases by issuing long-term fixed rate debt.

Finally, the key point is that when analyzing any proposal, the economic consequences and the religious implications must be considered separately. The first is an empirical question to be resolved by data gathering; the second is a matter of religious belief where each person has to reach their own conclusion. ☺

A brief look at Kestrl

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

One of the few bright spots in the UK economy is that London is a hotbed of financial services technology (fintech) innovation, both conventional and Islamic.

I had never heard of Kestrl (website <https://kestrl.io/>) until July when I found myself sitting opposite the CEO, Areeb Siddiqui, at an Islamic finance dinner. To write this article, I installed the Kestrl app on my iPhone and signed up for the free service.

One of the main service offerings is the ability to look across multiple bank accounts in one convenient place. A few years ago, UK regulators (and possibly EU regulators since this may predate Brexit) forced banks to give access to their transaction data upon customer request. Personally, I have never felt the need for such a service, but obviously many do as otherwise the service providers could not stay in business.

Kestrl also offers Zakat calculation, although again I would just use a spreadsheet if I wanted to calculate Zakat.

If you subscribe (monthly GBP1.49 (US\$1.82), with lower rates if you pay six-monthly or annually), you can use the app to see if any listed share is Shariah compliant. I could not see which markets are covered, but would expect it to cover the UK and US at least. You also get access to financial planning tools, which would help those who cannot do their own budgeting or record-keeping.

The app describes two services that are not yet available:

- A Halal instant access savings account.
- Investing into the HSBC Islamic Global Equity Index Fund.

As I have previously written, one of the joys of living in the UK is easy access to financial information about UK companies. Accordingly, I investigated Kestrl's website footer, part of which is reproduced below, verbatim.



"The Kestrl Account is issued by Contis Financial Services Ltd who are authorised by the Financial Conduct Authority under the Electronic Money Regulations 2011 (registered number 900025). The (brand name can be used here) Account and Card are electronic money products which are not covered by the Financial Services Compensation Scheme. The funds will be safeguarded by Contis Financial Services Ltd."

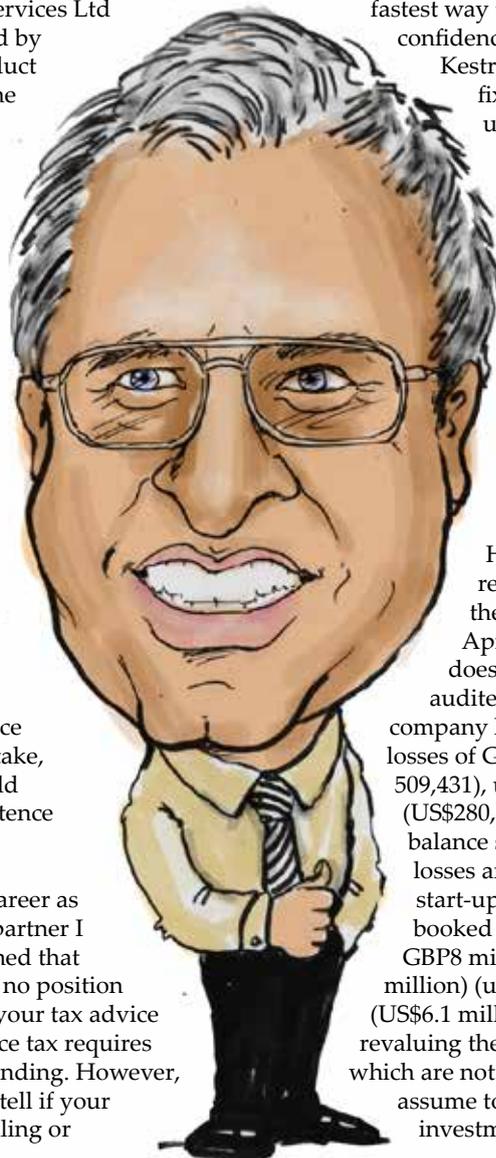
The middle sentence is obviously a mistake, since nobody would publish such a sentence intentionally!

Very early in my career as a tax advisor, the partner I reported to explained that clients are often in no position to assess whether your tax advice is good or bad, since tax requires specialist understanding. However, clients can always tell if your letter contains spelling or

grammatical errors, and that is the fastest way to lose your client's confidence. Accordingly,

Kestrl really needs to fix its website footer urgently. (It originally spelt the name of one of its advisors, Sultan Choudhury OBE, incorrectly, but that has been fixed after I pointed it out to him at IFN UK Forum.)

The Kestrl annual accounts are available from the UK's Companies House; the most recent ones being for the year to the 30th April 2022. The law does not require it to be audited, so it is not. The company had accumulated losses of GBP417,577 (US\$ 509,431), up from GBP229,906 (US\$280,478) at the previous balance sheet date. Such losses are not surprising in a start-up. The directors have booked a revaluation gain of GBP8 million (US\$9.76 million) (up from GBP5 million (US\$6.1 million)) based on revaluing the intangible assets, which are not described but I assume to be its software investment, etc. (🙄)



Fractional reserve banking benefits humanity, but with occasional crises

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I always like to hear from readers via the email address I publish on my personal website to make me easy to contact. In October, someone wrote to me after reading my 2nd October 2019 IFN column titled 'Islamic banks also create money'.

He was shocked. To quote just two short extracts from quite a long email:

1. "Humans can make things out of other existing things, and Allah alone can create (out of nothing). So, banks creating money out of nothing is acting as if they are God or they think they are God."
2. "So, in an economy where money is created out of loans, borrowers have an advantage and savers have a disadvantage. There is a wealth transfer in society from savers to borrowers."

My 10th February 2016 IFN 'A Letter from Amin' article explained the importance of distinguishing between religious questions and empirical questions. Point (1) is religious, so each Muslim needs to make up his own mind, and I refused to debate it with him, although I disagree with the reader's point.

Point (2) is an empirical point, and the reader is asserting its

universal truth, regardless of whether the finance provided is conventional or Islamic, since both conventional and Islamic banks charge for providing finance, at essentially similar rates.

Such wealth transfers can happen when governments artificially limit the price of credit, particularly at times of high inflation. This has the technical name 'financial suppression'. However, there is no overall evidence that the banking system unduly favors borrowers over savers; they contract with the bank to receive different services.

Most of the incoming email was about the harm to the real economy from fractional reserve banking, building on point (2) above, which is an empirical question.

The question applies for both conventional banking and Islamic banking, since my IFN article shows that the operations of both create money.

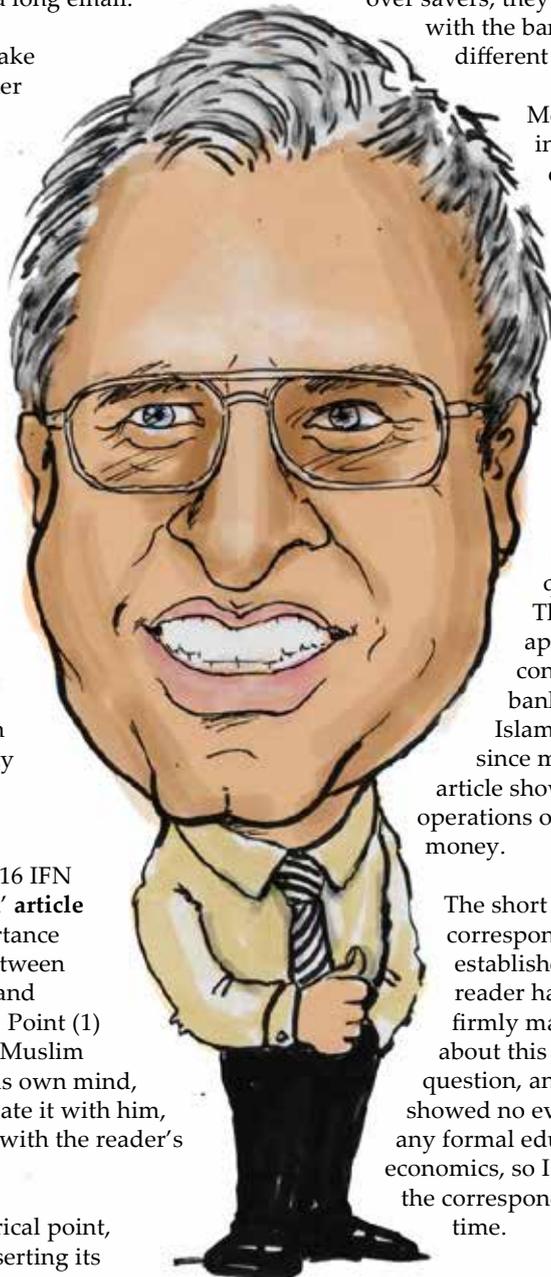
The short correspondence established that my reader had his mind firmly made up about this empirical question, and he also showed no evidence of any formal education in economics, so I discontinued the correspondence to save time.

Wikipedia explains 'Fractional reserve banking' quite well. The article says that almost every country in the world uses it. I do not know the exceptions but would guess that North Korea might be one! The main reason it is almost universal is that expanding the supply of credit enables more economic activity. For example, businesses can invest in more fixed assets and inventory, while individuals have greater capacity to purchase residential property. More economic activity makes societies richer.

“ The downside is that things can go wrong, either at the level of the individual bank or at the level of the entire banking system ”

The downside is that things can go wrong, either at the level of the individual bank or at the level of the entire banking system. The regulatory system is designed to minimize the risk of individual banks getting into trouble, but it will happen from time to time. A key regulatory goal is to minimize losses to depositors, so that shareholders bear the cost of failure.

Sometimes, as with the depression of the 1930s or the 2008 global financial crisis, there is a risk of systemic collapse; governments have successfully intervened to prevent it. While such risks need to be minimized, I regard them as an unavoidable byproduct if society is to continue to enjoy the benefits of fractional reserve banking. ☺



Some thoughts on Shariah compliant equity investing

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

This month, I decided to put myself into the shoes of someone starting out in equity investing, who wants to be Shariah compliant and who wants to invest for the long term, which I regard as 20–30 years. (I have never been a day trader and have nothing to say to those who want to do it, apart from “Don’t!”)

Many investors forget the most basic fact.

After you buy a share on the stock exchange, you own a (very small) part of the company’s business. Accordingly, to decide if the share is worth buying, you need to be able to value the small fraction of the business you are about to buy and compare that with the quoted price of the share.

Unless you think the value of that fraction of the business exceeds the share price by some reasonable margin (which the legendary investor Ben Graham called the “margin of safety”), buying the share is irrational.

If you feel unable to value businesses, you are not competent to buy individual shares.

The alternative is to invest in collective investment schemes,

usually known as ‘funds’. You buy a small fraction of the fund, while the fund buys individual shares, either chosen by the judgment of the fund manager or chosen by a computer algorithm. Investing via a fund involves charges, possibly an initial charge when you invest, and certainly an annual charge computed as a percentage of the fund’s value.

If you invest US\$1,000 into a fund today, and hold it for 30 years, the final value of your investment will be represented by the investment returns earned by the fund, less the charges you have suffered. However, in practice, very few people invest this way.

Since 1984, independent investment research firm Dalbar of the US has published a report annually, which it calls the ‘Quantitative Analysis of Investor Behavior’. The report finds consistently that the actual returns earned by fund investors are less, often by around 3%, than the investment returns of the fund after charges.

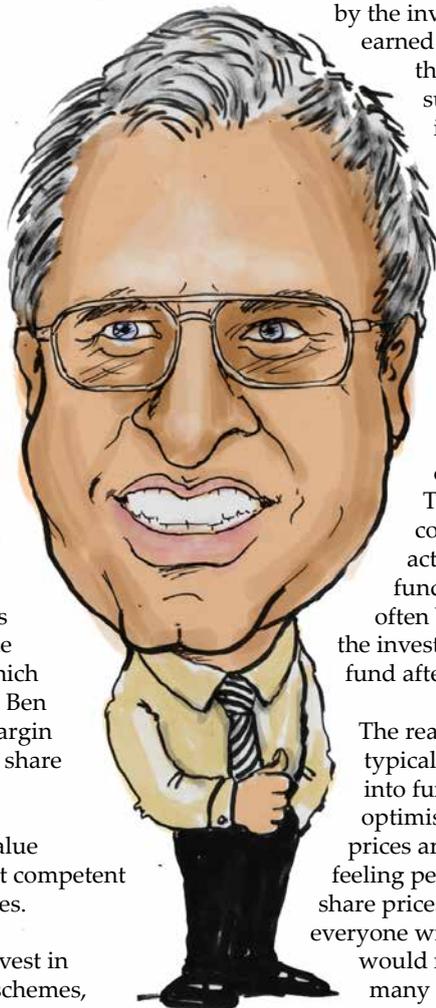
The reason is that individuals typically put more money into funds when feeling optimistic because share prices are ‘high’ and sell when feeling pessimistic because share prices are ‘low’. While everyone will tell you that they would never be so stupid, many investors do panic

when the stock market plunges and sell. Accordingly, once you invest in a fund, think of yourself as being stuck with it for the next 20-plus years, and never sell just because stock markets are down.

“ Once you invest in a fund, think of yourself as being stuck with it for the next 20-plus years, and never sell just because stock markets are down ”

The next step in the decision tree is the choice between ‘active funds’ where the investment manager selects individual shares based on the manager’s assessment of the value of the company’s business (just as you would do if buying an individual share) and ‘passive funds’ where the fund uses an algorithm to create a portfolio that will match some externally defined index, most commonly a market capitalization weighted index seeking to replicate the entire stock market concerned.

Index funds were only invented in the 1970s, while active funds go back for about 150 years. Despite that, index funds now represent a very large part of the fund universe. In my next column, I will look at the choices available to a UK Shariah compliant investor but wanted to start by ensuring a common understanding with readers. ☺



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Shariah compliant equity investing: A UK perspective

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

As promised in last month's column, I am taking a look at the choices available to a UK Shariah compliant investor.

Until now, I have avoided using artificial intelligence tools such as ChatGPT due to the risk of 'hallucinations' – false information presented as if it was fact. However, after listening to the co-founder of Perplexity. AI being interviewed on a podcast, I asked "what Shariah compliant equity investment funds are available in the UK?" What I liked about the answer was being given links to the sources.

Very briefly, my conclusion is that you can invest in Shariah compliant equity funds through all the major investment platforms in the UK, but the range of funds available is somewhat limited, compared with the profusion of conventional equity funds. That is not surprising, since UK Shariah compliant investors are a tiny fraction of the UK investor population.

As I wrote in December, once you have decided to

invest in a Shariah compliant equity fund, "The next step in the decision tree is the choice between 'active funds' where the investment manager selects individual shares based on the manager's assessment of the value of the company's business (just as you would do if buying an individual share) and 'passive funds' where the fund uses an algorithm to create a portfolio that will match some externally defined index, most commonly a market capitalization weighted index seeking to replicate the entire stock market concerned".

Decades of experience with conventional equity funds has demonstrated that (after deducting charges) over the long run the overwhelming majority of conventional equity funds fail to beat index funds. While some investment managers do outperform (for example Warren Buffet, although Berkshire Hathaway is not a 'fund'), the problem is how to identify them in advance. (Identifying in hindsight is easy but also useless!)

My view is that if you are going to select an active fund (which inevitably means higher charges than an index fund), the manager needs to have a clearly explained investment methodology which you believe will outperform the index, and you need to be confident that the manager will stick to the

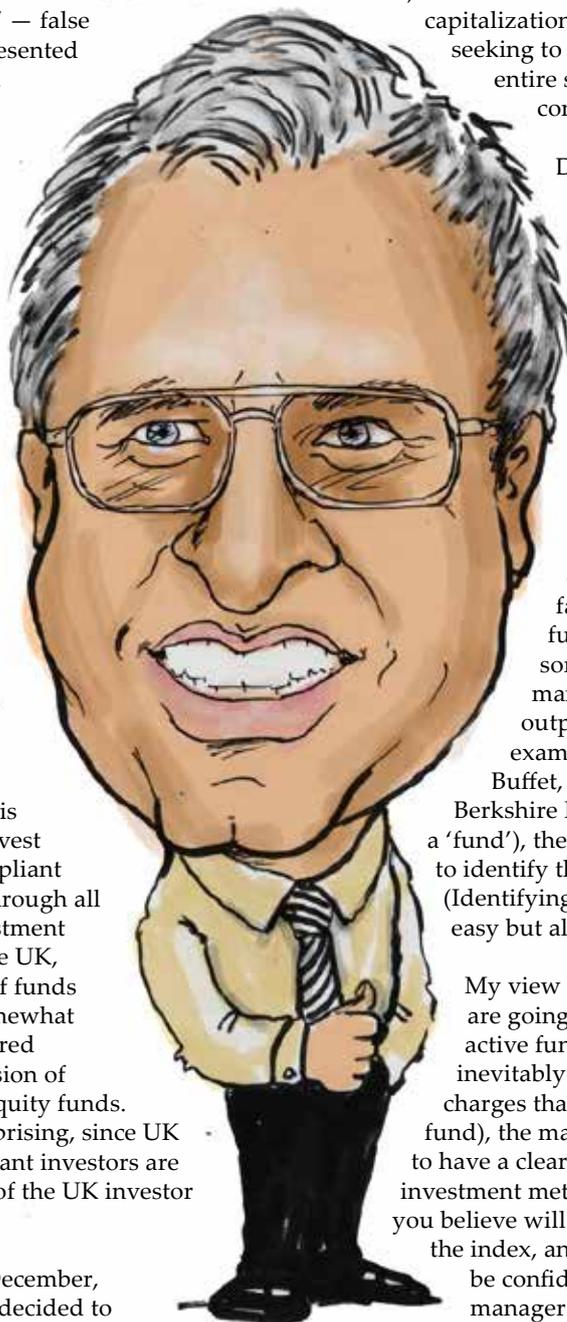
methodology, especially during times of underperformance as these will inevitably occur. Otherwise, play safe and go for an index fund.

As someone who has been investing now for about 50 years, I am dismayed by the high-cost funds that some managers are able to promote and sell.

I was particularly struck by the factsheet for the Franklin Templeton Shariah Global Equity Fund A (acc) USD dated the 31st October 2023. This states that there is a "Maximum Initial Charge" of 5.75% and the "Ongoing Charges Figure" is 1.9%. These charges are much higher than those of the other active Shariah compliant equity funds I looked at.

“ In most fields, for example law or tax advice, better people do charge more. However, in investing, higher charges rarely indicate higher quality ”

Some naive investors think that high charges are a pointer toward a better manager. In most fields, for example law or tax advice, better people do charge more. However, in investing, higher charges rarely indicate higher quality. Since inception on the 10th September 2012 this fund has returned only 47.23% in total, while its benchmark, the MSCI AC World Islamic Index-NR (USD), which you can track by investing in an exchange-traded fund, has returned 108.32%. ☺



The UK government finally reconsiders Shariah compliant real estate refinancing

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

As far as I can recall, I first wrote about the problem of refinancing commercial real estate using Islamic finance in my 1st May 2018 IFN column titled 'Harmonizing the taxation of conventional and Islamic finance requires careful detailed work'. Very briefly, if the commercial real estate is worth more when refinanced than when it was originally bought, the Shariah compliant refinancing transaction triggers a taxable capital gain. Conversely, no such capital gain arises if the refinancing uses conventional finance.

That column mentioned that with my help, the Chartered Institute of Taxation had written to the UK tax authorities to explain why UK tax law needed to change, and to outline how to change it. Eventually in late 2018, the UK tax authorities responded that they had no plans to change the law.

I reverted to the subject in my 1st August 2022 IFN column titled 'The UK government needs to tackle Shariah compliant refinancing'. This mentioned that the scale of the problem was growing, with an increasing number of UK taxpayers finding themselves

with an unexpected taxable gain. I also pointed out that the tax authorities were applying the law inconsistently, because in at least one case mentioned in the article, the HM Revenue and Customs head office specialist had concluded after reviewing the transaction documentation that no tax charge arose!

Since then, lobbying has continued behind the scenes, in parallel with a steadily growing number of affected taxpayers. Although

I have been involved with the lobbying, and many Islamic finance professionals are aware of it, as far as I am aware the lobbying is not in the public domain so I cannot say more about it. Finally, in January there was a positive development.

On the 16th January 2024, HM Treasury (the Treasury) issued a consultation document titled 'Tax Simplification for Alternative Finance' which can be downloaded from the link. Responses to the consultation must be submitted by the 9th April 2024. I will of course be submitting a response, and once I have done so will publish it on my website.

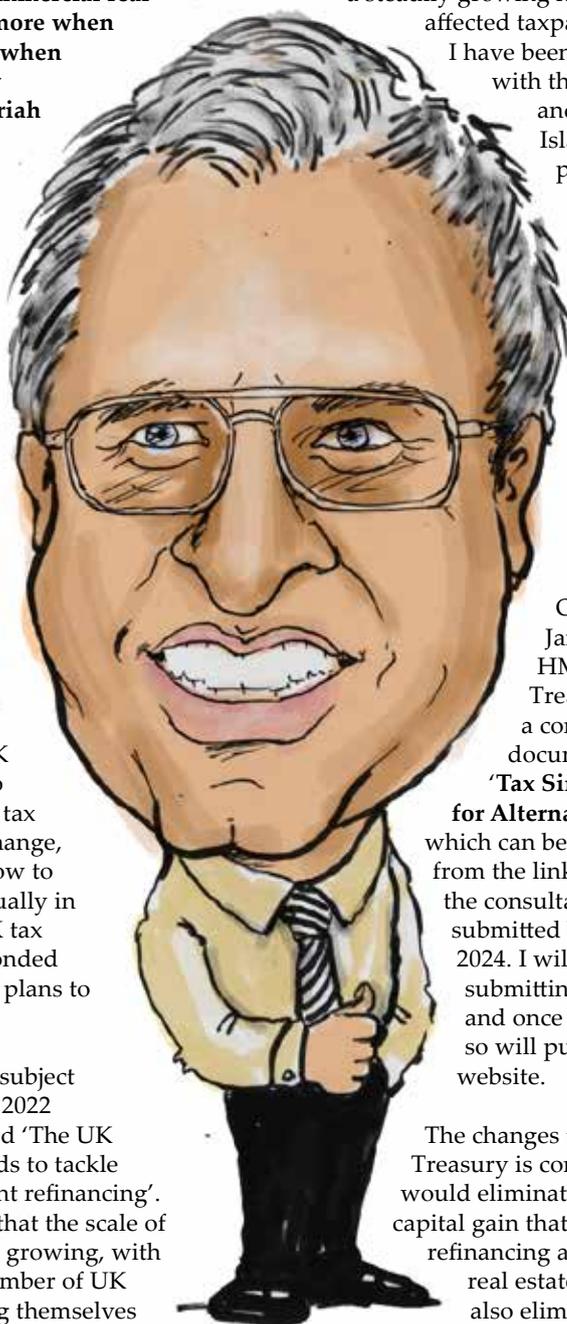
The changes that the Treasury is consulting about would eliminate the taxable capital gain that arises on refinancing appreciated real estate. They would also eliminate another

problem that receives much less discussion. If the real estate includes plant and equipment eligible for what the UK calls 'capital allowances' ('tax depreciation' in many countries' tax language), the refinancing transaction can cause a recapture of previously granted tax depreciation and lead to future tax depreciation being granted to the bank providing the refinancing rather than the beneficial owner who has undertaken the refinancing and who is using or subletting the real estate.

“ The changes that the Treasury is consulting about would eliminate the taxable capital gain that arises on refinancing appreciated real estate ”

The Treasury consultation document is understandably concerned that any legal changes do not create scope for tax avoidance. Conversely, one of my UK Islamic finance contacts reminded me that the current rules contain their own scope for tax avoidance! If the real estate has fallen in value since acquisition, under current law Shariah compliant refinancing will trigger a capital loss for tax purposes, which can be offset against other taxable gains.

Finally, the Treasury consultation ignores existing cases. I believe there is an overwhelming case for retrospectively eliminating the capital gains tax charge on Shariah compliant refinancing, since HM Revenue and Customs has been inconsistent between taxpayers. ☺



A question about perpetual futures contracts

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

From time to time, complete strangers ask me interesting questions since I deliberately make myself easy to contact via my website. I received another one in January.

"I am a professional trader and have a query regarding the permissibility of perpetual contracts. A lot of scholars say that they are not permissible because you don't own the underlying asset and you are only betting on the movements of the price (Maysir). The second issue is the cash settlement because when the contracts are settled, there is no exchange of any underlying asset, only money is exchanged."

My first task was to search for an explanation of perpetual contracts since I had never come across them before in this context. I found the Investopedia article titled 'Perpetual Futures: What They Are and How They Work' and my enquirer confirmed that I had tracked down the exact instrument that he was using, and that, as indicated by Investopedia, the underlying subject matter of his perpetual contracts mostly involved cryptocurrencies, and occasionally included other assets such as commodities.

I always emphasize that each of us has to reach their own

religious decisions because each of us is individually accountable on the Day of Judgment. It will be inadequate to say: "X said that what I was going to do was religiously permissible." However, I am always willing to share my thoughts.

In my opinion, many Islamic finance scholars fail to take into account the significant changes in the world over the last 1,400 years. For example, in my 7th

March 2018 **column** I said "Shariah scholars should stop analyzing corporations as if they were

partnerships" since they are not partnerships. Similarly, I consider much of the historic legal analysis of

commercial contracts to need radical updating.

I replied to my enquirer that I did not see why a properly drafted perpetual contract written under the

laws of a reliable jurisdiction should be prohibited. The rights and responsibilities of the parties will be clearly set out, along with enforcement mechanisms.

While the contracts involve a high level of financial risk, so do many other transactions since that is inherent in any dealings concerning something whose price fluctuates. While he himself had no use for the underlying

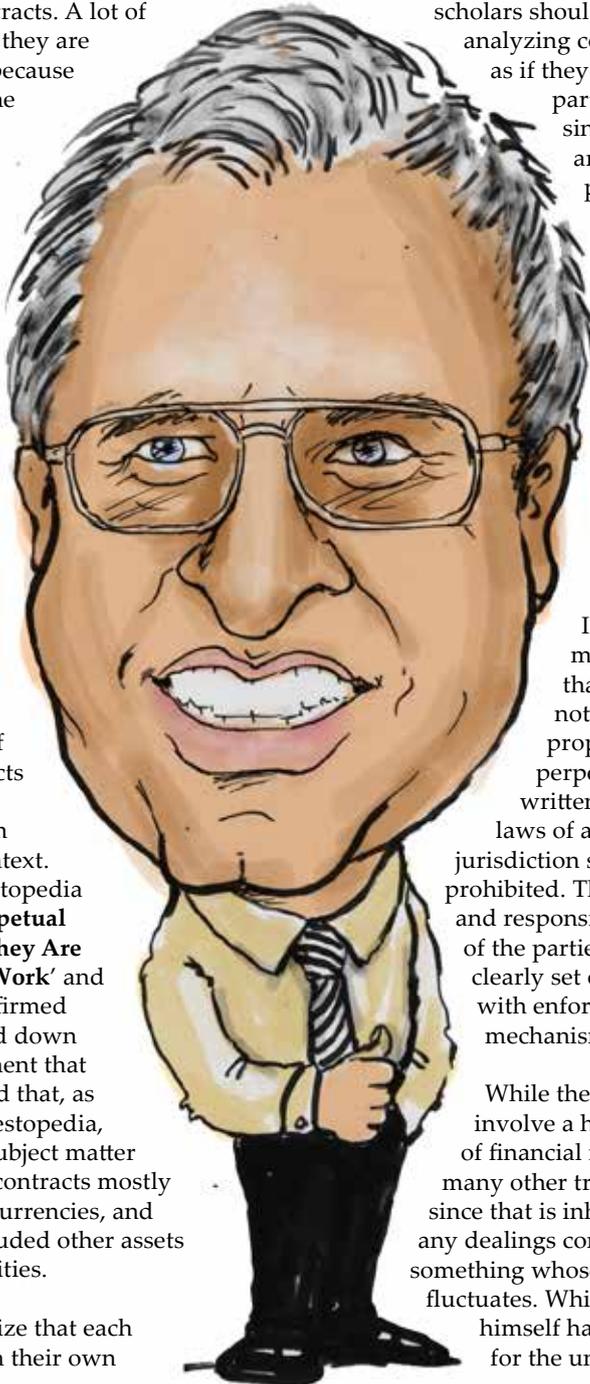
subject matter of the contracts, markets need speculators to provide liquidity. (My 11th November 2015 IFN **column** explained how commodity speculators fulfill a valuable social function.)

While responding, I explained that I personally avoid such transactions because I see no social value in cryptocurrencies, and regard short-term trading as a time-consuming activity where I have no reason to believe that I possess any special skill. However, that was a personal choice for my enquirer, as long as he could manage his risks and exposures sensibly.

“ In my opinion, many Islamic finance scholars fail to take into account the significant changes in the world over the last 1,400 years ”

I then received the supplemental question "Is speculation different from gambling?" I found this question much more difficult. I regard gambling to be the artificial creation of risk. For example, a roulette table exists only for the purpose of allowing people to place bets. Someone who puts on a stake is not a participant in any real economic activity. I am dubious about the real-world uses of cryptocurrency.

Accordingly, I see speculating in cryptocurrency as being much closer to gambling as opposed to being closer to commodity speculation. I closed with: "If you genuinely believe that cryptocurrency does serve a beneficial purpose for society, (disregarding any benefits to criminals) then you will come to a different answer from me." ☺



A brief look at Shariah compliant equity investing in the US

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

My 6th December 2023 column set out some general principles about long-term Shariah compliant equity investing. After my 3rd January 2024 column looked at some of the choices available in the UK, I wanted to build on the previous articles by looking at what is available in the US.

There too many funds for me to cover comprehensively but, as with the UK, looking at just a few brings out some general principles. I began with a couple of mutual funds managed by Saturna Capital (www.saturna.com).

Both are actively managed funds. I have some concerns about concentration risk in the Amana Income Fund with 13.6% of the fund in Eli Lilly, a



company which represents only 1.4% of the S&P 500 index. Concentration is not automatically bad (Warren Buffet has done very well by it) but investors should think about the issue before investing. Conversely, the Amana Growth Fund's 7.1% in Apple is only slightly over its 5.7% weight in the S&P 500.

The Amana Income Fund has a surprisingly high 7.3% held in cash. In the long run, cash holdings are a drag on investment performance. Mutual funds typically hold cash balances either to accommodate redemptions or because investor inflows have resulted in cash not yet invested. Conversely, neither factor impacts exchange-traded funds (ETFs) due to the mechanism for creation and redemption of ETF units by institutional market participants.

I also looked at just a couple of ETFs.

The largest holding represents an even greater percentage of the fund than with the actively managed ETFs. However, in this case, it arises from Microsoft's weight in the US stock market, amplified by excluding non-Shariah compliant companies.

In conventional equity investing, those wanting an ETF but concerned by concentration risk can choose ETFs that track equal weighted indices instead of market capitalization weighted indices. However, a quick search did not find any equal weighted Shariah compliant indices.

Finally, I have deliberately said nothing about the historic performance of these investment funds. Historic performance is a really poor way of selecting investment funds, even though most investors are guilty of making investment decisions on that basis.

I strongly recommend reading 'The Intelligent Fund Investor: Practical Steps for Better Results in Active and Passive Funds' by Joe Wiggins, and following his blog 'Behavioural Investment' at <https://behaviouralinvestment.com>. (2)

Table 1: Mutual funds managed by Saturna Capital

	Amana Income Fund	Amana Growth Fund
Established	1986	1994
Assets under management	US\$1.8 billion	US\$5.1 billion
Cash and equivalents (%)	7.3%	3.5%
Largest holding	Eli Lilly	Apple
Largest holding as % of fund value	13.6%	7.1%
Annual fund operating expenses, investor shares (what individuals buy)	1.02%	0.91%

Source: Author's own

Table 2: ETFs

	Wahed FTSE USA Shariah ETF	SP Funds S&P 500 Sharia Industry Exclusions ETF
Established	2019	2019
Index description	The index is composed of common stocks of large and mid-capitalization US companies the characteristics of which meet the requirements of the Shariah and are consistent with Islamic principles as interpreted by subject-matter experts.	The index is composed of the constituents of the S&P 500 Shariah Index other than those from the following sub-industries: Aerospace and defense; financial exchanges and data; and data processing and outsourced services.
Fund size	US\$393 million	US\$460 million
Largest holding	Microsoft	Microsoft
Largest holding as % of fund value	14.6%	12.6%
Net expense ratio	0.5%	0.45%

Source: Author's own

Some thoughts on stock index futures

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

The following question arrived without warning a couple of months ago, since my website makes it easy for complete strangers to email me.

“Could you please give some insight into futures — specifically stock index futures? I understand there is no interest involved in the margin as it’s a ‘good faith’ deposit and not an actual loan; however, there is some interest embedded into the actual cost of the contract as sort of a carry cost which is calculated using LIBOR. Would this make trading this future contract Haram as the price of the contract has interest embedded into the carry cost? Or would it only be Riba if there is an actual direct loan taking place?”

I responded with the same point I make regularly here. Each of us is individually accountable to God on the Day of Judgment, so we have to decide religious questions for ourselves. However, I am always willing to share my thoughts, in particular to help others think about the process by which they tackle religious questions.

Firstly, are you willing to own a stock index future?

Like all derivatives, it derives its value from something underlying, here a stock index such as the S&P 500. The S&P 500 contains some companies (such as casino companies) that I personally won’t buy for moral and religious reasons. My own view is that the companies I object to are a sufficiently small part of the S&P 500 index that I am willing to ignore them; obviously others may differ.

Does the futures contract contain so much uncertainty (Gharar in



Arabic) that it is religiously prohibited? My view is that Islamic finance scholars are too keen to dismiss contracts as having excessive Gharar. While the price will fluctuate, just as the S&P 500 index fluctuates, the contracts used in futures trading, with the margin arrangements and the use of a central counterparty, are all designed to ensure reliable enforceability, so I do not see an excessive Gharar problem.

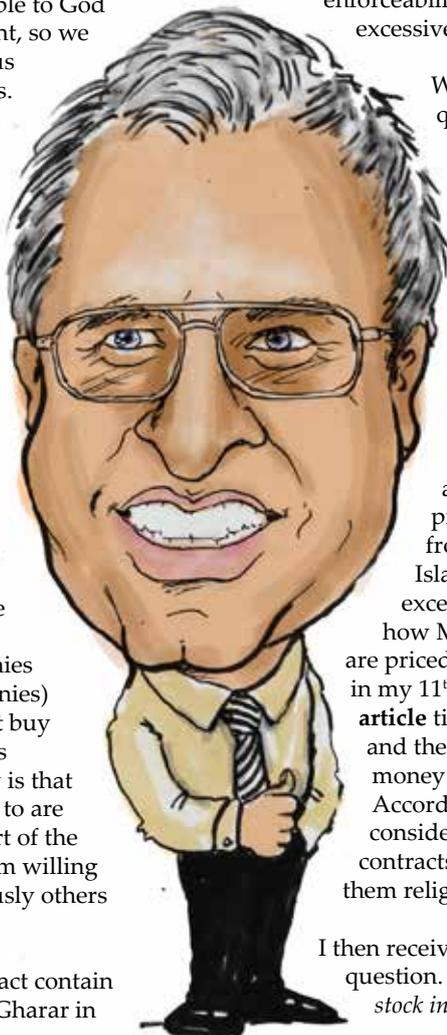
With regard to the question about ‘carry cost’, all financial transactions that involve cash flows taking place in the future involve some kind of recognition of the time value of money, either explicitly by periodical interest payments, or by adjusting the future price to be different from the spot price. Islamic finance is no exception. That is exactly how Murabahah contracts are priced. I explained this in my 11th January 2017 IFN article titled ‘Murabahah and the time value of money in Islamic Finance’. Accordingly, I do not consider the way futures contracts are priced makes them religiously prohibited.

I then received a supplemental question. *Does the fact that stock index futures contracts*

are cash-settled introduce Riba (prohibited interest payments or receipts)?

“ My more serious concern was whether the variability of returns, and the cash settlement, might result in the contract being seen as a gambling contract (Maysir in Arabic) ”

My view was that cash settlement does not mean anyone is paying or receiving interest. My more serious concern was whether the variability of returns, and the cash settlement, might result in the contract being seen as a gambling contract (Maysir in Arabic). That is not outlandish — spread betting on shares in the UK is legally treated as gambling under UK law. My view was that a cash-settled forward contract or futures contract that is based on a real underlying object (such as the S&P 500 index) is fulfilling a real economic need for some people, while providing a speculation tool for others, so is not gambling. ☺



How is the UK's only retail Islamic bank doing?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Al Rayan Bank, previously called Islamic Bank of Britain, is the only retail Islamic bank in the UK. My 6th February 2019 column titled 'The UK's first Islamic bank — a financial history' showed that it made significant losses until it was taken over by Qatari bank Masraf Al Rayan.

I wrote about it again in my 7th September 2022 column titled 'Retail Islamic banks need to become internet-only'. A journalist had written to me criticizing Al Rayan for closing its retail branches. Conversely, I think that for retail banks, branches are expensive and largely unnecessary. I finished:

“When market interest rates rise, banks typically raise interest (or its Islamic banking equivalent) paid on deposits more slowly than interest (or its Islamic banking equivalent) charged on finance provided to customers”

“With the closure of its last branch serving regular retail customers, in my view Al Rayan finally has the right strategy for a retail Islamic bank in the UK. I look forward to seeing the future results.”

We now have those future results, and I have set out the last six years. Unfortunately, the 2023 figures are incomplete. Full accounts have not

Table: Key statistics for year ended 31st December

	2018	2019	2020	2021	2022	2023
Total income	GBP38.6 million	GBP42.6 million	GBP39.1 million	GBP44.4 million	GBP55.8 million	
Total operating expenses	GBP32.5 million	GBP36.0 million	GBP34.9 million	GBP34.8 million	GBP35.0 million	
Cost to income ratio	84%	85%	89%	78%	63%	53%
Profit after tax	GBP6.4 million	GBP6.1 million	GBP3.8 million	GBP9.0 million	GBP16.5 million	GBP24.2 million
Total equity	GBP135.0 million	GBP145.9 million	GBP150.1 million	GBP157.3 million	GBP167.3 million	GBP191.5 million
Return on equity	4.7%	4.2%	2.5%	5.7%	9.9%	12.6%
Employee numbers:						
Front office	112	108	82	52		
Back office	134	227	204	175		
Total	246	335	286	227	210	200+
12 month retail prices index change	2.7%	2.2%	1.2%	7.5%	13.4%	5.2%

Source: Author's own

yet been filed with the UK Companies House registry; instead I have relied on Al Rayan's 23rd April 2024 press release announcing the 2023 results, and had to estimate its tax rate to convert pre-tax profits to post-tax profits, and estimate its equity.

Until November 2021, UK interest rates were very low, ranging from 0.75% to 0.1%.

It is very hard for banks to make profits in a low-interest rate environment, so Al Rayan's 2018–21 results were unsurprising.

Interest rates rose throughout 2022, continuing to rise until August 2023. Accordingly, it is no surprise that Al Rayan's profits increased. When market interest rates rise, banks typically raise interest (or its Islamic banking equivalent) paid on deposits more slowly than interest (or its

Islamic banking equivalent) charged on finance provided to customers.

Total operating expenses remained reasonably flat at about GBP35 million (US\$44.65 million). I expected them to fall due to branch closures, after a delay. (Initially employee severance payments and lease termination costs increase your total costs when you close branches.)

However, in the UK's inflationary environment, if the employee and branch numbers had remained unchanged, the operating expenses would have risen significantly.

For example, if costs had risen in line with inflation, the 2018 figure of GBP32.5 million (US\$41.46 million) would have become GBP42 million (US\$53.58 million) for 2022.

Accordingly, Al Rayan can be commended for successful cost reduction by getting rid of its retail branches. ☺



What will the UK's general election mean for Islamic finance?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

On Thursday, the 4th July 2024, the UK will hold a general election, electing a new House of Commons to replace the one elected in December 2019. Humans cannot foretell the future – only God has that prerogative. However we can make guesses, which sound more respectable when we call them ‘predictions’.

My expectation is that the Labour Party will emerge with a majority of at least 100 over all other parties combined. This will end the period of a Conservative-Liberal coalition government from 2010 – 2015 which was followed by the Conservative Party governing alone from 2015.

I have been thinking about what this means for the Islamic finance industry, not just in the UK, but also globally.

“ My expectation is that a Labour government will take Islamic finance far more seriously than the Conservative Party has ”

As an example of the UK's global influence, I recall that when I presented on Islamic finance at the Central Bank of Indonesia in 2009, an Indonesian official commented that, despite being a Muslim minority country, the UK had eliminated the double real estate transfer tax on Shariah compliant property finance, which Indonesia had not yet done. Indeed, several countries have copied from the UK when writing their Islamic finance legislation.

The previous Labour Party government that was in office 1997 – 2010 created the UK legislative framework for Islamic finance starting from a clean sheet. Until then, the UK had no tax, or regulatory, provisions to facilitate Islamic finance. The main provisions eliminated double real estate transfer tax on Shariah compliant property finance, and created clear rules for Murabahah, Mudarabah, Wakalah, diminishing Musharakah, and Sukuk. This made it possible to operate Islamic banks in the UK, and for UK companies to issue Sukuk.

Since the groundwork had been done, any developments by the Conservative led governments from 2010 onwards would inevitably have been less significant. However, even with that allowance, I regard the progress as pitiful. Apart from some minor legislative tidying up, the only significant developments that come to mind are:

- The UK issuing a GBP200 million (US\$1.19 billion) sovereign Sukuk in June 2014 for a five-year term. Nearly two years after it was redeemed in June 2019, the UK made a second five-year Sukuk issue in April 2021.
- The Bank of England has introduced a facility for taking Shariah compliant “deposits” to provide a place for Islamic banks to securely hold their liquidity buffers.
- Civil servants have been thinking about Shariah

compliant student finance since 2011. Prime Minister David Cameron said in 2013 that the government would introduce it. A scheme using Takaful has been worked up and consulted on. However, it has still not been implemented.

- After many years of lobbying, consultation has taken place on eliminating the capital gains tax charge on Shariah compliant refinancing of commercial real estate, but there has been no announcement yet of any legislative action.

My expectation is that a Labour government will take Islamic finance far more seriously than the Conservative Party has during the 2010 – 2024 period. My reasons are the Labour Party's focus on growth and promoting inward investment, greater support amongst Muslim voters (hence more impetus behind Shariah compliant student finance), and there being many more Labour Muslim Members of Parliament than Conservatives.

Accordingly, I expect the Labour Party to be much more willing to make improvements in the legislation if suggested by the Islamic finance industry.

Full disclosure: I was a Conservative Party member from 1983 to July 2019, and since October 2019 have been a member of the Liberal Democrats. ☺



Is trading contracts for differences Halal?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Every email user in the world can write to me via the email address I publish on my website. Accordingly, I regularly receive enquiries asking whether a particular investment is permissible within Islam.

The most recent one was last month, and I have copied a brief extract: "I've been training to trade for two years and I'm a little lost. I wanted to know if trading CFDs [contracts for differences] on forex or commodities was legal in Islam."

I gave my enquirer the same response that I give everyone who approaches me for religious advice. "Each of us is individually accountable to God on the Day of Judgment, so we have to decide religious questions for ourselves." With that preliminary disclaimer, I am always willing to share my thoughts to enable others to think about the question asked.

Almost nine years ago, my 11th November 2015 column discussed commodity speculation using futures contracts. I explained that speculators have an essential role in making markets by providing the liquidity without which

markets would not function properly. While buying futures contract entitles (indeed requires) you to take delivery of the commodity on the expiry date, I explained that in practice all speculators, and indeed most commodity users, close out their positions in cash by transacting the opposite contract.

A CFD eliminates the delivery issue by always being cash settled. Also, CFDs are not transacted on an organized market, but with financial firms that offer CFDs to their customers.

Some may wish to religiously prohibit CFDs because they are off-exchange and there are Hadith pronouncing against transactions outside the recognized market.

For example, **Sahih Muslim Book 10 Number 3623** "Ibn 'Umar (Allah be pleased with them) reported Allah's Messenger (may peace be upon him) as saying: Do not go out to meet merchandise in the way, (wait) until it is brought into the market. This Hadith has been reported on the authority of Ibn Numair but with a slight change of words."

When considering any Hadith, you need to take into account why it was given: 1,400 years ago, it would be easy to take advantage of someone away from a market, because they would not know what the market price was. Today, everyone has instant electronic access to market prices, so I see nothing wrong with transacting off-market unless the off-market contract contains other exploitative terms within it.

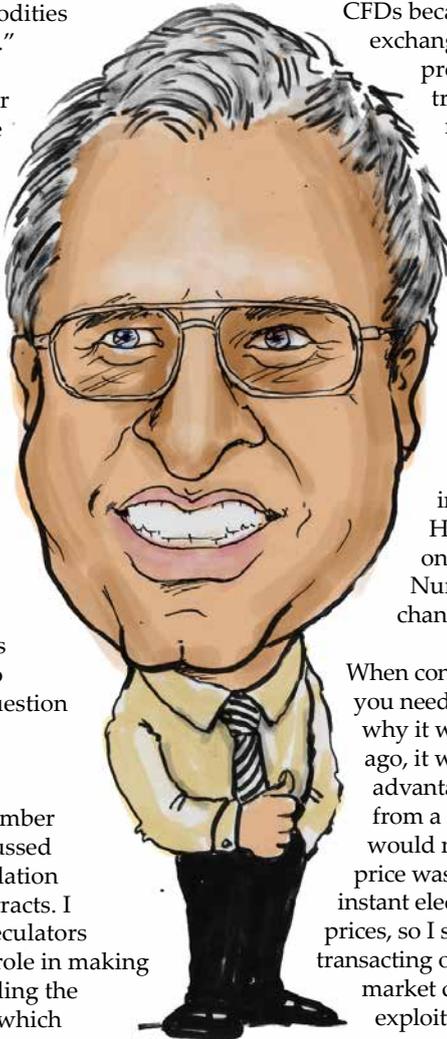
My enquirer had a supplemental question: "Could you enlighten me on the leverage granted by brokers offering 'Islamic accounts'. Can I trade with leverage via these accounts?"

I explained how leverage arises, since the CFD will normally be over a much larger value of commodity than the customer is required to deposit as margin.

“ While leveraged contracts have more risk than unleveraged contracts, I see this as a normal market price risk, rather than the type of risk ('Gharar' in Arabic) that Islam prohibits ”

For example, if the price of copper is US\$9,000 per tonne, then a CFD where the two sides are US\$9,000 and 1 tonne of copper has zero value when it starts. However, the broker will demand a deposit from you, of say US\$1,000. That is leverage of 9:1. (If the value of 1 tonne of copper rises by US\$100, you need to deposit another US\$100 of margin, so the broker stays protected against your default.)

While leveraged contracts have more risk than unleveraged contracts, I see this as a normal market price risk, rather than the type of risk ('Gharar' in Arabic) that Islam prohibits. ☺



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How is the UK's largest Islamic investment bank doing?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Bank of London and The Middle East (BLME) has been the largest standalone Islamic investment bank in the UK since shortly after it was established in the mid-2000's. However, it has a disappointing financial history, with annual results being a mix of small profits interspersed with large losses.

It has been almost two years since I last looked at BLME's business in my 5th October 2022 column, when the latest available results were those for the year ended 31st December 2021. The simplest approach is to update Table I included in my previous column.

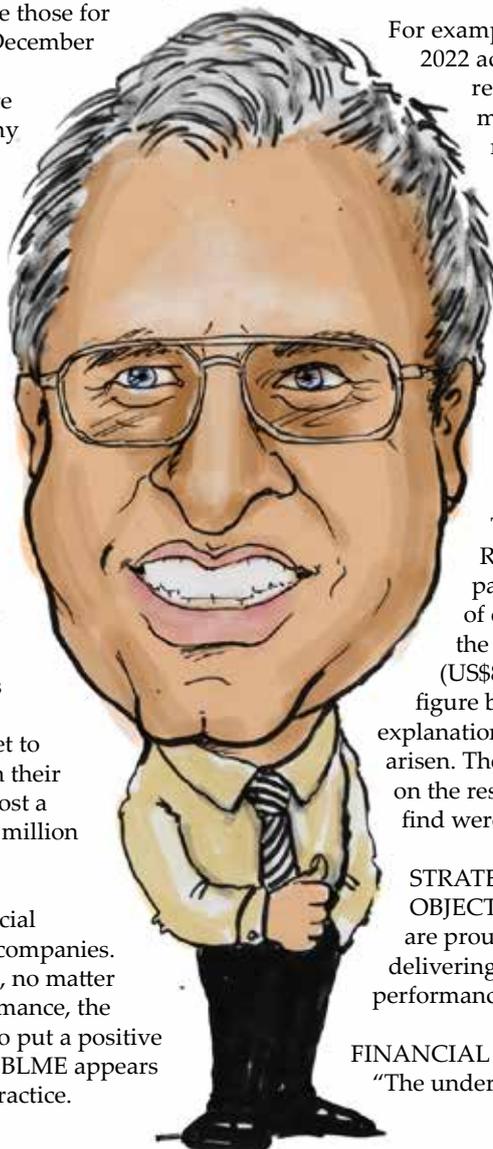
For simplicity, I have computed the return on equity by using the equity figure at the end of the year, rather than the more precise approach of averaging the opening and closing equity. This will not materially change the message.

After nearly 20 years of operations, the shareholders have yet to see any net return on their investment, having lost a cumulative GBP17.1 million (US\$22.47 million).

I have read the financial statements of many companies. With rare exceptions, no matter how poor the performance, the management tends to put a positive 'spin' on the results. BLME appears to follow the same practice.

Calendar year	Profit/(loss) after tax GBP million	Shareholders' funds GBP million	Return on equity %
Cumulative to 31.12.2017	(31.6)		
2018	10.7	228.1	4.7
2019	8.7	233.5	3.7
2020	0.9	234.3	0.4
2021	(4.3)	229.7	(1.9)
2022	(6.8)	222.9	(3.1)
2023	5.3	228.2	2.3
Cumulative to 31.12.2023	(17.1)		

Source: Author's own



For example, in the bank's 2022 accounts, where it reports a GBP6.8 million (US\$8.94 million) loss, the Director's Report does of course state the loss, but then simply says "The results for the year are discussed further in the Bank's strategic report."

The 2022 Strategic Report is over seven pages long. It does of course include the GBP6.8 million (US\$8.94 million) loss figure but contains no explanation of why it has arisen. The only comments on the results that I could find were:

STRATEGY AND OBJECTIVES section: "We are proud of our efforts in delivering steady operating performance."

FINANCIAL RESULTS section: "The underlying results of the

Bank remain resilient and in line with the strategic set up plan."

As a reader of the accounts, I would expect to see a serious attempt to explain why the bank lost money in 2021 and 2022, and in 2023 why the results turned round, even though with a return on equity of only 2.3% which is still not acceptable in my opinion.

While it is not easy reading the accounts as an outsider, in my view, the main reason for BLME's lack of profitability is that it has insufficient income generating assets in relation to its equity. Using the 31st December 2023 balance sheet, Financing Arrangements/Equity = GBP1.01 billion (US\$1.33 billion)/GBP 228.2 million (US\$299.72 million) = 4.42.

This 4.42 ratio seems low to me. As a comparison, I looked at the 31st December 2023 balance sheet of Bank Boubyan of Kuwait, BLME's ultimate parent company, which has a much higher 2023 return on equity. Doing a similar calculation:

(Islamic financing to customers + investment in Sukuk)/Equity attributable to equity holders of the bank = (KWD6,321 million [US\$20.70 billion] + KWD886 million [US\$2.9 billion]/KWD855 million [US\$2.80 billion]) = 8.4. This ratio is nearly twice as high as BLME's. ☹️

How do you choose an investment fund?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I have been looking at IFN Investor, which was launched in the cover story of IFN's 17th July 2024 issue. In the past, I found it hard getting information about Shariah compliant investment funds. Accordingly, I am grateful that IFN has created IFN Investor.

There are too many resources to cover in a short article. One I found quite interesting was the League Tables menu item, in which I looked at the Global Rankings. As of the 8th July 2024 the best performing global fund over three months was the PRUlink Syariah Extra Capital Fund managed by Prudential Indonesia, with a three-month return of 79.67%, well ahead of the second place fund which had a three-month return of 32.24%.

I was able to investigate further within IFN Investor. The Fund Directory page linked to a page for Prudential Indonesia, which showed intriguing return figures for the abovementioned fund.

The fund was launched on the 1st July 2019, so I am surprised that three-year figures were not available. I assume that the return figures are not adjusted for the period length; if so, simple arithmetic indicates that almost all of this year's returns were achieved in the last month.

My curiosity led me to download the factsheet.

Table: PRUlink Syariah Extra Capital Fund recent returns

1 Month	3 Months	6 Months	YTD	1 Year	3 Years
79.82%	79.67%	79.49%	77.32%	77.32%	-

Source: IFN Investors

Unfortunately, though understandably, the factsheet is in Indonesian. I would have used Google Translate on it, but unfortunately it is loaded as an image scan of a paper copy, rather than a character-based PDF. I couldn't summon up the enthusiasm to try optical character recognition on the image!

The wider question is how should investors choose funds?

League tables are compiled because many investors want to invest in high performing funds. It is only human nature – who wants to invest in a poorly performing fund? Unfortunately selecting investment funds by looking at past performance really does not work.

I repeat my 3rd April 2024 IFN article's strong recommendation to read "The Intelligent Fund Investor: Practical Steps for Better Results in Active and Passive Funds" by Joe Wiggins, and to follow his blog 'Behavioural Investment' at <https://behaviouralinvestment.com>

I believe the most important part of fund selection is to read what the manager says about the fund's strategy and investment methodology, ensuring that you understand it (sometimes explanations are deliberately confusing) and concur with

it as a strategy for part of your overall portfolio in the context of the rest of your portfolio. (It is rash to put all your money into one strategy.)

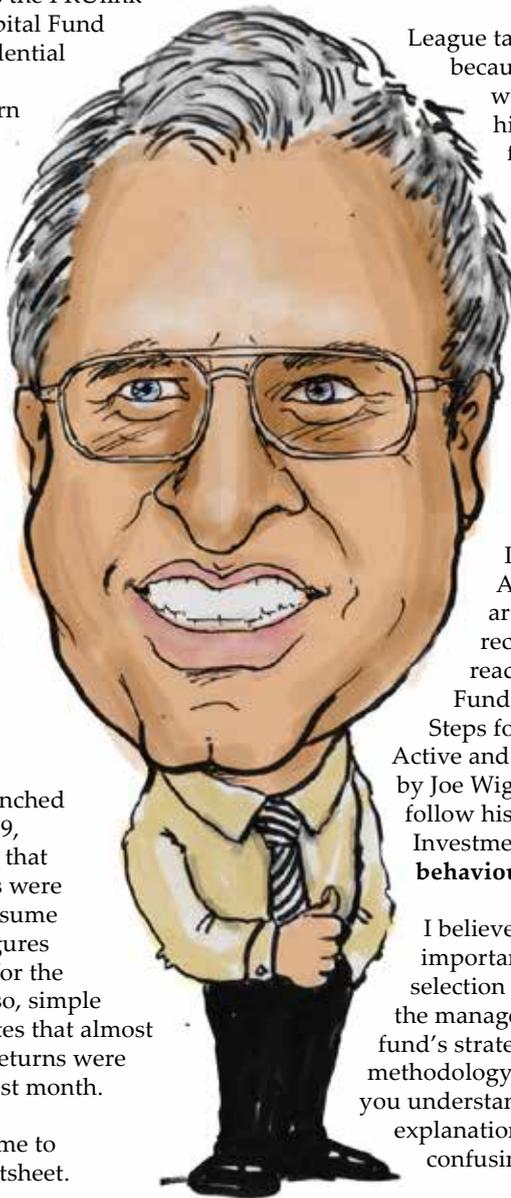
“ It is only human nature – who wants to invest in a poorly performing fund? Unfortunately selecting investment funds by looking at past performance really does not work ”

If you don't feel confident about your ability to evaluate the methodologies and strategies followed by active investment managers, then I recommend buying only index tracking funds, tracking broadly based indexes with low tracking error and low costs.

These comments are equally applicable, regardless of whether you are looking for Shariah compliant investment funds or conventional investment funds.

Once you have invested, stay put.

As mentioned in my 6th December 2023 IFN article, according to the independent US investment research firm Dalbar, investors on average earn about 3% less than the actual post-charges return of their funds, because investors buy in and out. They buy high and sell low, because they panic when markets are falling, and get enthusiastic when markets are rising! (☹️)



The UK government will eliminate the Shariah compliant refinancing trap

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

My 7th February 2024 column 'The UK government finally reconsiders Shariah compliant real estate refinancing' discussed the consultation document issued by the UK government in January 2024 regarding the possibility of eliminating the taxable capital gain that arises on using diminishing Musharakah ("diminishing shared ownership, DSO" in UK tax language) to refinance appreciated real estate.

The consultation also covered the problem of tax depreciation recapture if the real estate includes assets eligible for tax depreciation ("capital allowances" in UK tax language.)

On the 30th October 2024, the new Chancellor of the Exchequer, the Rt Hon Rachel Reeves MP, delivered her first Autumn Budget. While Islamic finance was not mentioned in her speech as it is a niche interest in the UK, on the same day HM Treasury published the document 'Tax Simplification for Alternative Finance - Summary of Responses'.

The October document stated that the January consultation document received 22 responses. 16 respondents are listed; the remaining six were individual respondents, including of course me! Looking at the

16 named respondents, they cover well the entire UK Islamic finance industry, since apart from the 14 organizations listed, most of the industry inputs into the All-Party Parliamentary Group on Islamic and Ethical Finance and into the Islamic Finance Hybrid Group who were the other two named respondents.

After discussing the responses, HM Treasury concluded by committing the government to including legislation in the next Finance Bill to eliminate the capital gains tax charge on refinancing of the type under discussion.

However, the government will not be legislating to eliminate any tax depreciation recapture.

The October document states that a quarter of respondents "did not think capital allowances implications arise in practice – respondents had not seen a case in practice or did not think there was a risk of capital allowances implications arising as DSO arrangements are typically used for residential properties where capital allowances cannot generally be claimed". Three-quarter of respondents did think capital allowances implications could arise, but two-thirds of these had not seen a case in practice.

While I am disappointed about capital allowances not being tackled, I recognize that the Finance Bill space is limited, and all tax law changes risk unintended consequences. The important thing in my view

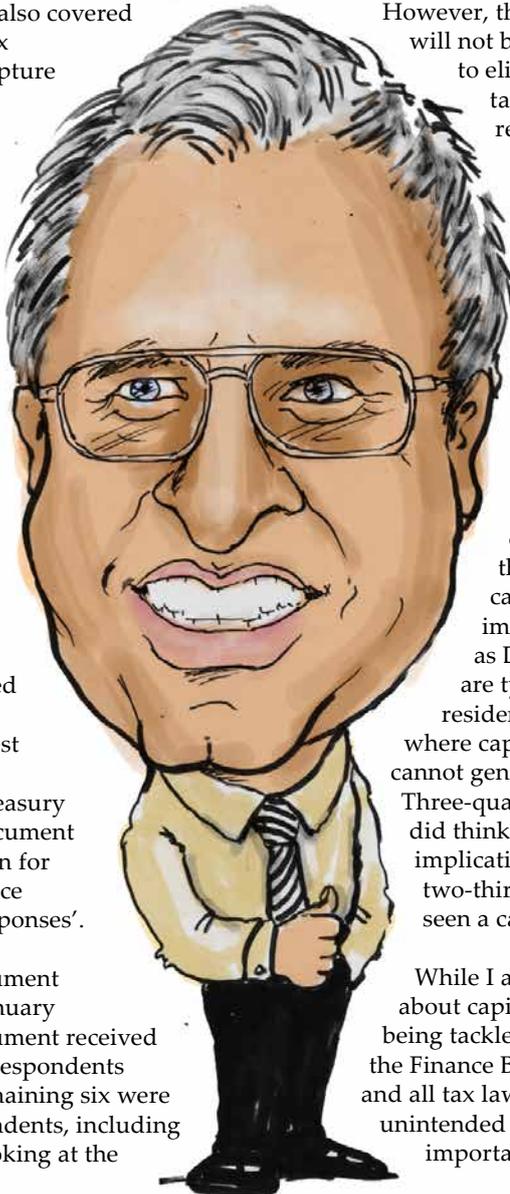
is to have the capital gains tax problem resolved.

More disappointing is that the legislation will only apply to transactions taking place from the 30th October 2024 onwards. No retrospective relief will be included for past transactions, although I expect those affected to continue to lobby for retrospective concessional relief, which I believe would be appropriate.

“ While I am disappointed about capital allowances not being tackled, I recognize that the Finance Bill space is limited, and all tax law changes risk unintended consequences ”

My 3rd July 2024 column 'What will the UK's general election mean for Islamic finance?' included a forecast of the winner of the general elections taking place the following day. Nobody will regard me as a political genius for getting it right, since every credible political commentator was forecasting a Labour Party victory!

As the above consultation was launched in January, I consider that the Conservative Party would also have legislated for Shariah compliant refinancing in the same way the new government is doing. However, I remain of the view that the new UK government will take more interest in Islamic finance than the last one did, for the reasons I gave on 3rd July. ☺



A first look at Ahli United Bank (UK)

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

Just over 20 years ago, the first standalone Islamic bank in the UK, Islamic Bank of Britain, opened for business. Over the next few years, it was followed by four other Islamic banks. It is hard to remember how optimistic the UK Islamic finance sector specifically, and indeed the whole of the country in general, felt in the years before the global financial crisis of 2007-2008.

The global financial crisis and the

“ Overall, I think this is a very satisfactory set of results for a small bank in the UK. It will be interesting to see if the bank remains as profitable once it becomes Islamic ”

recession that it led to were followed by many years of exceptionally low interest rates, an environment in which it is hard for banks to make profits. UK Islamic banking experienced a long winter. The history of the first five Islamic banks can be summarised as follows:

- Islamic Bank of Britain was taken over and is now Al Rayan Bank. Having closed its retail branches, it is reasonably profitable.
- European Islamic Investment Bank suffered years of losses, left the stock exchange, gave up its banking license and became an alternative investment firm, Rasmala UK.
- European Finance House became a

	Year ended 31 st December 2023	Year ended 31 st December 2022
	US\$ million	US\$ million
Net profit after tax	47.0	39.5
Loans and advances	1,536.0	1,454.9
Other assets	1,389.2	1,382.8
Total assets	2,925.2	2,837.7
Total equity	334.7	331.7
Post tax profits / equity	14.0%	11.9%
Equity / total assets	11.4%	11.7%
Loans and advances / equity	4.6	4.4

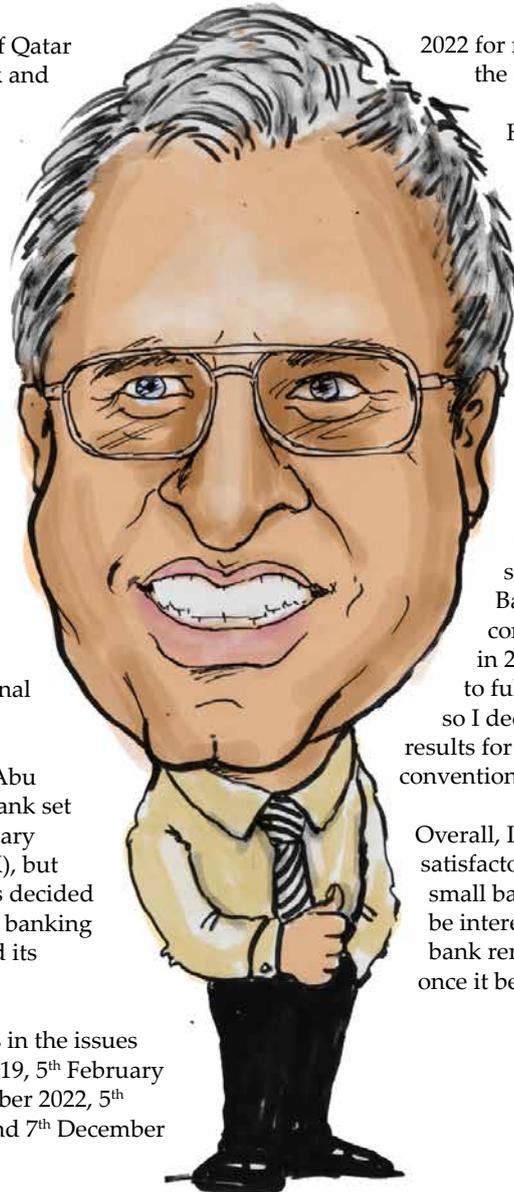
Source: Published accounts and author's arithmetic

subsidiary of Qatar Islamic Bank and continues in business as QIB (UK).

- Gatehouse Bank also continues to be in business.
- Bank of London and the Middle East has had many years of small profits interspersed with occasional big losses.

Along the way Abu Dhabi Islamic Bank set up a UK subsidiary bank, ADIB (UK), but after a few years decided to get out of UK banking and surrendered its banking license.

See my columns in the issues of the 3rd July 2019, 5th February 2020, 7th September 2022, 5th October 2022, and 7th December



2022 for more details about the above history.

However the mood seems to be changing, and I think the UK Islamic banking winter is probably over. In the Middle East, in early 2024, Kuwait Finance House completed the acquisition of Ahli United Bank of Bahrain, which had a UK banking subsidiary Ahli United Bank (UK). That is a conventional bank, but in 2024 is converting to fully Islamic banking, so I decided to look at its results for the last two years of conventional banking.

Overall, I think this is a very satisfactory set of results for a small bank in the UK. It will be interesting to see if the bank remains as profitable once it becomes Islamic. (👍)

Another development in UK Shariah compliant refinancing

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

My 6th November 2024 column 'The UK government will eliminate the Shariah compliant refinancing trap' pointed out that the government was only changing the law from the 30th October 2024 onwards. No retrospective relief was announced for past transactions.

For many years the UK tax authority, HM Revenue & Customs (HMRC), has sought to tax individuals and companies who used Shariah compliant refinancing for real estate that had increased in value, unless it was a principal private residence exempt from capital gains tax.

“Of course, the past six years of lobbying for a law change were needed because HMRC considered that tax was due under the law as it stood”

HMRC's view was that nothing in the UK tax legislation governing "diminishing shared ownership" (which is the part of the law used in Shariah compliant refinancing) precluded a capital gains tax charge on the initial sale from the owner to the financial institution. That was also my view of the law.

That is why, when I learnt that in the refinancing case mentioned in my 3rd August 2022 column, an HMRC official had concluded that the initial sale was not taxable, I considered that the official had reached the wrong legal conclusion.

That case did not stop HMRC seeking to tax many other people who had undertaken refinancing transactions.

I was recently approached for advice by another individual facing a very large capital gains tax charge on a refinancing transaction. Despite my view that strictly tax is due, I decided to help, pro bono, and composed the written argument I would put forward if I were acting for him. No matter how bleak a case may be, an experienced adviser can always find some argument to put forward!

The act of writing down the argument caused me to change my mind. I now think that the better interpretation of the capital gains tax law is that the initial sale in the refinancing transaction does not give rise to a taxable capital gain. (The law change announced in October is still welcome, since it puts the matter beyond doubt going forward.)

I had never thought about the issue as carefully as I did when composing the written argument on behalf of the individual. It shows the importance of writing down your detailed analysis of any issue, rather than just leaping to the end conclusion.

The key point is that the initial sale from the original owner to the bank is not a free-standing contract. It is integrally linked with the subsequent contractual provisions covering the lease back of the property, and the original owner's contractual right and obligation to repurchase the property.

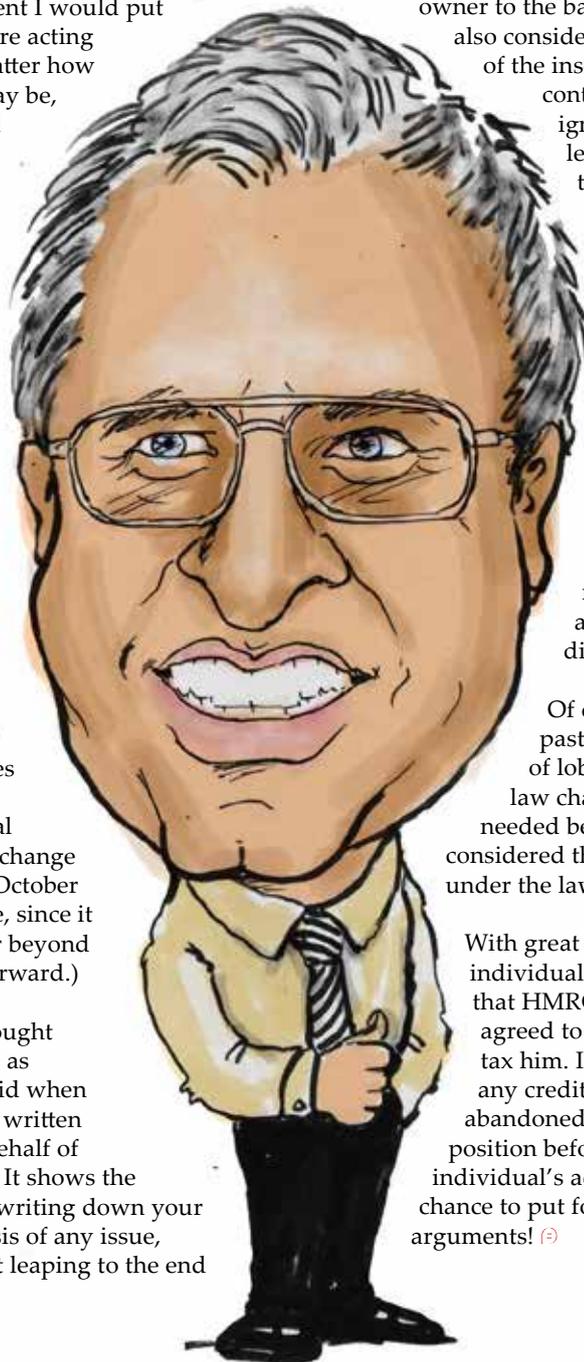
Taxing the initial sale from the original owner to the bank without also considering the effect of the inseparably linked

contracts is to ignore both the legal reality and the commercial reality.

As Lord Wilberforce said in 1978 in the tax case *Aberdeen Construction Group Ltd v CIR* "capital gains tax is a tax upon gains: it is not a tax upon arithmetical differences."

Of course, the past six years of lobbying for a law change were needed because HMRC considered that tax was due under the law as it stood.

With great delight, the individual has told me that HMRC has now agreed to stop trying to tax him. I cannot claim any credit, since HMRC abandoned their previous position before the individual's advisers had a chance to put forward my arguments! ☺



UK government reviewing Shariah compliant pensions

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

In my 3rd July 2024 column written immediately before the UK's general election, I wrote: "My expectation is that a Labour government will take Islamic finance far more seriously than the Conservative Party has during the 2010-2024 period."

After eliminating the Shariah compliant refinancing trap as explained in my 6th November 2024 column, the government is now reviewing the Shariah compliant pensions market. As an indicator of both seriousness and complexity, three government departments are involved: the Treasury, the Department for Work and Pensions and the Department for Business and Trade.

“ Designing a Shariah compliant annuity using Takaful concepts is not difficult. The problem is the unavailability of longterm Sukuk ”

In the UK and around the world, state pension provision is covering a smaller proportion of retirees' income needs. This means individuals need to save more for their own retirement. However, pension savings also matter for the economy. Where pension schemes invest their large funds, directly affects economic growth. That is why the Chancellor of the Exchequer, Rachel Reeves, is putting so much effort into merging small local government

pension schemes to produce larger pools of investable funds.

Growing individual pension savings also means more business for financial services firms who operate pension schemes and for asset managers who invest the funds.

Despite the complexity of pension funds (remember the training needed to become an actuary), there are only two key issues.

Firstly, in the savings phase, how should an individual's pension pot be invested? There is already a range of Shariah compliant equity investment funds, but in the UK it is far smaller than for

conventional funds which also have more esoteric options such as venture capital and private equity. What proportion of the pot should be invested in fixed return investments such as Sukuk? That depends on the saver's risk tolerance. During my savings phase, I was 100% equity invested because pensions have a long time-horizon, and I don't get upset by temporary falls in the value of my investments. However, most people have a lower risk tolerance.

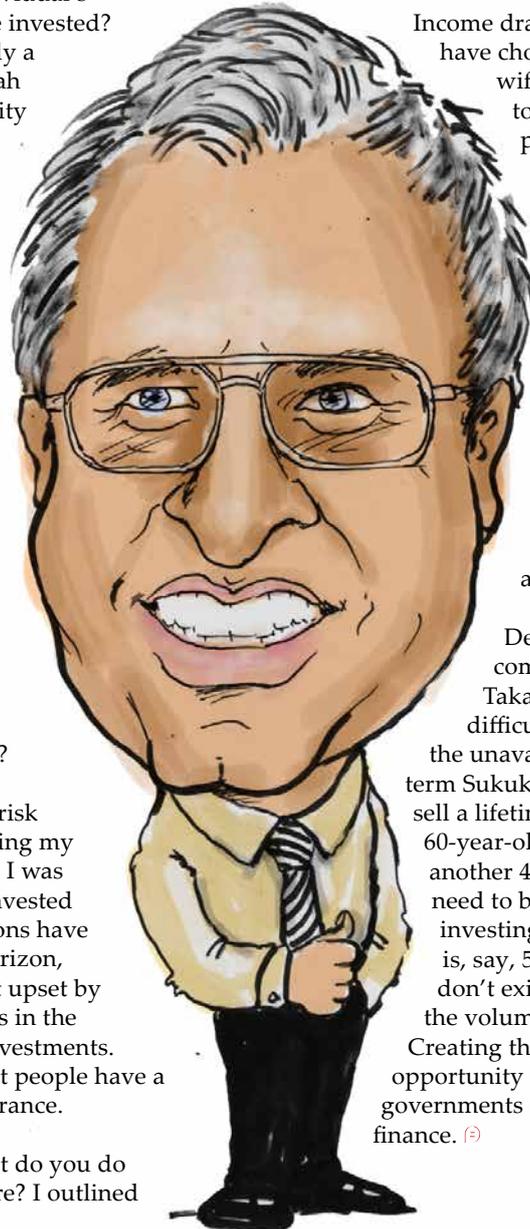
Secondly, what do you do when you retire? I outlined

the question in my 13th April 2016 column. Nearly nine years later, the issues are still the same.

The UK used to require the purchase of an annuity once you started to withdraw money from your pension scheme. However, about a decade ago, the rules were sensibly liberalized. You can now purchase an annuity as before or you can leave the fund invested (in any mix of permitted investments) and take either regular or occasional withdrawals of money from the fund. This is called 'income drawdown'.

Income drawdown is what I have chosen because my wife and I don't expect to spend all of our pension pots during our lifetimes. The residue will be left to our children or to charity. However, individuals with smaller savings face the risk of living longer than the money in their pension fund. Accordingly, they need to be able to buy a lifetime annuity.

Designing a Shariah compliant annuity using Takaful concepts is not difficult. The problem is the unavailability of long-term Sukuk. If you are going to sell a lifetime annuity to a 60-year-old, who may live for another 40 years or more, you need to back that annuity by investing in Sukuk which life is, say, 50 years. They just don't exist, certainly not in the volumes required. Creating them could be a major opportunity for companies and governments seeking long-term finance. ☺



How to boost UK Islamic finance?

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I think UK Islamic finance practitioners have been more optimistic since the change of government in July 2024. In another recent development, on the 25th February 2025, I attended a breakfast roundtable in the House of Lords hosted by Liberal Democrat peer Lord Sharkey. This was to launch Gatehouse Bank's report 'Striving for Growth: Fostering the UK's Islamic Finance Sector.' (I wrote about Gatehouse's calendar 2021 results in my 7th December 2022 column so need to do another catch-up.)

Apart from Lord Sharkey, there were other peers and elected members of Parliament present, as well as industry participants, so it was a high-quality audience.

“ Getting the balance right between requirements that were too onerous, or were so light that they would be abused, would not be easy ”

Gatehouse Bank CEO Charles Haresnape outlined the report's key recommendations:

1. Establish a government-led Islamic finance taskforce to identify areas of growth, including facilitating inward investment and attracting international investors seeking alternative sustainable options.
2. Attract new Islamic finance entrants by removing barriers and disadvantages compared to conventional finance such as increasing the Bank of England's

Alternative Liquidity Facility (See my 2nd March 2022 column).

3. Develop a cohesive UK government strategy on Islamic finance, to level the playing field and ensure alternative finance structures are considered when formulating policy and proposing new legislation.
4. Foster global collaboration on Islamic fintech, to fuel the already strong UK market and enable it to grow.

During the discussion, I pointed out a change falling within recommendation three above that is needed to the UK's tax law relating to 'alternative finance arrangements.' This is the tax law that was enacted to facilitate Islamic finance.

From inception in 2005, it has required one of the parties to be a 'financial institution' as defined in the legislation. I understand this requirement was imposed for two reasons:

- To reduce the scope for people to avoid tax using the new law (That has not stopped people trying!)
- To avoid transactions getting sucked into the new tax rules inadvertently.

However, the requirement is an impediment for Islamic finance start-ups, particularly small fintech firms, since there is a significant regulatory burden (with significant related costs) in becoming an entity that qualifies within the existing definition.

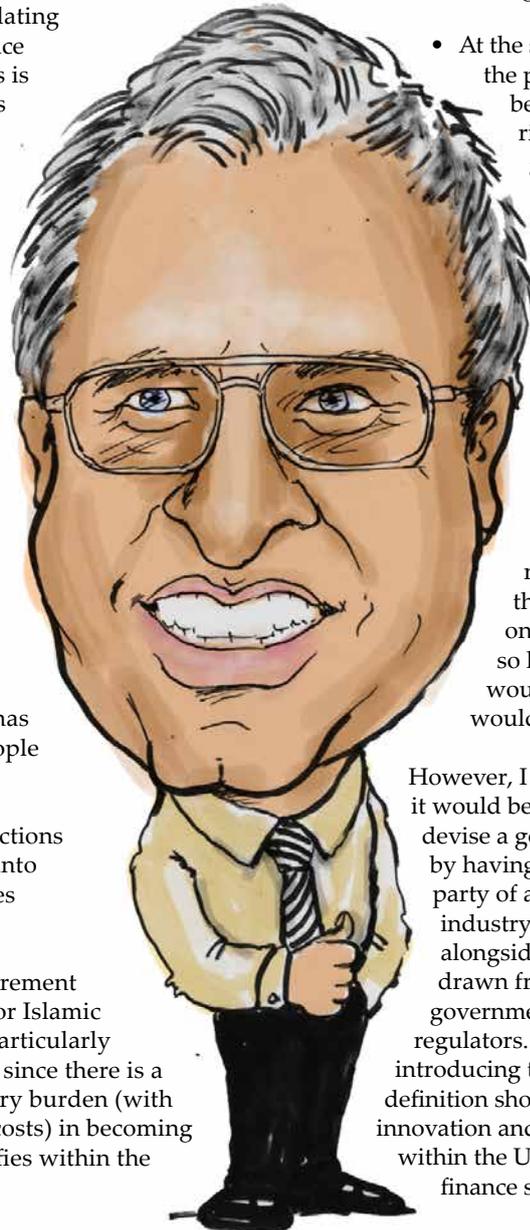
I recommended that the Islamic finance sector work with the government to devise a new definition of, say, an 'Alternative Financial Services Provider', 'AFSP' (name only created while writing this column!) which would satisfy the following conditions:

- A properly defined registration process policed by (preferably) one of the existing financial regulators, so there would always be a clear list of which entities were AFSPs.
- The process for becoming an AFSP should be easier, and therefore less expensive, than the process for falling within the existing definition.

- At the same time, the process should be sufficiently rigorous that the government was satisfied that AFSPs would not be used for tax avoidance, or for other forms of financial misbehavior.

Getting the balance right between requirements that were too onerous, or were so light that they would be abused, would not be easy.

However, I considered that it would be possible to devise a good definition by having a working party of a small group of industry practitioners alongside a small group drawn from the government's existing regulators. Done properly, introducing the AFSP definition should allow more innovation and more start-ups within the UK Islamic finance sector. ☺



Yet another request for religious advice

Mohammed Amin is an Islamic finance consultant and former tax partner at PwC in the UK.

I eventually add each of my monthly columns to the Islamic finance section of my website, after a few months delay to ensure IFN has a reasonable priority period. My website contains much else besides Islamic finance such as articles about politics, career advice, book reviews, etc.

Every website page allows readers to post comments, using technology from Disqus. I receive an email each time someone comments, and usually they are asking a question. I respond whenever I can, while deleting occasional attempts at 'comment spam.'

A few days ago, I noticed that although my site has over 800 pages, over the last year a disproportionately high number of comments arose from just two articles:

- My 2nd December 2020 column 'Futures trading: Economically beneficial. Religiously permissible?'
- My 11th November 2015 'Letter from Amin' explaining why commodity speculators are socially useful.

As well as public comments on my website, I also receive private questions via email, or last month by Facebook Messenger, copied below with one redaction and minor grammatical corrections:

"I'm XXXXXX from Pakistan. I have done a Masters in finance.

I just want to ask about online forex trading (derivatives market). Is it allowed in Islam or is it Haram?

Secondly, I want to ask about short selling or futures trading on the Pakistan stock exchange. My question: is it Halal or Haram? I read your article about this but still want to ask about (1) possession, (2) the Ulemah says there is interest in it, (3) and we get benefits at the loss of the other party.

Please guide me. I have skills but am very worried and confused about this. Please guide me about the above points."

I have been thinking about why I get so many questions of this type.

Most of the questioners strike me as being young. Of course, when you are 74, most other people are young!

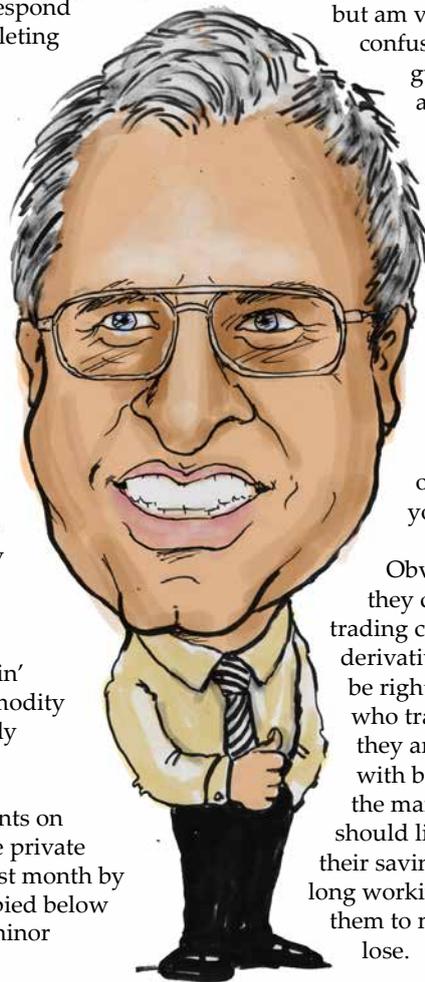
Obviously, they think they can make money trading currency or equity derivatives. Some may even be right! For the others who trade at a loss, unless they are speculating with borrowed money, the margin requirements should limit losses to 100% of their savings. They will have long working careers ahead of them to make up what they lose.

Personally, I occasionally used to buy traded options when younger but haven't bothered for many years. There is no point speculating with a tiny proportion of my portfolio, since even small amounts require time and effort. Conversely at my age and being retired, I don't want to risk a meaningful proportion of the portfolio in such risky activities.

“ In my opinion, too many people fail to think from fundamental principles. Instead, they try to shoehorn new questions into old categories ”

I always remind enquirers that they must answer religious questions for themselves, since they are individually accountable to God for their actions and cannot shift the responsibility by asking someone else. They need to think about the purposes which underlie the rules they are asking about, and whether they are still the same in today's environment when exchanges have precise rules governing trading arrangements, collateralization, margining, etc.

In my opinion, too many people fail to think from fundamental principles. Instead, they try to shoehorn new questions into old categories. I illustrated this in my 7th March 2018 column 'Shariah scholars should stop analyzing corporations as if they were partnerships.'⁽²⁾





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