

DIVERGENT POLITICAL DYNAMICS OF ISLAMIC BANKING IN BRITAIN & FRANCE

A thesis presented by

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## ABSTRACT

Since the late 1980s, Britain has experienced unprecedented and unexpected growth in its Islamic financial sector, raising questions about the future of Islamic banking in conventional markets in Western Europe. The state not only has 22 different banks offering Islamic banking products, but it has also accrued over \$19 billion of *shari'ah*-compliant assets. France, however, with its minimal Islamic finance development, is representative of other Western European states. Using a comparative historical, institutional, and legal analysis of Britain and France, this paper examines the divergent development of Islamic banking in the two countries. This paper demonstrates that the flexible and open nature of state regulatory bodies determines the development of Islamic financial sectors. Moreover, this paper finds that institutional preferences for financial inclusion influence the extent, sectorial structure, and effects of reform for the integration of Islamic finance into conventional markets. Contributing to discourses on diversity politics in Western Europe, this paper also argues that reforms for Islamic finance have constituted social policy in the UK within the policy framework of multiculturalism for the recognition and integration of Muslim minorities.

Depuis la fin des années 1980, la Grande-Bretagne a connu une croissance inattendue et sans précédent de son secteur financier islamique. Ce fait soulève des questions sur l'avenir de la finance islamique au sein des marchés traditionnels en Europe de l'Ouest. L'Etat a désormais 22 banques différentes qui offrent des produits bancaires islamiques, et a également accumulé plus de 19 milliards de dollar d'actifs conformes à la Charia. La France, au contraire, avec son développement minime du financement islamique, est représentative des autres Etats d'Europe. Cette thèse s'appuie sur une analyse comparative de l'histoire, des institutions et du droit de la Grande-Bretagne et de la France, et elle examine les évolutions divergentes de la finance islamique au sein de ces deux pays. Cette thèse démontre que le caractère souple et ouvert des institutions gouvernementales de régulation détermine le développement de secteurs financiers islamiques au sein des pays aux marchés financiers conventionnels. En outre, cette thèse constate que lorsqu'il y a une préférence institutionnelle pour l'inclusion financière, cela influence la mesure, la structure sectorielle, et les effets de réformes éventuelles pour l'intégration de la finance islamique dans les marchés traditionnels. Contribuant au discours sur les politiques de diversité en Europe, cette thèse fait valoir que les réformes pour la finance islamique ont constitué la politique sociale en Grande-Bretagne dans le cadre des politiques multiculturalistes pour la reconnaissance et l'intégration des minorités musulmanes.

## AUTHOR'S NOTE

Islamic finance, Islamic banking, and *shari'ah*-compliant banking and finance are terms I use basically interchangeably throughout this thesis. Consistent with the literature at large, I define Islamic banking as a set of financial products and services compliant with Islamic law, the *shari'ah*. Compliance with Islamic law means that a given financial product or service has been reviewed and declared licit by an Islamic scholar (jurist) or body of scholars. Most simply and typically, *shari'ah*-compliant banking means banking without interest or speculative transactions, since both are forbidden in the Qur'an and the Sunnah. Practically, this means that Islamic banks generally use profit-loss sharing contracts and the purchasing and reselling of goods at mark up prices instead of giving loans. On a practical note, *Shari'ah*-compliant products appear the same as conventional products on the surface since their differences are inherently structural.

Unless otherwise noted, all translations in this paper are my own, for which I take responsibility for accuracy.

Most foreign quotations are translated into English in this paper. Notably, names of French foreign institutions, such as the Autorité des Marchés Financiers, are generally not translated. I include a brief glossary of major foreign terms as Appendix I of this paper. Additionally, Chapter II (Section VI) includes an overview of major Islamic financial contracts, which appear under their Arabic names in the text. Finally, I include a brief list of repeated abbreviations prior to Chapter I.

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## PREFACE & ACKNOWLEDGEMENTS

The first time I heard about Islamic banking was in July 2010. I was sitting in a summer term advanced business Arabic class and my classmate and I were reading about Saudi banking practices in Arabic. After teaching us how to fill out a loan contract with a Saudi bank, my professor, Dr. Raji Rammuny, directed us to a reading about something called *al masrafiyya al islamiyya*. I was not exactly sure what this “Islamic financing” meant. What could be particularly Islamic about the leasing contracts we were learning how to fill out? Through more reading, I began to understand that the various ‘Islamic’ contracts were designed to circumvent something called *riba*, which I came to understand as excessive interest or usury. I began to be interested in what the social and political effects could be for using a structurally different set of banking products and how those products might interact with the ‘normal’ banking products I used daily.

A year later, I spent much of my summer in Paris on a minority rights fellowship, studying the history of diversity politics in the French Republic. The experience was transformative and, while in Paris, I began to wonder whether French Muslims had access to the religiously conscious banking services that I had been learning about in my Arabic class. I asked my French Muslim friends what they and their families did for banking and I learned that there were no Islamic mortgages or savings accounts in Paris or anywhere in France. Some of my friends used checking accounts instead of savings accounts to avoid interest. Others simply used conventional banking, saying that it was just too difficult otherwise.

Soon, I learned that Muslims across the Channel in Britain did not face the same quandary between using basic banking services and being a devout Muslim because they had numerous banks offering Islamic banking services. This was puzzling and fascinating, but I was not sure if there was a political science thesis under all of the question marks. Initially, when weighing thesis topics back in Ann Arbor, I decided to research Islamic banking as a negative determinant for foreign investment in Islamic states. But when this topic failed to keep my interest, I spoke to Dr. Markovits who encouraged me to return to the question of Islamic banking in Europe. And with the generous help of both Dr. Markovits and my principal advisor, Dr. Anne Pitcher, I reworked my thesis to be a comparative paper about the divergent development of Islamic finance between two very similar Western European states: Britain and France.

It would not have been possible for me to have written this thesis without the immense support from the mentioned professors. I would like to thank Dr. Anne Pitcher for guiding me through conceptual revisions and academic freak-outs alike. Her no-nonsense approach kept me focused and her generosity made me proud to write a thesis. My research and writing would also have not been possible without the constant kind support from Dr. Andrei Markovits, ever helpful in both enthusiasm and constructive criticism. I would not have been able to keep writing, week after week, without his guidance. I would also like to thank Dr. Rita Chin from the Department of History who kindly agreed to function as my third reader.

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I must also thank my parents, Leonard and Patricia Chase. I would not be able to write a sentence without my mother's guiding voice, and I would not be able to analyze an article without my father's critical thinking. For these, I am eternally grateful.

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## ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AIDIMM	Association d'Innovation pour le Développement économique et IMMObilier
AMF	Autorité des Marchés Financiers
BCCI	Bank of Credit and Commerce International
BLME	Bank of London and the Middle East
BoE	Bank of England
CECEI	Comité des Établissements de Crédit et des Entreprises d'investissement
FSA	Financial Services Authority
HMRC	Her Majesty's Revenue & Customs
HMT	Her Majesty's Treasury
IBB	The Islamic Bank of Britain
IFAAS	Islamic Finance Advisory and Assurance Services
IFOP	Institut français d'opinion publique
IHPP	Islamic home purchase plan
MCB	Muslim Council of Britain
SAC	<i>Shari'ah</i> Advisory Council or board



## CHAPTER I: INTRODUCTION

As the European continent emerged from the rubble of the Second World War and began to rebuild, few Europeans foresaw the phenomenal economic, political, and social changes their states would experience as a result of immigration in the ensuing half-century. The economic growth witnessed in Western Europe drew immigrants first from Eastern Europe and later from former colonies to states that seemed to promise improved livelihoods and standards of living.<sup>1</sup> Immigrants would transform metropolises like Paris, Amsterdam, Berlin, and London beginning in the 1950s.<sup>2</sup> In these cities, state officials quickly confronted two challenges arising from Europe's newfound diversity. First, most migrant laborers would never return 'home.' Second, immigrants who came seeking opportunities carried with them entrenched cultural and religious traditions.<sup>3</sup> As immigrant communities grew and became embedded in urban centers across Europe, the challenges of immigration and integration would dominate public, political, and academic discourse.

Sixty years later, the challenges have intensified. By 2006, the 5.4 million foreign-born, non-EU immigrants and their children had forever changed the French Republic.<sup>4</sup> The United

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1. By 1974, the French national census had documented a total of 3.4 million foreigners, making up 6.2 percent of the total population. This figure was split between immigrants from other European states and immigrants from former colonies. Particularly, there were 710,000 Algerians, 260,000 Moroccans, and 139,000 Tunisians. See Patrick Weil, *How to Be French: Nationality in the Making since 1789*, trans. Catherine Porter, (Durham: Duke University Press, 2008), 152-153. Across the Channel, by 1981, 30 years after Great Britain's opening to immigrants, 1.5 million immigrants from former colonies (and their children) had settled in the country. See Russell King, *Atlas of Human Migration* (New York: Firefly, 2007), 178-181.

2. Tony Judt, *Postwar: A History of Europe since 1945* (New York: Penguin, 2005), 333-336.

3. Christopher Caldwell, *Reflections on the Revolution in Europe: Immigration, Islam, and the West* (New York: Doubleday, 2009); and "A Treacherous Path? A Pessimist's View of What Islamic Immigration May be Doing to Europe," *The Economist*, August 27, 2009, Print Edition.

4. Catherine Borrel and Bertrand Lhommeau, *Être né en France d'Un Parent Immigré* (Paris: National Institute of Statistics and Economic Studies [INSEE], March 2010): 1287.

Kingdom, likewise, became home to 4.76 million foreign-born, non-EU persons by 2010.<sup>5</sup> In these states and others, governments and their constituencies struggled with questions of diversity, inclusion, and exclusion in democracy. The questions have remained largely unanswered: can a single nation-state be home to a multitude of different cultures while also existing as a participatory democracy? Can a minority group be separate but equal under the law? How does a state allow for freedom of belief and expression while holding to its national traditions and identities? What do these ideas mean for the law?

The different ways European governments have answered these questions have formed national traditions of inclusion, exclusion, liberalism, and nationalism. The variety of state approaches to diversity speaks largely to different notions of national identity and conceptions of the place of diversity within the nation-state. Equally, state approaches depend on which immigrant group the state is trying to accommodate. In the contemporary period, responses to diversity have not so much been about the challenge of integrating Eastern Europeans into Western European cities as during the Cold War; rather, governments have wrestled with the question of what the growth of Muslim populations in Western Europe means for liberalism and national identity in democracy.

With respect to the inclusion of Muslim immigrants, the *burqa* has emerged as the most visible and controversial symbol of diversity politics in Europe. Indeed, questions of national identity, liberal democracy, and diversity have mostly concerned social issues: veils, graffiti, schools, civil unrest, and family law. Yet the challenges of incorporation extend equally to economic issues and, with respect to Muslims, to the balance between culture and commerce. This paper argues that the question of commercial integration is equally as consequential as the

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5. Katya Vasileva, *Population and Social Conditions* (Luxembourg: Eurostat and European Commission, July 7, 2011).

social integration of Muslim minorities in Western Europe and that these two ‘integrations’ are interrelated and interdependent.

The increased mobility and economic prosperity of second- and third-generation immigrants in Western Europe is often obscured by stereotypical and inaccurate views of European Muslims: the unemployed Algerians in the Parisian *banlieues*<sup>6</sup> or the poor Turks in the factories of industrial Munich.<sup>7</sup> Because these Muslim communities are perceived as poor and without much use for a bank, the need of Muslim communities for banking and financing services is not well understood in the literature on multicultural policies in Western Europe.<sup>8</sup> More specifically, the literature has not addressed the difficulties Muslims in Paris, Munich, and across Western Europe face in obtaining interest-free banking services like mortgages and savings accounts that comply with the economic principles of Islamic law. Finally, the literature has glossed over how the fulfillment of these interest-free banking needs contributes to inclusion and integration in broader social spheres. An examination of these commercial and economic factors is ultimately consequential since the level of commercial activity and economic standing of Muslim minorities will directly influence their political and social integration over the coming decades.

To explore the commercial and economic aspects of immigrant communities, this paper examines Islamic banking and the regulatory challenges faced by Islamic financial institutions. In practical terms, Islamic banking is a set of financial services that do not use interest or

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6. While there are also wealthy *banlieues* in France, some of which are comparative to American suburbs, the term more typically refers the outskirts of a city where the lower class lives in mostly social housing.

7. Mohammad Farrukh Raza, “Does Islamic Finance Have a Room to Thrive in Europe?,” (presentation at the Islamic Finance and Real Estate Conference, Islamic Finance Advisory & Assurance Services [IFAAS], Frankfurt, Germany, November 4, 2008): 15.

8. Diversity and multiculturalism are not synonyms. Diversity is a demographic reality while multiculturalism is a political approach. Multiculturalism is a framework of policies that recognize (and often encourage) distinct cultures that form a diverse nation-state.

speculative transactions. I provide a more theoretical and contextual definition in Chapter II.

While mostly unaddressed in the literature, understanding how European societies have dealt with the legal inclusion of a structurally different foreign banking system contributes to larger discussions on how Muslim immigrants and their children can be integrated into European societies without compromising their own cultural and religious traditions. An analysis of the accommodation of Islamic finance in Western Europe raises related questions as to the *extent* of integration. Policies of multiculturalism rest on a tenuous ‘give-and-take’ relationship between integration and assimilation. To what degree should the government labor to accommodate difference? Are there ‘differences’ that go too far for inclusion? How much should minorities compromise for the sake of assimilating into a Western European country?

The debate over policies of multiculturalism that deal with Islam in Europe has been driven mainly by extremes: polygamy, child brides, honor killings, and, broadly, what has been termed as ‘the assault of *shari’ah* law on European liberalism.’ A discussion of these extremes is counterproductive since extremes shed little light on the actual plight of Muslim minorities in countries like Britain and France. Few would argue that honors killings could be combatable with liberal democracy. Instead, more practiced and accepted traditions within Muslim communities in Western Europe should shape the debate about the prudence of multicultural policies.

Like headscarves in schools, Islamic banking in Western markets is a contested practice but is less antithetical to liberal democracy than other practices and is one that might yield positive social results for Western democracies. Such results could include financial inclusion and the economic development of poor immigrant communities. Extreme practices, such as child brides, do not yield such clear social benefits for the nation.

An examination of Islamic finance in Europe is useful for several reasons. First, the variance observed in state policy relating to Islamic finance across Europe informs discussions on how European states react differently to the growing Muslim populations within their borders. Second, Islamic finance offers an important perspective on how commercial and financial law contribute to the inclusion or exclusion of Muslims as a religious minority in Europe through commercial transactions in daily life. Third, an inquiry into Islamic finance as a new paradigm for politics of multiculturalism uncovers how institutional and legal mechanisms for inclusionary policies interact with the social and cultural mechanisms observed widely in the literature through the veil paradigm.

#### I. THE DISTRIBUTION OF ISLAMIC BANKING ACROSS WESTERN EUROPE

There are over 17 million Muslims<sup>9</sup> and 31 Islamic financial institutions in Western Europe.<sup>10</sup> The distribution of these 31 institutions is hardly even. Out of the 18 states in Western Europe,<sup>11</sup> only 6 have Islamic banks: the United Kingdom, France, Switzerland, Germany, Ireland, and Luxembourg.<sup>12</sup> Moreover, 22 of the 31 Western European Islamic banks are in a single country: the United Kingdom.<sup>13</sup>

With *shari'ah*-compliant<sup>14</sup> assets totaling over \$19 billion, Britain has a greater presence of

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9. Pew Research Center, *The Future of the Global Muslim Population: Projections for 2010-2030*, January 27, 2011.

10. International Financial Services London (IFSL), *Islamic Finance 2010* (London: IFSL Research Publications, January 2010): 1.

11. This paper defines Western Europe as inclusive of what the United Nations has termed Western Europe, Southern Europe, and Northern Europe. Included countries are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

12. Number of Islamic financial institutions by country: United Kingdom (22), France (3), Switzerland (3), Germany (1), Ireland (1), and Luxembourg (1). Additionally, outside of Western Europe, Russia has 1 Islamic bank.

<sup>13</sup> Fully *shari'ah*-compliant banks in the UK are Bank of London and the Middle East, European Finance House, European Islamic Investment Bank, Gatehouse Bank, and Islamic Bank of Britain. Islamic 'windows' are Ahli United Bank, Alburaq, Bank of Ireland, Barclays, BNP Paribas, Bristol & West, Citi Group, Deutsche Bank, Europe Arab Bank, HSBC Amanah, IBJ International London, J Aron & Co., Lloyds Banking Group, Royal Bank of Scotland, Standards Chartered, UBS, and United National Bank.

14. As described in Chapter II, *shari'ah* compliance is whether or not a given financial product or service has been declared licit by a scholar (or body of scholars) of Islamic law, the *shari'ah*.

Islamic finance by far than any other European (or Western) state.<sup>15</sup> This raises interesting questions for discussions on the intersection between culture and commerce. Why are all the Islamic banks in the United Kingdom? Why are they not more equally dispersed across Western Europe and the West as a whole? And even if only a single European city is to be the ‘capital of Islamic finance,’ still the question remains—why London?

In asking the question of why London and not Paris, or Frankfurt, Zurich, or Amsterdam, conventional logic might suggest that Islamic finance as a sector will follow population. Under this logic, a larger population of Muslims would correlate with a larger Islamic financial sector. But empirically, this is not true. A state like the Netherlands with over 900,000 Muslims lacks a single Islamic financial institution while Luxembourg has one Islamic financial institution but only 11,000 Muslims.<sup>16</sup>

To return to the question of London, while it is true that the United Kingdom has a greater number (2.9 million) of Muslims than many Western European states, it certainly lags behind states like France (estimated at 4.7 to 6 million)<sup>17</sup> and Germany (4.1 million).<sup>18</sup> Yet, despite having larger Muslim populations than the UK, both France and Germany have fewer Islamic financial institutions: three and one financial institutions, respectively.<sup>19</sup> First, this discrepancy means that the portrait of Islamic finance in Europe is more complicated than it appears at first glance. Second, it means that the initial logical hypothesis, that size of Muslim community determines size of Islamic financial sector, appears to be incorrect.

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15. IFSL, *Islamic Finance 2010*, 1.

16. Pew Research Center, *The Future of the Global Muslim Population*.

17. Religious and ethnic statistics in France are infamously illegal in France, making estimates very wide and sometimes contradictory of each other. Most scholars agree, however, that the Pew Research Center’s figures are very conservative and more accurate figures (of at least 6 million Muslims in France) from the U.S. Department of State are more accurate. See U.S. Department of State, “Background Note: France,” Bureau of European and Eurasian Affairs, U.S. Department of State, May 27, 2011.

18. Pew Research Center, *The Future of the Global Muslim Population*.

19. Anouar Hassoune, “Islamic Finance in France: Strong Potential but Key Obstacles Persist,” *Moody’s Global Banking*, July 2008.

Moreover, comparisons with other European financial heavyweight states further complicate the puzzle and weaken the traditional ‘population as determinant’ hypothesis. Switzerland, a non-Eurozone financial center like the UK, has about 400,000 Muslims,<sup>20</sup> comprising 5 percent of the total population.<sup>21</sup> With a small but proportionate number of Muslims, Switzerland has three Islamic banks, the same number as France.<sup>22</sup> Germany, meanwhile, with a major finance capital in Frankfurt, has 4.1 to 4.3 million Muslims (5 percent of the total population of Germany)<sup>23</sup> and only 1 Islamic bank.<sup>24</sup> Finally, a global comparison complicates initial explanations for the distribution of Islamic finance even further. Major states with Muslim majorities (or very large Muslim populations) including Bangladesh, Sudan, Egypt, Pakistan, Jordan, Syria, Iraq, and Indonesia *all* have smaller *shari’ah*-compliant asset reserves than the United Kingdom had accrued by 2010.<sup>25</sup>

Additionally, other arguments also fail to explain the unequal distribution of Islamic financial institutions, services, and capital across Europe. While this paper agrees that the large size of Britain’s financial services industry contributes to the sector growth of Islamic finance, this alone could not have been the driver of the sector’s growth. When we compare London to other European financial capitals, such as Paris, Zurich, Frankfurt, and Luxembourg, it is clear that status as a large international banking capital backed by a country of a large GDP does not necessarily lead to the development of an Islamic financial sector. Paris, Frankfurt, and London

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20. Central Intelligence Agency, “Europe: Switzerland,” The CIA Factbook, January 4, 2012, accessed January 21, 2012 at <https://www.cia.gov/library/publications/the-world-factbook/geos/sz.html#People>, and Pew Research Center, *The Future of the Global Muslim Population*.

21. While the total number of (resident) Muslims in Switzerland is quite small in comparison to other discussed European states, the Muslim percentage (5 percent) of the total population of Switzerland is quite comparative to France’s 7-10 percent, the UK’s 4.6 percent, and Germany’s 5 percent.

22. International Financial Services London, *Islamic Finance 2010* (London: IFSL Publications, 2010).

23. Pew Research Center, *The Future of the Global Muslim Population*; Deutsch Welle, “Study: Significantly more Muslims in Germany,” *Deutsch Welle*, June 23, 2009, accessed January 21, 2012 at <http://www.dw-world.de/dw/article/0,,4419533,00.html> (in German).

24. IFSL, *Islamic Finance 2010*.

25. IFSL, *Islamic Finance 2010*, 2.

all have comparative makeups as financial capitals; in fact, Paris has upwards of 100 more banks than London (roughly 600:500).<sup>26</sup> Yet, as discussed, these cities have very few Islamic financial institutions and very limited *shari'ah*-compliant assets. In comparing London with New York, Hong Kong, and Shanghai—also urban centers without a considerable presence of Islamic finance—it is clear that the status of being a major world finance capital does not ensure the development of Islamic finance.

## II. THEORY & HYPOTHESIS

In sum, this paper finds the presence of a large Muslim community and the status of global financial capital to be insufficient conditions to explain the growth of Islamic finance in any given urban center. Instead, I argue that particular institutional aspects of a given country account for the development of Islamic finance. This paper claims that the degree of flexibility and openness of state financial regulatory systems to inclusionary reform determines the distribution of Islamic finance across Europe. Consequently, states with more flexible financial regulatory institutions experience greater development of Islamic finance. Conversely, states with inflexible financial regulatory institutions experience a smaller degree of development.

I examine comparative cases of the United Kingdom and France to test my hypothesis that institutional flexibility and openness to reform determines the development of Islamic finance. The difference between the development of Islamic finance in Britain and France is extraordinary when we consider how similar the two countries are. Their list of common traits is significant: early democratizers, unitary and highly centralized governments, European Union member states, *jus soli* citizenship states, colonial powers with long relationships with the Islamic World, and countries of global languages and international banking capitals. Yet, despite

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26. Xinhua-Dow Jones, 22-23.



all of these commonalities, the development of Islamic finance between two countries separated by the English Channel could not be more different.

I claim that this divergence in Islamic banking sector development corresponds with a variance in the political dimensions in France and Britain relating to banking regulation and authorization. I argue that the UK's financial regulatory system's openness and flexibility toward inclusive financial reform provided the foundation for the unprecedented growth of Islamic financial institutions and services in the United Kingdom. Particular institutional mechanisms and a political climate open to Islamic finance not only allowed but also encouraged inclusionary legal reforms in the tax code. Subsequently, these reforms allowed for and encouraged the authorization and opening of Islamic banks and financial institutions in the UK.

Actual policy, its implementation, and the financial regulatory system's support for 'alternative' finance are key points in understanding what led to the sector's growth. In more detailed terms, I argue first that a series of reforms pertaining mostly to tax law—spearheaded by Her Majesty's Treasury and the Financial Services Authority (FSA)—allowed institutionally for the establishment of Islamic banks and the marketing of their financial products on British soil. Second, I argue that the state's pragmatic and comprehensive approach to the implementation and enforcement of these reforms helped to stimulate the actual establishment of financial institutions. Third, I claim that the state regulatory system's general approach to the reforms and alternative finance, which was marked by ideas of openness, tolerance, and liberal democratic inclusion, provided an encouraging environment for investors seeking to open Islamic financial institutions in the West.

Central to my claim and my explanation for the distribution of Islamic financial institutions across Western Europe is my argument that France and other European states have lacked these

three enabling and encouraging factors of 1) legal reform, 2) implementation and enforcement, and 3) general openness to alternative finance. Thus, to better understand this unequal distribution, I compare Paris, France, and London, UK, to reveal the institutional aspects of each country's government that encouraged and discouraged (enabled and disabled) the establishment of Islamic banks within their borders.

The differences between French and British governmental approaches to the development of Islamic finance correspond with national traditions of liberal capitalism and nationalist *dirigisme* in each country. Under John Stuart Mill's framework, Britain's liberalism makes the country's political, economic, and cultural climate more favorable to Islamic investors and more open to accommodation of Islamic finance generally. Liberalism extends the ease of business entry to Islamic banks and bankers. Consistent with liberal economic thought, regulatory officials are open and flexible to this inclusion and provide the necessary institutional, legal, and tax accommodations. A more *dirigiste* economy like that in France, however, can be influenced by degrees of nationalism from the state. French political, economic, and cultural climates are much more state-driven and state-defined. Since Islamic banking represents *différence*, the French more state-led economy is less apt to pursue inclusionary accommodation that might infringe upon enforced national principles of *laïcité* and Republicanism.

In practice, the French regulatory establishment has been unwilling to liberally accommodate Islamic finance. I argue that key French regulatory institutions have discouraged the growth of an Islamic financial sector through to several factors. First, the lack of comprehensive legal reforms enacted by the state handicapped the sector's development. Second, in response to the pervading political climate, French regulatory authorities have approached Islamic finance with tepidity and—at times—outright opposition. In addition to discouraging

legal reforms, this political climate cast an over-all negative light on the limited number of reforms for Islamic finance, which regulatory officials instituted or the French Parliament passed. Third, the French financial regulatory system did not follow through with its reforms by implementing and enforcing them to insure that they led to actual sector development. Finally, by examining why the French Republic has experienced very little Islamic finance development, Paris functions as an indicator for other European financial centers. Consequently, this paper can begin to answer “Why not Zurich, or Frankfurt, or Amsterdam?,” as it answers “Why not France?”

### III. CASE STUDY SELECTION

Before moving forward, it is important to first explain the case selections of the United Kingdom and France. The literature on the financial performance of urban areas around the world in the global economy almost uniformly finds London as the financial capital of Europe.<sup>27</sup> In several articles and indexes, London is listed as the financial capital of the world, edging out even New York City.<sup>28</sup> Thus, London’s status as a major financial center of the world is confirmed. Next, as aforementioned, Britain has a Muslim population of 2.9 million, the third largest Muslim population in Europe after France and Germany.<sup>29</sup> A plurality of British Muslims (over 1 million) lives in London.<sup>30</sup>

Both historically and today, Paris is also considered one of the financial capitals of Europe

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27. Randal Michie, “A Financial Phoenix: The City of London in the Twentieth Century” in *London and Paris as International Financial Centres in the Twentieth Century*, eds. Éric Bussière and Youssef Cassis (Oxford: Oxford University Press, 2005), 15-41; Kristen Bindemann, *The Future of European Financial Centres* (London: Routledge, 1999).

28. Heather Timmons, “London: Financial Capital of the Universe?” *International Herald Tribune*, October 26, 2006, Business Section; Dan Bayley, “London Remains the Financial Capital of the World,” *The Banker*, June 1, 2011; James Quinn, “Britain Overtakes US as Top Financial Centre,” *The Telegraph*, October 8, 2009; Elizabeth MacDonald, “The Safest Financial Capital?,” *Forbes*, November 8, 2006.

29. Pew Research Center, *The Future of the Global Muslim Population*.

30. Muslim Council of Britain (MCB), “Recent Books, Reports, & Studies Relating to Muslims in Britain,” Muslim Council of Britain, <http://www.mcb.org.uk/library/studies.php>

and the world. Paris has appeared in several recent indexes on the top ten financial capitals or centers of the world, ranking above all European cities *except* London. First, a 2001 Dow Jones-Xinhua index in association with the Chicago Mercantile Exchange lists Paris as the 7<sup>th</sup> top financial center in the world.<sup>31</sup> Second, MasterCard’s 2008 Worldwide Centres of Commerce Index listed Paris again in 7<sup>th</sup> place.<sup>32</sup> Last, also in 2008, a Forbes index of the “most economically powerful cities in the world” listed Paris for a third time at 7<sup>th</sup> place.<sup>33</sup> In *Forbes*’s research, London was first (notably over New York City). No other European cities were in Forbes’s top ten rankings besides London and Paris.<sup>34</sup>

Moreover, reasons behind the financial capital index rankings of European urban centers help to explain the primacy of France in the European and world economy. France had a GDP of \$2,555.44 billion in 2010, comparative to the United Kingdom’s \$2,258.57 billion GDP.<sup>35</sup> Germany, the largest economy in Europe, had a GDP of \$3,305.90 billion in 2010, and Switzerland, much smaller, had a \$522,435 billion GDP.<sup>36</sup> Consequently, Frankfurt and Zurich would not have been comparative to London since their GDPs are significantly larger and smaller, respectively. Paris ranked higher than all other European financial capitals (*other* than London) in each of the Xinhua-Dow Jones index’s subcategories, including financial market size, industrial support, service, and general (built) environment.<sup>37</sup>

With a financial industry dating back before the 19<sup>th</sup> century, Paris has over 600 banks

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31. Dow Jones & Company, Xinhua News Agency, and the Chicago Mercantile Exchange, “Xinhua-Dow Jones International Financial Centers Development Index (2011).”

32. Mastercard, *Worldwide Centers of Commerce Index 2008* (New York: Mastercard International, 2008).

33. Joshua Zumbrun, “World’s Most Economically Powerful Cities,” *Forbes*, July 16, 2008.

34. The one major financial center index on which Paris does not appear in the top 10 is the 2011 Global Financial Centres Index, which is compiled by the British think-tank Z/Yen and published by the City of London Corporation. Notably, Zurich appears in eighth on this list. More information about Z/Yen’s index can be found at <http://zyen.com/PDF/GFCI%2010.pdf>

35. International Monetary Fund (IMF), “World Economies Data,” IMF Research, 2010.

36. *Ibid.*

37. Xinhua-Dow Jones, 22-23.

(roughly 100 more than London) and close to 40,000 branches. Four hundred thousand people work in the financial sector in France. Total assets of the banking sector reach €7 trillion.<sup>38</sup> Major banks including BNP Paribas, Société Générale, Crédit Agricole, Group Caisse d'Épargne, and Crédit Mutuel make up 93 percent of banking assets in France.

Across the Channel, London is comparative to Paris while also ranking at the very top of global financial center indexes contested only by New York.<sup>39</sup> An important detail of London's financial sector is that the vast majority of the city's 500 banks are foreign. London also is inarguably the global capital of insurance as it boasts more than 800 insurance companies, of which 170 are foreign. Finally, London is also a major hub for currency transactions and securities trading on the London Stock Exchange.<sup>40</sup>

In many ways, Paris is unable to compete with London in several of these subsectors within financial services. Yet, at the same time, New York is also unable to compete with London on multiple levels, notably insurance. Out of all the European Union capitals, Paris is the best choice for comparison with London because of the size of the French economy, international trade, and, most importantly, the primacy of its banking sector, which is heavily centralized in Paris.

Other European financial capitals are Frankfurt, Germany; Zurich, Switzerland; and Amsterdam, the Netherlands. Zurich appears only on Z/Yen's Global Financial Centres index (notably, upon which Paris does *not* appear) and none of the other indexes referenced. Frankfurt, meanwhile, appears both on MasterCard's World Centers of Commerce index and the Xinhua-Dow Jones index, ranking below Paris in both. Finally, Amsterdam ranks only on the Xinhua-

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38. Ibid 25.

39. Cyrus Sanati, "New York Tops London as Financial Center," *The New York Times*, October 30, 2009.

40. Xinhua-Dow Jones,, 22-23.

Dow Jones index in 10<sup>th</sup> place.

This paper did not consider Amsterdam as an option for a comparative case study pairing with London because Amsterdam does not have any Islamic banks and, relatedly, has seen very minimal interaction between prospective Islamic banking investors and the government. Consequently, there would be no source material for research. I did not consider Zurich for a case study since Zurich's entire finance market is significantly smaller than London's (and Paris's and Frankfurt's) and because Switzerland is not in the EU. Finally, I did not choose to analyze Frankfurt because Germany has only one Islamic bank and therefore had much fewer sources to research.<sup>41</sup>

Finally, in devising a comparison of two states, it was important to avoid having two states at opposite extremes of contact with Islamic banking. A comparative pairing of London-Frankfurt would have supplied a financial capital that has experienced unprecedented exposure to Islamic finance with another financial center, which has experienced next to no exposure to Islamic finance. Establishing such extremely contrasting cases would not have allowed for a dynamic analysis of state responses to the global growth of Islamic finance. Thus, Paris is useful in the London-Paris comparative pairing since it does not sit on one of the extremes: the French capital has experienced some growth of an Islamic financial sector, even if that growth has been very limited. This provides adequate data for analysis and the ability to generalize for Western European financial sectors at large, which would not be feasible using two polarized case studies.

This paper examines Islamic finance within the European context. Some finance firms have conducted market research on global financial centers like New York City and Singapore

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41. See Killian Bälz, "Islamic Finance for European Muslims: The Diversity Management of Shari'ah-Compliant Transactions," *Chicago Journal of International Law*, 7 (Winter 2007): 551-67. Interestingly, this article was written in 2007 and analyzed the struggle for offering Islamic financial services in Germany with comparative examples of the United Kingdom. This appears to be the only serious research done on Islamic banking in Germany.

and their inclusion or exclusion of Islamic financial institutions, but the number of sources remains small. In brief, while the United States has 10 Islamic banks,<sup>42</sup> they are not centralized in New York (or any other metropolitan region) and they have generated an estimated \$1.5 billion in capital, considerably less than European Islamic banks.<sup>43</sup> (The United Kingdom had accrued over \$19 billion in *shari'ah*-compliant assets by 2010.)<sup>44</sup> Singapore, meanwhile, has had some major successes with Islamic banking and the sector continues to develop.<sup>45</sup>

#### IV. A MULTI-CULTURED & MULTI-FINANCED EUROPE

In broader terms, this paper aims to provide new insight into the highly-contested discourse on diversity and liberal democracy in Europe. Beginning with an explanation of the unequal distribution of Islamic financial institutions and services across Europe and then revealing what led one financial capital—London—to become a global center of Islamic finance while Paris has curiously lagged behind, this paper will demonstrate how and why states allow or obstruct (and either encourage or discourage) ‘alternative’ finance within their borders. In doing this, I hope to contribute to discussion on the status of minority democratic inclusion in Europe.

In beginning to tease out some small answers to huge questions of nationalism, national identity, and multiculturalism, my work explores a growing perspective in the literature that holds that access to financial products complying with one’s religious beliefs is a civil right that must be guaranteed in citizenship.<sup>46</sup> At present, this right is not guaranteed in any country in

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42. Duncan McKenzie, *Financial Market Series: Islamic Finance* (London: The City UK Publications, May 2011), 6.

43. M. Mansoor Khan and M. Ishaq Bhatti, “Islamic Banking and Finance: On its Way to Globalization,” *Managerial Finance*, 2008: 34, 722; Stephen Lange Ranzini, “Islamic Finance (Finally) Taking Roots in North America,” *Islamic Finance News*, March 30, 2007:4, 10-11.

44. IFSL, *Islamic Finance 2010*.

45. See Philip Gerrard and J. Barton Cunningham, “Islamic Banking: A Study in Singapore,” *International Journal of Bank Marketing*, 15 (1997): 204-16.

46. Until Islamic finance began to emerge in non-Muslim majority states, scholars discussed the concept of a civil right of access to financial products and services mainly in association with class, socioeconomic standing, and geographic location. In the contemporary period, Muhammad Yunus, founder of Bangladesh’s Grameen Bank, is the most vocal proponent

Europe.<sup>47</sup> It is by examining this perspective that my research hopes to better understand how states can be more inclusive of their citizens on issues of finance. Democratic inclusion has been discussed mainly in terms of culture, religion, nation, and ethnicity, but it has lacked discussion on commerce. What this work suggests, thus, is that debates on democratic inclusion must not only consider notions of a multi-cultured Europe, but also a multi-financed Europe. It is within this conception of Europe that citizens might have the unique right to take part in commercial exchange on a level playing field in accordance with their religious beliefs.

#### V. ORGANIZATION OF THESIS

Prior to defending my claim in following chapters, Chapter II (“Principles of Islamic Financial Law & Banking”) provides an introduction to Islamic banking and finance. I explain how banks apply the theological principles of Islamic financial law to practical and modern banking services. I also discuss how Islamic banks can function parallel with conventional banks in a modern, capitalist economy. Finally, I conclude the chapter by describing the major Islamic financial contract types used by banks in the United Kingdom and the few that French banks use.

After Chapter II, this paper is divided into two core parts. The first analyzes institutional aspects and the second discusses legal aspects for the inclusion of Islamic finance in Western Europe. Part I and Part II each contain four chapters.

Chapter III (“Population, Interest, & Organization: Lobbying for Islamic Banking”) explores how the growth of the British Muslim community has enabled the community to lobby

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of access to credit as a human right. In his book on his microfinance institution, he wrote “Why have economists remained silent while banks rejected the poor as unworthy of credit? . . . because of this silence and indifference, banks have imposed a financial apartheid and gotten away with it. If economists would only recognize the powerful socioeconomic implications of credit, they might recognize the need to promote credit as a human right.” Muhammad Yunus, *Banker to the Poor: Micro-lending and the Battle Against World Poverty* (New York: PublicAffairs, 1999), 150. See also Muhammad Yunus, “Credit for Self-Employment: A Fundamental Human Right,” background paper prepared for World Food Day, 1986. For alternative views see John Gershman and Jonathan Morduch, “Credit Is Not a Right,” Financial Access Initiative Research Framing Note, April 2011.

47. Some states, like the United Kingdom, have made overtures to this perspective on access to finance as a civil right.



for Islamic banking in political and economic spheres. Comparing the potential for Muslim interest groups in Britain to France, I explore how the institutionalization of the concept of *laïcité* has discouraged the formation of Muslim interest groups in France. This, in turn, contributes to the French financial regulatory system's non-consultative approach to Islamic finance, which contrasts strongly with Her Majesty's Treasury's long-lasting consultations with British Muslim organizations.

Chapter IV ("The First Emergence of Islamic Finance in Western Europe") examines the interactions between banks, regulatory officials, and the British Muslim community when Western Europe's first two banks offering Islamic financial services opened in London.

In Chapter V ("Authorization & Bank Licensing"), I analyze why financial regulatory officials would authorize a new fully *shari'ah*-compliant bank or not. The chapter demonstrates that the institutional structures and preferences of financial regulatory bodies dictate whether or not fully *shari'ah*-compliant banks will ever open in France or Britain. Consequently, such authorization determines whether the state will provide a parallel banking sector for its Muslim minority.

Chapter VI ("Sector Structures & State Preferences") explores the structures of Islamic financial sectors in France and the UK. I make two claims in this chapter. First, diverse Islamic financial sectors that offer both retail and wholesale banking services develop much more fully and attract more foreign capital than Islamic financial sectors, such as France's, that offer only wholesale investment banking options. Second, I argue that the way that each state's financial regulatory system chooses to structure its Islamic financial sector has had a major effect on the expansion of Islamic finance.

After Chapter VI, the paper shifts into Part II to analyze why and how regulatory bodies

introduced legal reforms to provide level playing fields for Islamic financial products and services and how such reforms differ between Britain and France.

Chapter VII (“Tax Reform for Islamic ‘Mortgages’”) explores how the FSA and HM Treasury engineered tax code reforms to enable Islamic banks to offer Islamic home purchase plans at rates competitive with conventional mortgages. I then compare these to similar French reforms that were consequential symbolically but have remained meaningless since they instated fewer provisions for Islamic bankers than those of Britain and have not been enforced.

Chapter VIII (“Comprehensive Retail Diversification in Britain”) continues discussing Islamic retail banking by addressing why and how British regulators in the FSA and HM Treasury continued revising the tax code to supply further provisions for a parallel Islamic financial sector. Particularly, this chapter examines the legal reform in the UK that changed language in tax law to treat returns and income payments as if they were interest. The comprehensive nature of the reforms enabled Islamic banks to offer diverse lineups of *shari’ah*-compliant financial products.

Next, in Chapter IX (“*Shari’ah*-compliant Wholesale Banking”) I compare state reforms that exempted certain Islamic wholesale banking agreements from double taxation in France and the UK. This chapter demonstrates that the lack of institutional support from French authorities for Islamic wholesale banking has crippled the few reforms the Ministry of Finance instated.

Chapter X (“The *Sukuk* Project: Issuing Islamic Bonds in Britain and France”) details initiatives and reforms in both France and the UK to introduce *sukuk* (Islamic bonds). Interestingly, British regulators pursued this (more lucrative) aim only after already establishing legal frameworks for Islamic retail banking services. Thus, with a comparison of France’s wholesale-driven approach to Islamic bonds, this chapter provides a final analysis of how

bottom-up and top-down reforms for Islamic finance vary in their results.

In my Conclusion (“Faith, Commerce, & Liberal Democracy”), I provide a summary of this paper’s theory, claim, and evidence for why Islamic finance has succeeded in London, but remains stalled in Paris. My conclusion then discusses what legal reforms and institutional arrangements ultimately mean for the integration of French and British Muslims into European societies.

## CHAPTER II: PRINCIPLES OF ISLAMIC FINANCIAL LAW & BANKING

You who believe, do not consume usurious interest, doubled and redoubled. Be mindful of God so that you may prosper—beware of the Fire prepared for those who ignore [Him]—and obey God and the Prophet so that you may be given mercy. The *Qur'an* (3:130-132)<sup>48</sup>

But those who take usury will rise up on the Day of Resurrection like someone tormented by Satan's touch. That is because they say, 'Trade and usury are the same.' But God has allowed trade and forbidden usury. Whoever, on receiving God's warning, stops taking usury may keep his past gains—God will be his judge—but whoever goes back to usury will be an inhabitant of the Fire, there to remain. God blights usury, but blesses charitable deeds with multiple increases. He does not love the ungrateful sinner. The *Qur'an* (2: 275-76)<sup>49</sup>

[God] has forbidden you to take usury; therefore all interest [and usury] obligations henceforth are abrogated. Your capital, however, is yours to keep. You will neither inflict nor suffer inequity [in this affair]. Mohammed in his final sermon.<sup>50</sup>

The question of Islam in Europe rests on ideas of tolerance and the inclusion of difference. Contemporary liberal discourses on immigration and diversity have often ignored the fact that state governments have the ability—and often the interest—to simply refuse to include difference. There are a multitude of logical arguments for a Western European government to refuse to allow veils in public, the adjudication of Islamic law, or the establishment of *shari'ah*-compliant banks. These arguments can be made on liberal grounds, owing to notions of republicanism and the interests of the collective. In following chapters, I examine how regulatory institutions approached the question of including a structurally different banking system. But before examining institutional structure and action, it is important to understand the 'difference' of Islamic financial practices in comparison to conventional financial practices in Western

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48. *Qur'an* 3:130-32, trans. M.A.S. Abdel Haleem (Oxford: Oxford University Press, 2005).

49. *Ibid*, *Qur'an* 2:275-76.

50. Abdurrahman al-Shelha, *Muhammad, the Messenger of Allah*, trans. Abdurrahmaan Murad (Riyadh: Islamic Propagation Office in Rabwa, 2006), 28.

Europe. Thus, beginning with a discussion on banking theory, this chapter covers the principles of the *shari'ah* relating to commerce, then moves into how financial institutions integrate these principles institutionally into banking, and ends with summaries of the major Islamic financial and commercial contract types used by banks in the United Kingdom and France in the contemporary period.

### I. THEORETICAL FUNCTIONS OF FINANCE & BANKING

Traditionally, banks functioned primarily to mobilize funds and to transfer capital and goods to business people. But as the financial needs of customers have evolved, banks have expanded to serve other functions such as the securitization of capital and assets and a multitude of account and managerial services (payment of bills, checking accounts, transfers, loans of items and for investment, and project financing).<sup>51</sup>

As the fundamental facilitator of economic exchange, banking has significant economic and social impact. One area of banking's social impact is in retail banking: the offering of services like mortgages, savings accounts, and debit and credit cards to ordinary people. In financial systems where these services are readily available, it can be difficult to comprehend exactly what a loan or a savings account means to individuals and communities who do not have access to them. It is important to remember the social ramifications of banking as this paper explores the access (and lack of access) Muslim communities have to financial products and services in France and the United Kingdom that comply with the principles of their religion. For many French and British Muslims, access to banking services provides the loan for opening a small grocery store in Marseille, a savings account for retirement, and a college loan for

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51. Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (London: Palgrave Macmillan, 2005).

Cambridge. Without access to *shari'ah*-compliant banking services, these prospects would not be possible.

*Shari'ah*-compliant banking services form the basis of Islamic economies whether they encompass an economy in total (such as in Iran) or are a subset of a larger economy (such as in the United Kingdom or Saudi Arabia). In these localities, Islamic banking sectors function for the same purposes of conventional finance sectors: the mobilization of capital—whether for investor or retail client—within the economy. The point of divergence between conventional economies and Islamic (sub-) economies is *how* the common functions of banks and financial sectors are conducted and mechanized. The performance and mechanization of banking is thus the key difference between Western/conventional and Islamic/traditional modes of finance.<sup>52</sup> This chapter outlines the fundamental characteristics of Islamic banks that differentiate such institutions from conventional banks and will begin by defining Islamic banking and Islamic financial law.

## II. WHAT IS ISLAMIC BANKING?

Consistent with the literature at large, I define Islamic banking and finance as a set of financial products and services compliant with Islamic law, the *shari'ah*. Compliance with Islamic law means that a given financial product or service has been reviewed and declared licit by an Islamic scholar or body of scholars. Most simply, *shari'ah*-compliant banking means banking without interest. Practically, this means that Islamic banks generally use profit-loss

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52. Although a comparison between Islam and Christianity on the topic of usury is far beyond the scope of this paper, it is interesting to consider that the Catholic Church banned lending for interest until Pope Benedict reversed the doctrine with a Papal ruling in 1751. Moreover, the Old Testament states that “if you lend to those from whom you hope to receive back, what credit is that to you? For even sinners lend to receive as much back. But love your enemies, do good, and lend, hoping for nothing in return and you will be sons of the Most High.” See Luke 6:34-35 (New King James Version). Many books on Islamic finance provide comparative historical analyses of the treatment of usury by religious bodies. See Mohamad Ariff, “Ethics-based Financial Transactions,” in *The Foundations of Islamic Banking: Theory, Practice and Education*, eds. Mohamed Ariff and Munawar Iqbal (Cheltenham, UK: Edward Elgar, 2011), 11-38.

sharing contracts and the purchasing and reselling of goods and services with banking fees instead of giving loans. Islamic law is not a law canon *per se*, but rather a vast collection of jurisprudence and rulings. As such, definitions of what actually constitutes Islamic finance can vary from legal scholar to legal scholar. What is constant in the definition of Islamic finance and banking is that in order to be ‘Islamic’ it must be reviewed and approved by a scholar of the *shari’ah*.<sup>53</sup>

While the definition of Islamic finance being finance without interest is generally accurate and forms the basis for the divide between Islamic and conventional finance, it is important to outline how Islamic financial law has been understood by scholars and institutions from the *shari’ah*’s formative period to today within the larger framework of ‘Islamic economics.’ The *shari’ah* forbids *gharar* (speculative transactions) and *riba*, which has most commonly been translated and conceptualized as usury, the practice of making money from money generally at excessive rates of interest.<sup>54</sup> Deeming *riba* to be illicit, Islamic jurisprudence instead generally mandates that wealth should be made through legitimate asset investment and trade. Scholars such as Aharon Layish (2002) note that the concept of *riba* has changed throughout Islamic history. While it may have initially been interpreted as usury in early Islamic exegesis in the 7<sup>th</sup> Century, it later became a civil matter, being often defined as “any illicit gain or unjustified enrichment and benefit.”<sup>55</sup> Thus, *riba* could also be understood to include betting and speculative transactions. This broadening of Islamic financial law’s scope thus forms the

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53. Islamic jurists and judges have particular responsibility and qualifications to meet in order to be legitimate interpreters of the law. The way that the *shari’ah* is not a law code, but rather a legal methodology of interpreting religious texts, speaks to the inherent plurality and adaptability of Islamic law generally and lawful financial products and services specifically. Rulings (produced by judges) and jurisprudence (produced by jurists) often contradict one another and allow for great flexibility in the application of the law, particularly outside of modern nation-state governments, such as on issues in family law or banking.

54. Rahul Dhumale and Amela Sapcani, “An Application of Islamic Banking Principles to Microfinance.” United Nations Development Programme Publications in cooperation with the Regional Bureau for Arab States and the Middle East and North Africa Region, World Bank, 2.

55. Aharon Layish and Gabriel Warburg, *The Reinstatement of Islamic Law in Sudan under Numayrī: An Evaluation of a Legal Experiment in the Light of its Historical Context, Methodology, and Repercussions* (Leiden: Brill, 2002), 244.

beginning of what has been called in the literature the ‘Islamic economy,’ which is marked by a much greater penetration of Islamic financial principles. Yet, this Islamic economy is fundamentally structurally different from the larger conventional global economy surrounding it. Thus, even at its emergence Islamic finance and the larger Islamic vision of economics has faced challenges of integration and competition with conventional finance.

Generally, each Islamic bank or conglomerate has its own small body of Islamic scholars to review and approve the ‘licitness’ of the institution’s financial products. Such bodies are called *shari’ah* advisory councils or boards (SACs). These SACs serve three main purposes: 1) to advise bank management on the compliancy of financial products to the *shari’ah*; 2) to provide a religious legal basis ensuring bank customers that they themselves are not violating religious law by using the bank’s financial services;<sup>56</sup> and 3) to work with financial experts to develop new business-friendly financial instruments compliant with the *shari’ah*. The very nature of Islamic financial institutions’ difference in corporate management, authority, and accountability is thus the most notable managerial difference between Islamic and conventional corporate banking.

This unfamiliar difference has been a key source of contention in Western Europe, particularly in France, as Islamic bankers have attempted to open branches in Paris. The Banque de France and other regulatory institutions have opposed SACs for two reasons: first, because the government cannot recognize religious bodies, and second, because the SACs inappropriately influence managerial and operational decisions within the corporate structure of a bank.

Across the Channel, SACs have proven to be a critical component of British Islamic banks’ marketing strategies. In brief, the presence and the publicizing of *shari’ah* advisory

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56. Sebastian Tong, “Islamic Finance Faces Diversity Crossroads,” *Reuters*, August 12, 2009.



councils help to reassure British Muslims that advertised products are, in fact, *shari'ah*-compliant and comparative to financial products that might be offered in their country of origin.<sup>57</sup> Chapter IV examines the Banque de France's position on SACs in comparison to the Bank of England's accommodation of SACs.

### III. HOW DO ISLAMIC BANKS MAKE MONEY?

The question that always arises when first discussing the inclusion of Islamic banking and finance in a Western conventional financial system is, "How do Islamic banks and financial institutions make money if they cannot charge interest?" Islamic banks are organized like joint-stock companies where shareholders generally provide the initial capital for a joint venture and entrepreneurs and customers provide management and planning services. Islamic banks make money through two main mechanisms: 1) markup fees and service fees based on labor not time, and 2) shared profit made through profit-loss sharing joint-ventures. Markup fees and service fees can be applied in contracts for reselling and leasing goods and services.<sup>58</sup>

Fees and profits from different contract types differ greatly between institutions and individual contracts of unique partners. For profit-loss sharing contracts, a bank's rate of return is determined by the proportion of its capital and management contributions to the venture. This ratio for profit distribution is decided upon at contract signing by both parties but is not a fixed lump sum, only a fixed proportion. For reselling contracts, the rate of return is determined by benchmarks or estimates of the rate of return. In the contemporary period, many banks use international standard rates, such as the LIBOR (London Interbank Offered Rate).<sup>59</sup>

Like a conventional corporate bank, a board of directors governs an Islamic bank and

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57. DTZ Asset Management and Norton Rose, *Islamic Finance and Real Estate in France: A White Paper* (Paris: DTZ, 2010).

58. Brian Kettell, *Frequently Asked Questions in Islamic Finance* (London: Wiley, 2010): viii

59. *Ibid*, ix.

represents the interests of management and the shareholders. As aforementioned, the chief way in which an Islamic bank differs from a conventional bank in terms of management and bank governance is that it is also supervised by a *shari'ah* advisory council (SAC), which evaluates the compliancy of the institution's financial products with Islamic law.<sup>60</sup> The level of influence SACs yield over bank management varies from bank to bank. Outside of Muslim-majority countries, SACs usually play only a consultative role. Yet, as Chapter IV demonstrates, this key difference in the governance structure has remained a source of contention between Islamic bankers and regulatory authorities in Britain and France.

#### IV. THE EMERGENCE OF MODERN ISLAMIC BANKING IN PAKISTAN & EGYPT

Given that Muslim communities have been established and growing in France and the UK since the 1950s, one might ask why Islamic finance has only emerged in the present period. In reality, the emergence of Islamic finance in London in the 1980s, which the next chapter will examine, was not 'late' but rather, on time. While the principles of *riba* and *gharar* were present in the *shari'ah* since its formative period in the late 7<sup>th</sup> Century CE, the institutional manifestation of Islamic banking emerged much later.

Most scholars trace the beginning of banking that adhered to the principles of Islamic law to social equity projects in Pakistan in the 1950s and in Egypt in the 1960s.<sup>61</sup> Yet, both projects failed within a few years of introduction due to insufficient profit. Bankers experimenting with Islamic banking in this early period seemingly had not yet discovered how best to structure

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60. Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 26.

61. Landlords in rural Pakistan were recorded making interest-free deposits to an institution, which then advanced the funds to poorer landowners. These 'loans' were typically for long-term investments, and generally constituted "one-time commitments" for the institution. The project, thus, ran out of funds relatively quickly after it got off the ground. In Egypt, the Mit-Ghamr Savings Bank started a project in 1963 to encourage poor lower-income farmers to save and mobilize their funds. The project was initially very successful with 60,000 depositors and four new branches, yet the bank never showed sufficient profit to cover expenses and eventually closed. See Delwin A. Roy, "Islamic Banking," *Middle Eastern Studies* 27, no. 3 (July 1991): 428.

services to bring revenue into the bank while adhering to the *shari'ah*. Thus, Islamic finance and banking only truly emerged in the 1970s during a series of meetings held in Jeddah by a collection of foreign ministers of states in the Islamic World. As a result of these meetings, Egyptian bankers opened the Nasser Social Bank of Egypt in 1972. The bank had 25 branches throughout Egypt and total deposits of \$28.6 million by 1979.<sup>62</sup>

Consequently, when the first bank in Britain began offering *shari'ah*-compliant services in the early 1980s, Britain was actually on the 'cutting-edge' of the emergence and development of Islamic finance. The following chapter examines this first emergence in Western Europe in detail.

#### V. GLOBAL PREVALENCE OF ISLAMIC BANKING & EFFECTS ON LONDON & PARIS

The International Financial Services London (IFSL) estimated the *global* market for Islamic financial services to have reached \$951 billion at the end of 2008. The size of the market is difficult to measure precisely because it has been expanding so quickly. Between 2007 and 2008, the global market had expanded by 25 percent.<sup>63</sup> IFSL measures the market by *shari'ah*-compliant assets. The global geographic breakdown of *shari'ah*-compliant assets in banking, *takaful* (insurance), and funds is as follows: Iran (\$293 billion), Saudi Arabia (\$128 billion), Malaysia (\$86 billion), United Arab Emirates (\$84 billion), Kuwait (\$68 billion), Bahrain (\$46 billion), Qatar (\$28 billion), United Kingdom (\$19 billion), Turkey (18 billion), and other combined countries at \$52 billion.<sup>64</sup> Banking assets (over *takaful* and fund assets) make up the vast majority of total Islamic assets in each country.

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62. Ibid.

63. IFSL, *Islamic Finance 2010*.

64. Ibid.

Notably, none of these major Islamic finance countries are the countries of origin for Muslims in Britain and France. The vast majority of British Muslims are from the Indian subcontinent: Pakistan (43 percent), Bangladesh (17 percent), and India (9 percent). It can be estimated that British Muslims of Arab background<sup>65</sup> make up less than 10 percent of the total Muslim population in the UK.<sup>66</sup> Across the Channel, 75 percent of French Muslims are of Maghrebi origin, from Algeria, Morocco, or Tunisia. Additionally, about 10 percent are from West Africa or the Indian Ocean, and 11 percent are from Turkey.<sup>67</sup> Thus, since immigrants from countries with high prevalence of Islamic finance do not compose a significant proportion of British and French Muslims, the development of Islamic finance in Britain and France is not likely to be dependent on any previous experience with Islamic finance in their countries of origin.

This means that the UK and France are essentially ‘clean slates’ for Islamic finance. Although no statistics are available, it is very likely that a good proportion of British and French Muslims are not aware of the principles of Islamic financial law and their practical applications in banking. Thus, the role of dissemination of knowledge of Islamic finance lies in the hands of banks and domestic and international Muslim organizations. International Islamic banks (or banks offering Islamic services) have driven the initial emergence of Islamic finance in Britain more than domestic Muslim populations. Thus, what drew the Bank of Credit and Commerce International or the Bank of Kuwait to open Islamic branches in London were the open and

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65. Although there are not any statistics on the national origin of customers at Islamic banks in the UK, the fact that Islamic bankers market their products widely and open numerous branches in Birmingham provides some hints that Pakistanis provide a better market for Islamic banking than Arab communities in the UK. Birmingham, England’s second largest city, is home to 140,033 Muslims, the second largest percentage in the UK. Birmingham’s Muslims make up 8.8 percent of the total BM population and 14 percent of the general population of Birmingham. Birmingham City Council, *2001 Population Census in Birmingham: Religious Group Profiles* (Birmingham, UK: Birmingham City Council, 2002), 21-23.

66. Sophie Gilliat-Ray, *Muslims in Britain: An Introduction* (Cambridge: Cambridge University Press, 2010), 120.

67. Jonathan Laurence and Justin Vaïsse, *Integrating Islam: Political and Religious Challenges in Contemporary France* (New York: Brookings Institution Press, 2006), 17-21.

liberal business laws of the UK, which are generally encouraging of new and innovative enterprises. Chapter V examines British economic liberalism and its effect on Islamic finance in detail.

The likelihood that the development of Islamic finance in Britain and France is not dependent on the national origins of domestic Muslim populations does not, of course, rule out other ways that Muslim population may play into the development of Islamic financial sectors. While the size itself of Muslim populations does not determine whether or not such a sector will develop, Chapter III argues that the level of organization of Muslim minorities does influence the development of Islamic finance.

#### VI. MAJOR ISLAMIC FINANCIAL & COMMERCIAL CONTRACT TYPES

This chapter's final section provides a general overview of the major contracts used in the contemporary period by Islamic banks and financial institutions in the UK and France. Islamic financial contracts generally fit into one of two categories: 1) risk and profit sharing or 2) trading in assets and commodities. The contract types of *mudaraba* (passive partnership), *wakala* ('agency'), *musharaka* (active partnership), *murabaha* (sales contract), *ijara* (leasing), and *sukuk* (bonds) are the most widely used *shari'ah*-compliant contracts in both the Islamic World and Western Europe.

*Mudaraba*, or passive partnership, is a contract between a capital owner and an investment manager where one partner receives profit based upon their capital investment while the other party receives profit based on their labor or management of the venture. Any distribution of profit is licit—whether equal, unequal, proportional, or disproportional—as long as the ratio was agreed upon at contract signing. Loss must be shared in proportion to capital contributions, which means that only the capital owner (the bank) is responsible for direct

financial loss. If the venture fails, the investment manager essentially loses an opportunity to generate income. The capital owner's (or bank's) liability is limited to their capital contribution. Iqbal (2002) notes that although the capital owner can "impose certain mutually agreed conditions on the manager, he has no right to interfere in the day-to-day work of the manager."<sup>68</sup>

A *wakala* contract is structured similarly to a *mudaraba* contract and is often used for savings accounts. Using a *wakala* contract, the banking customer gives capital to an investor (bank) to use for a venture or to hold. . The profits (if any) are shared between the customer and the bank (the *wakil*) in agreed upon proportions. An important aspect of *wakala* is the legal relationships between parties. In the United Kingdom, the *wakil* is understood to be acting legally as an agent to the banking customer and accordingly the capital never becomes the bank's property. The customer, meanwhile, is understood to be the party that deposits funds. In case of insolvency, the *wakala* customer has legal claim to the underlying commercial venture, which he does not under a *mudaraba* contract.<sup>69</sup>

The *musharaka* contract is one of the most widely-used contracts structured on trading assets and commodities. In brief, the *musharaka* contract is a commercial partnership contract between two or more parties where both parties share in the profit or loss of a joint venture. Under this contract, both partners must contribute capital for the joint venture. Generally, both partners also contribute labor and management, but this is not always the case. Profits and losses from the joint venture are distributed in proportion to each partner's contribution; the proportions and ratio must match what was agreed upon by both parties at contract signing. Loss must be

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68. Muhammad Ayub, *Understanding Islamic Finance* (London: Wiley, 2007), 311; Iqbal and Molyneux, *The Foundations of Islamic Banking*, 21.

69. Humayon A. Dar and Umar F. Moghul, *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance* (New York: Chancellor Publications, 2010) 82-83.

shared in proportion only to the capital contributions of each partner. Profit, meanwhile, is shared in proportion to all available contributions, whether capital, management, or labor. While profit is shared at agreed upon ratios, a *musharaka* contract cannot use a fixed lump sum profit for either partner at contract signing. Banks in the United Kingdom have used *musharaka* contracts to structure venture capital financing.<sup>70</sup>

Banks can also use *musharaka* contracts for “diminishing partnerships,” where partners agree that the main financing partner will gradually sell its share to the other partner at an agreed-upon price on an agreed-upon payment and transfer schedule. These diminishing partnership contracts structure a variety of banking services including lease-to-buy mortgages and project financing.<sup>71</sup>

*Murabaha* (or *bay al murabaha*) is a sales contract under which one partner agrees to purchase a commodity from a second partner with an agreed-upon fee. Within the contract, the seller must disclose the actual cost of the commodity and the cost the seller has incurred in handling the commodity. This profit for the seller can be a percentage of the cost of the commodity or can be a lump sum, as long as there is mutual consent at contract signing.<sup>72</sup> This contract type has been the source of much contention in Islamic legal discourse as many scholars have objected to how closely the markup fees resemble interest. In the United Kingdom, the United Bank of Kuwait’s Islamic Investment Banking Unit offered their highly successful Manzil ‘mortgages’ initially using *murabaha* structures, but later offered *ijara* structuring in response to both legal reform within the British tax code and the mentioned controversy. Chapter VI examines Manzil home purchase plans in detail.

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70. Iqbal and Molyneux, *The Foundations of Islamic Banking*, 20-22.

71. *Ibid.*, 21.

72. Kettell, *Frequently Asked Questions in Islamic Finance*, 26.

Traditionally preferred over *murabaha* by conservative Muslims, an *ijara* contract is a contract for leasing assets and can be used for mortgages. Under this contract, an asset owner (the lessor) leases a product to the second party, the lessee. Instead of lending capital and taking interest, the lessor (the bank) leases a product to a customer and earns profit through rent. Islamic banks use this contract type to lease buildings and equipment primarily. In practice, a bank would purchase the item a customer desires and the bank would then lease it for an agreed-upon period of time at an agreed-upon rate. At the end of the contract period, the total ownership and usage of the item returns to the lessor (the bank).<sup>73</sup>

The *ijara muntahia bittamleek* (also called *ijara-wa iqtina* in the literature) is an *ijara* contract under which the ownership of the leased asset is eventually transferred to the lessee. This can happen through several different avenues, as Kettell (2010) explains. 1) the contract can transfer the ownership of the asset to the lessee at a price matching the payments made over the leasing term. If this was agreed upon by both partners, the legal title of the asset transfers automatically to the lessee after the final installment is paid. 2) Alternatively, the lessor can offer the lessee the right of ownership of the asset for a specified price at the end of the least term. This would be the basis of a new contract. 3) The lessor can give the lessee one of three options at the end of the lease term being: the purchase of the asset, renewal of *ijara* for another term, or returning the asset to the lessor (owner). The contract is typically used for financing reusable merchandise and equipment such as airplanes, cars, and buildings.<sup>74</sup>

The final contract type is the *sakk* contract. This contract type is used for *sukuk*, which is *sakk*'s plural form in Arabic and the more-recognized term for *shari'ah* compliant bonds. Islamic bonds have become a major focal point for the development of Islamic finance in Western

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73. Ibid, 210.

74. Ibid, 210-212.



Europe because of the hope that the issuance of Islamic bonds would attract Gulf liquidity to financial centers like Paris, London, and Luxembourg. The *sakk* contract is a promissory note for a receivable and represents the ownership of assets. In practical terms, the issuer of a *sukuk* (a bank, government, or corporation, traditionally) sells an investor or group of investors the *sakk* promissory note for an agreed-upon fee. The issuing partner makes a contractual promise to buy the bonds back in the future on a specific date and at a specific value.<sup>75</sup>

These contracts form the practical and institutional structure of Islamic financial services whether offered in Dubai, Kuala Lumpur, or London. While they are structured differently to avoid interest and speculative transactions, Islamic financial products closely resemble conventional financial products once they are in the hands of customers. They serve the same basic purposes as conventional products: the mobilization of funds through products like savings accounts, project financing, bonds, checking accounts and debit cards, and mortgages.

Financial regulatory bodies in France and Britain must confront these inherent *structural* differences if they intend to develop Islamic financial sectors. This paper examines the decision of state financial regulators to either tolerate services structured on the principles of Islamic law or not. These decisions, their execution, and their extent determine whether an ‘alternative’ or Islamic financial sector can function alongside the established conventional financial sector in France or the UK. In more basic and human terms, these decisions determine whether or not French and British citizens are able to finance their house with a mortgage based on an *ijara* contract, just as their neighbors financed their home with a conventional loan from Barclays. The following chapters of this thesis examine how British and French financial regulatory officials

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75. Munawar Iqbal, “Development, History, and Prospects of Islamic Banking,” in *The Foundations of Islamic Banking: Theory: Practice and Education*, eds. Mohamed Ariff and Munawar Iqbal (Cheltenham, UK: Edward Elgar, 2011), 72.

have approached the inclusion of parallel Islamic financial sector in their economies, why these approaches differ greatly between countries, and what they mean for European Muslims.

**PART I**  
**INSTITUTIONAL ASPECTS FOR A MULTI-FINANCED ECONOMY**

*How have different institutional arrangements and institutional preferences influenced the divergent development of Islamic finance between France and Britain?*

“[London] has always been ready to innovate and to respond flexibly to new ideas...Our financial services industry has a proven record of developing and delivering new products; and English law is already the preferred jurisdiction for many Islamic transactions.”

- Clive Birault, Managing Director of Retail Markets, Financial Services Authority<sup>76</sup>

“With [Islamic banking], we are changing the rules of democracy and the Republic. It is totally contrary to the principles of *laïcité*. Islamic Finance is reserved for Muslims and [thus] is religious discrimination.”

- Christine Tasin, President of the Republican Resistance, a prominent French ultra-conservative organization and blog<sup>77</sup>

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76. Clive Briault, “London: Centre of Islamic Finance?” (speech, Industry Forum, London, October 17, 2007).

77. Julien Van Caeyseele, “Ce ‘Prêt Islamique’ Qui Dérange la Bred,” *L’Express*, October 28, 2010.

**CHAPTER III:**  
**POPULATION, INTEREST, & ORGANIZATION:**  
**LOBBYING FOR ISLAMIC BANKING**

In the 1950s, unprecedented immigration in the wake of the Second World War forever changed the demography of Western Europe.<sup>78</sup> Numerous governmental initiatives facilitated immigration from Eastern Europe and former colonies in Africa and the East to support industries essential to postwar recovery.<sup>79</sup> The resulting increased diversity in states like Britain and France raised the question that is at the crux of policies of multiculturalism: Should a state force assimilation or should it tolerate and include the difference of cultures within one nation?

Increased cultural and ethnic diversity in urban centers across Western Europe prompted historian Tony Judt to observe that Europeans did not “especially welcome the sudden eruption of so many foreigners on their soil.”<sup>80</sup> Even after liberal immigration policies were abandoned in 1962 in Britain and 1974 in France,<sup>81</sup> state authorities and citizens still faced the fact that their new neighbors who had immigrated on guest and work permits would not be returning ‘home.’ This realization brought a shift in urgencies, from forming prudent state policy for immigration

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78. Tony Judt, *Postwar: A History of Europe since 1945* (New York: Penguin, 2005), 333-336.

79. Generally, it was men between the ages of 18 and 30 that immigrated by themselves to Western Europe. With a mean age of around 24, these immigrants came from mainly rural areas of their home countries to urban centers like Paris and Marseille, and London and Birmingham. Largely unexpected in the 1950s by immigration authorities in France and the Britain, these immigrant males were soon joined, legally and illegally, by their spouses, children, and families. As the period of immigration continued, entire families began immigrating together. See Walter Laqueur, *The Last Days of Europe: Epitaph for an Old Continent* (New York: Thomas Donne, 2007), 34-106.

80. Judt, *Postwar*, 335.

81 The UK began restricting immigration from Commonwealth countries in 1962 with the Commonwealth Immigration Act. See Judt, *Postwar*, 336. The French government halted immigration on July 3, 1974 following the oil crisis. See Patrick Weil, *How to Be French: Nationality in the Making since 1789*, trans. Catherine Porter, (Durham: Duke University Press, 2008), 152

to establishing prudent state policy to cope with diversity.<sup>82</sup> In turn, these state directives established national doctrines on multiculturalism, a conceptual set of policies that deal with recognizing distinct cultures forming one diverse nation-state.

The recognition of diversity and its political ramifications is at the core of this paper. As governments formed policies of multiculturalism to address diversity, state authorities slowly realized that one of these policies would relate to banking. Not only did minorities of immigrant background need *access* to financial institutions and services, but one particular minority—Muslims—needed access to banking services that were structurally different and consistent with its own religious persuasions.

Framing Islamic finance as one of many policies of multiculturalism, this chapter explores the need for Islamic financial services and the first attempts from the British banking industry to provide such services. First, I briefly examine the demography and geography of Muslim minorities in the UK and France to establish a context for these communities' banking needs. Second, I compare 1) how the organization of these minority communities has differed between countries and 2) what institutional constraints have inhibited organization. Finally, I analyze how increased population size and organization led to successful lobbying campaigns for Islamic banking in Britain.

### I. MEASURING THE BRITISH MUSLIM POPULATION

Although significant Muslim communities had been present and growing in the United Kingdom since the 1950s, the government had never officially counted their numbers until 2001. In this year, the National Census included a question on religious affiliation for the first time.

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82. For a discussion of the French case, see Jean-François Berda, "Citizenship and National Identity in France from the French Revolution to the Present," in *Citizenship in Historical Perspective*, eds. S.G. Ellis et al. (Pisa: Edizioni Plus, 2006), 141-153.

Such a question would never have been allowed across the Channel in France, where state-sponsored inquires into religion and ethnicity have long been considered illegal and illiberal under the vanguard of *liberté, égalité, fraternité* and the principle of *laïcité*.<sup>83</sup>

The National Census in Britain found that there were 1,591,000 Muslims in the UK in 2001, making up 2.7 percent of the British population in 2001.<sup>84</sup> This figure is generally considered accurate by scholars like Housby (2011) who note that less than 1 percent of respondents of South Asian origin declined to answer on religious affiliation.<sup>85</sup> By 2010, the Pew Research Center estimated that the British Muslim population had grown to 2,869,000 (rounded to 2.9 million), a 74 percent increase from 2001.<sup>86</sup>

## II. MUSLIM POPULATION SIZE & COLLECTIVE INTEREST IN THE UK AND FRANCE

The combined real growth of Muslim communities in the UK and prospects for continued growth dominates debates on minority rights, multiculturalism, and, in turn, access to Islamic finance in the United Kingdom. Whether argued by very conservative parties such as the British National Party or by organizations like the Muslim Council of Britain, discourse on Islam in the UK has been rooted in the logical assumption that the phenomenal growth of British Muslims will continue at exponential rates for the foreseeable future. Consequently, both ends of the

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83. The French ban on ethnic (and religious) statistics has remained controversial and holds a very particular history within French Republicanism. See Patrick Simon, “‘Ethnic’ Statistics and Data Protection in the Council of Europe Countries: Study Report,” European Commission Against Racism and Intolerance, Council of Europe, 2007; Patrick Simon, “The Choice of Ignorance: The Debate on Ethnic and Racial Statistics in France,” *French Politics, Culture, & Society*, Spring 2008(26), 7-31; Alain Blum, “Resistance to Identify Categorization in France” in *Census Identity: The Politics of Race, Ethnicity, and Language in National Censuses*, eds. David I. Kertzer and Dominique Arel (Cambridge: Cambridge University Press, 2002), 121-147; and Eric Bleich, “The French Model: Color-blind Integration,” in *Color Lines: Affirmative Action, Immigration, and Civil Rights Options in America*, ed. John David Skrentny (Chicago: Chicago University Press, 2001), 270-296.

84. Office for National Statistics, National Census UK, 2001. The National Census was conducted in early 2011 and also asked respondents about their religious affiliation, but the resulting data has not been released in time for this paper’s research.

85. This contrasts sharply with the 7 percent of the population as a whole who declined to respond. Elaine Housby, *Islamic Financial Services in the United Kingdom* (Edinburgh, UK: Edinburgh University Press, 2011), 1.

86. Pew Research Center, *Muslim Networks and Movements in Western Europe*, Pew Research Center Publications, September 15, 2010.

political spectrum argue that the state must act now to ensure rights and privileges, although notions of what these are and to whom they apply varies greatly between political associations.

The growth of British Muslims is consequential for the development of Islamic finance because with greater size, British Muslims carry greater political and economic influence as a collective. Increased size and influence means that a multitude of institutions ranging from governmental offices to political parties to private banks and corporations take greater stock of the interests of the British Muslim community. Thus, with population growth, British Muslims gain greater leverage to lobby for institutional change for a variety of issues within their interests, such as zoning permits for mosques, *halal* lunches at schools, and Islamic mortgages from banks on high street.

The same is not true, however, of French Muslims, who lack the level of influence of British Muslims even while they have a greater population size. With estimates ranging from 4.7 to 6 million, the number of Muslims in France is impossible to pin down due to aforementioned French national ban on ethnic and religious statistics. It is difficult for French Muslims to organize politically since, as Bleich (1998) writes, nationalistic French political culture stresses political participation at the individual level and discourages community-based political activity or representation.<sup>87</sup> This is especially true for communities that would organize based on ethnicity or religion. Consistent with the central claim of this paper that the flexibility and openness of institutions allows for the development of Islamic finance, the difference in minority group organization, interest articulation, and interest aggregation of Muslim minorities across Europe is institutional. France's institutions of governance are built on *laïcité* and

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87. Erik Bleich, "From International Ideas to Domestic Policies: Educational Multiculturalism in England and France," *Comparative Politics*, 31(1): October 1998. See also Carolyn M. Warner and Manfred W. Wenner, "Religion and the Political Organization of Muslims in Europe," *Perspectives on Politics*, 4(3): September 2006.

Republicanism,<sup>88</sup> which actively discourage recognition of difference on a community level (blacks, Jews, gays, Maghrebis, women).<sup>89</sup>

The United Kingdom, however, does not institute a legal separation between religion and state. Instead, in a country where the government is linked to established religion through the Church of England, governing institutions do not formally shun the recognition of religious bodies and communities as institutions do in France.<sup>90</sup>

### III. RELIGIOUS IDENTITY & GEOGRAPHIC LOCATION OF FRENCH & BRITISH MUSLIMS

Institutional separation between religion and state remains an important ideological and institutional constraint in France because French Muslims have generally retained their faith of origin whether as first-, second-, or third-generation immigrants. In France, 68 percent of Muslims believe that the sense of Islamic identity in their communities is increasing; 69 percent of Muslims in the UK believe this to be true of their communities. Moreover, a slight majority of both French and British Muslims observe a struggle between being a devout Muslim and living in France and Britain, 56 and 54 percent, respectively.<sup>91</sup> This is particularly notable for the United Kingdom: while British Muslims are institutionally able to organize and live in a state where religion is recognized, they still feel a conflict between ‘Britishness’ and Muslim identity.

Moreover, the geographic localities of the development of Islamic financial products have generally followed Muslim communities in France and the UK. The 2001 National Census

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88. In English, *laïcité* translates very roughly as secularism; but, more to a point, the term has to do ‘freedom from religion,’ and more institutionally with the complete absence of religion in the affairs of the state and its reverse. Tied closely to ideas of the nation-state and the national motto (*liberté, égalité, fraternité*), the concept and principle of *laïcité* holds extraordinary weight in political and social discourse in France. *Laïcité* has continued to shape policies on immigration and integration of Muslims in France.

89. Patrick R. Ireland, “Facing the True ‘Fortress Europe’: Immigrant and Politics in the EC,” *Journal of Common Market Studies*, 29(5): 1991, 457-480.

90. Talal Asad, *Formations of the Secular: Christianity, Islam, Modernity* (Palo Alto: Stanford University Press, 2003), 5.

91. Jodie T. Allen and Richard Wike, “How Europe and Its Muslim Populations See Each Other,” in *Muslims in Western Politics*, ed. Abdulkader H. Sinno (Bloomington, Ind.: Indiana University Press, 2009), 149.



found that a plurality of British Muslims live in London. The number of Muslim in London was 607,083, which made up 38 percent of the total population.<sup>92</sup> Birmingham, England's second largest city, is home to 140,033 Muslims, the second largest percentage in the UK. Birmingham's Muslims make up 8.8 percent of the total BM population and 14 percent of the general population of Birmingham.<sup>93</sup> This second concentration of British Muslims in Birmingham is critical for this paper's discussion since a number of important steps in the development of Islamic finance were made first in Birmingham before London. For example, the UK's first independent fully *shari'ah*-compliant bank, the Islamic Bank of Britain, opened first in Birmingham and is still headquartered there.<sup>94</sup>

A plurality of French Muslims lives in the Île-de-France, a small region of France that includes Paris.<sup>95</sup> About a second third are divided between Marseille and Nice, both in Southern France, and there are also sizable Muslim communities in areas like the Lille-Roubaix-Tourcoing area in Northern France.<sup>96</sup> The majority of development in Islamic finance in France has been in Paris. Yet, in this respect, the location of French Muslims is less critical than that of British Muslims because the very limited number of Islamic financial services in France have only targeted corporations and foreign investors (primarily from the Gulf). Thus, although the Île-de-France has the greatest number of French Muslims, they have not benefitted from any of the developments in Islamic finance. Chapter VI ("Sector Structures & State Preferences") examines this point in detail.

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92. Office for National Statistics, National Census UK, 2001.

93. Birmingham City Council, *2001 Population Census in Birmingham: Religious Group Profiles* (Birmingham, UK: Birmingham City Council, 2002), 21-23.

94. Islamic Bank of Britain, "About Us," accessed March 9, 2012, <http://www.islamic-bank.com/about-us/>

95. The strongest concentration of Muslims in the Île-de-France is in the *banlieues*, the outlying areas (or suburbs) of Paris, such as the Seine-Saint Denis area. While there are also wealthy *banlieues* in France, which are comparative to American suburbs, the term is strongly associated in the French with lower and working class areas with a large presence of social (subsidized) housing. The *banlieues* were a source of much international attention in 2005 during a series of riots of underserved minority youth. A liberally estimated 45,000 cars were torched in France in 2005.

96. Laqueur, *Last Days of Europe*, 45.

IV. TOP-DOWN OR BOTTOM-UP?: ISLAMIC FINANCE INTEREST GROUPS IN FRANCE & THE UK

It can be generally observed that initiatives for the development of Islamic finance have been implemented from the bottom-up in the United Kingdom and from the top-down in France. Interest groups for Islamic finance in the UK have been comprised primarily of private banks, Muslim community organizations, and Islamic banking organizations. Yet, interest groups have failed to organize similarly in France, where initiatives for Islamic finance have been driven mainly by the government's *Ministre de l'Économie, de l'Industrie et de l'Emploi*, which is commonly shorted to the Ministry of Finance in English.

All of France's institutional and legal developments for Islamic finance have been at the hand of Christine Lagarde, head of the Ministry of Finance from 2007 to 2011.<sup>97</sup> Consequently, Lagarde's contribution to Islamic finance in France cannot be understated, even if her efforts have not succeeded. She has remained the sole vocal government official lobbying for Islamic finance in a hostile political climate; her lobbying for the integration of Islamic finance has been publically equated by other state actors to *shari'ah's* invasion into French secularism. It is also notable that Lagarde has remained vocal in spite the fact that she is part of Nicholas Sarkozy's center-right Union for a Popular Movement party. Sarkozy and the UMP, which has held the presidency since Sarkozy's 2007 election, is generally perceived to have taken a hardliner-approach to the integration and assimilation of Muslims in France.<sup>98</sup>

Outside the government, several private organizations have supported Lagarde's

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97. New York Times, "Times Topics: Christine Lagarde," *The New York Times*, last modified September 26, 2011, [http://topics.nytimes.com/top/reference/timestopics/people/l/christine\\_lagarde/index.html](http://topics.nytimes.com/top/reference/timestopics/people/l/christine_lagarde/index.html)

98. While Nicholas Sarkozy's administration has led to a number of laws which have been widely deemed to be anti-Islam, Sarkozy, as Laurence (2012) writes "was not predestined" to be anti-Islam. As such, it should be noted that among Sarkozy's accomplishments was to establish the French Council of the Muslim Faith (CFCM). While he has been in office, the first Muslim cemetery was founded, he inducted the CFCM president into the *Légion d'Honneur*, and the state featured the Great Mosque of Paris on a national stamp. Additionally, a thousand new spaces for Islamic prayer have opened in France since he joined the government in the 1990s. Whether these landmarks have been reached because of Sarkozy's administration or in spite of his administration is for other research to examine. See Jonathan Laurence, "France's Beef with Islam," *Foreign Policy*, March 7, 2012.

initiatives. These organizations either have established stakes in Islamic finance or lobby for Islamic finance for its market gains for France. The organizations include the Islamic Finance Advisory & Assurance Services (IFAAS), an Islamic finance consultancy firm based in London; Finance Islamique France, an interest network that published the first book on the possibilities for Islamic finance in France;<sup>99</sup> and Paris Europlace, an organization aiming to increase investment in Paris. The lack of contribution from Muslim organizations can be attributed to mentioned fact that French institutions actively discourage organization and representation based on religion or ethnicity in the public sphere.

As discussed, this is not true across the Channel where Muslim organizations like the Muslim Council of Britain have spearheaded campaigns for Islamic finance in the UK. The Muslim Council of Britain has sat on several governmental working groups for legal reforms for Islamic finance and has published educational materials on Islamic finance for non-Muslim audiences.<sup>100</sup> Ansar Finance Group (AFG), an Islamic banking trade organization based in Manchester, has also lobbied widely for reforms and has functioned as an intermediary between Muslims and Islamic bankers.

Thus, Islamic finance interest groups in the United Kingdom contain representatives from Muslim community organizations, both conventional and Islamic banks, Islamic banking organizations, and governmental branches. Her Majesty's Treasury, the Financial Services Authority (FSA), and the Bank of England have all represented government and regulatory interests in consultations and working groups with these other organizations.<sup>101</sup>

The difference in structure and makeup of Islamic finance interest groups between France

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99. Jean Paul Laramée, *La Finance Islamique à la Française : Un Moteur pour l'Économie, une Alternative Éthique* (Paris: Bruno Leprince, 2008).

100. Muslim Council of Britain, *London and Islamic Finance: Briefing Paper for the Mayor of London* (London: Muslim Council of Britain, 2009).

101. See Chapter VII (Section III) for a detailed examination of the Islamic Finance Experts Working Group's efforts.

and the United Kingdom has greatly influenced the divergent development and distribution of Islamic finance in Western Europe. The state-led approach to Islamic banking sector development in France helps to explain institutionally how the achievements made in ‘French-Islamic’ finance have benefitted investors over ordinary French Muslims. This is further discussed in Chapter IX, where I argue that difference in retail and wholesale sector foci is one critical factor determining the development of Islamic finance. The United Kingdom’s wide pool of parties interested and invested in Islamic finance has led to the British Islamic financial sector’s diversity in product offerings and ultimately, as Chapter VIII argues, the success of the sector as a whole.

Beginning with a discussion of historic immigration, this chapter has demonstrated that the Muslim populations in Western Europe matter for the emergence of Islamic finance because of interest group politics and influence. As long as it represents a sizable minority, the actual size of Muslim population remains relatively inconsequential for the development of Islamic finance. The question of whether or not Muslim minorities are able to form influential interest groups is the decisive matter for Islamic finance over actual population size. Thus, the institutional tolerance of minority organization based on religion and ethnicity is critical. Conversely, institutional obstacles blocking such organization in turn block the development of Islamic financial services in Western Europe by muting voices of support. The next chapter explores how the British government responded to the voices of interest groups for the first emergence of Islamic finance in Western Europe.

## **CHAPTER IV:**

### **THE FIRST EMERGENCE OF ISLAMIC FINANCE IN WESTERN EUROPE**

This chapter analyzes how the size, influence and location of British Muslims led to the first two attempts at offering Islamic financial services in Western Europe through two banks in London: the Bank of Credit and Commerce International (BCCI) and Al Baraka Bank. Both banks ultimately failed. Interactions between bank management and financial regulatory officials in the Bank of England (BoE) in the period leading up to the closures in the mid-1990s provides a look into the politics of establishing an Islamic bank in an environment foreign to the *shari'ah's* banking principles.

#### I. AL BARAKA BANK & THE FAILED BEGINNINGS OF ISLAMIC FINANCE IN WESTERN EUROPE

In 1982 and 1984, the first two banks offering Islamic financial services in Western Europe opened in London. Within a decade, however, both banks had closed. The closures came on the heels of increased tensions between Islamic bankers and the Bank of England and contributed to a public perception in the UK that Islamic finance was not compatible with British law. This episode's remarkably different narrative from the overarching successful story of the emergence of Islamic finance in the United Kingdom ultimately helps to explain both how Islamic banks have navigated the complicated political territories of conventional financial regulations and how British financial regulatory authorities worked more closely with Islamic investors and prospective bankers in the later 1990s and early 2000s.

Al Baraka Bank opened in 1982 and was the first fully *shari'ah*-compliant bank in the UK and all of Western Europe. It functioned as the London arm of Al Baraka Investment

Company<sup>102</sup> of Jeddah, Saudi Arabia, and was owned by a wealthy Saudi banker, Sheikh Saleh Abdullah Kamel.<sup>103</sup> A major figure in international Islamic banking, Kamel received Malaysia's Royal Award for Islamic Finance in 2010.<sup>104</sup> The bank offered a range of financial services (including home financing) and was successful, making a profit of £3 million in 1992, its last full year of business.<sup>105</sup>

Yet, even as Al Baraka had emerged as a profitable bank with a growing clientele, the bank's relations with the British financial regulatory system were strained. The BoE did not like the fact that Al Baraka Bank was owned by only one individual, Sheikh Kamel. It opposed single ownership because bank stability would rest entirely on the financial solvency and commitment of that individual and would thus expose account holders to too much risk.<sup>106</sup> A secondary and related concern was territorial regulation and oversight; the BoE was uncomfortable that the UK division of Al Baraka was not incorporated in Saudi Arabia, Kamel's home country. Since he also was not based in the UK, it was unclear where the bank itself was subject to regulatory oversight, providing the potential for financial loopholes.<sup>107</sup> The BoE encouraged Al Baraka to diversify its ownership structure, but the bank's limited efforts to find additional major shareholders did not yield significant results. In June 1993, the BoE forced Al Baraka to surrender its banking license. Following its closure, the bank continued to operate as an investment company.<sup>108</sup>

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102. Al Baraka Investment Company is now called Dallah Al Baraka.

103. Housby, *Islamic Financial Services in the United Kingdom*, 26.

104. Malaysia International Islamic Financial Centre, "Malaysia Honours Shaikh Saleh Abdullah Kamel," (2 November, 2010, <http://www.prweb.com/releases/2010/11/prweb4727694.htm>)

105. Housby, *Islamic Financial Services in the United Kingdom*, 25-26.

106. *Ibid* 26.

107. Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), 194.

108. Housby, *Islamic Financial Services in the United Kingdom*, 26.

II. BCCI & ALLEGATIONS OF TERROR-FINANCING AND FRAUD

During the same period, Western Europe's second institution offering Islamic financial products was facing regulatory challenges from the Bank of England as well. The Bank of Credit and Commerce International (BCCI) was under intense international scrutiny in the late 1980s from financial regulatory authorities and American and British intelligence services alike since it had become associated with money laundering and terrorism. Allegations of "crony capitalism" strongly influenced public perception of BCCI's Islamic subdivision, the Islamic Banking Unit in London.

While BCCI opened in 1972 with offices in London, Karachi, and Luxembourg,<sup>109</sup> the bank did not offer Islamic financial services until it opened the Islamic Banking Unit in London in 1984. The Islamic Banking Unit had \$1.4 billion in deposits at its peak. BCCI broadly "made heavy use of Islamic rhetoric and symbolism," as Warde (2000) notes,<sup>110</sup> and being owned by a Muslim Pakistani banker, the bank targeted British Muslims as customers for its Islamic and conventional financial products alike.<sup>111</sup>

International intelligence and domestic financial regulatory scrutiny of BCCI and its Islamic Banking Unit began in the early 1990s when a Price Waterhouse report found that BCCI had accrued \$589 million in "unrecorded deposits," which allowed the bank to manipulate its accounts.<sup>112</sup> A net \$331 million of these deposits were from the Faisal Islamic Bank of Egypt and the Dubai Islamic Bank.<sup>113</sup> These allegations strongly colored public perception of Islamic banks,

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109. Angelos Kanas, "Pure Contagion Effects in International Banking: The Case of BCCI's Failure," *Journal of Applied Economics*, May 2005.

110. Warde, *Islamic Finance in the Global Economy*, 1.

111. Housby, *Islamic Financial Services in the United Kingdom*, 24.

112. Mark Potts, Nicholas Kochan, and Robert Whittington, *Dirty Money: BCCI: The Inside Story of the World's Sleaziest Bank*, (Washington: National Press Books, 1992), 77-8.

113. These banks' deposits were intended for commodity investments. Neither bank was formally suspected of wrongdoing, but nevertheless, the image of Islamic financial institutions took a hit internationally.

especially among financial regulatory authorities in Europe.<sup>114</sup> Meanwhile, CIA and American Congressional investigations revealed that BCCI had been at the center of an international network of money laundering schemes between 1990 and 1992.<sup>115</sup>

Thus, as quickly as Islamic banking had emerged in Western Europe, it became associated with illegal activity. Amid strong domestic and international pressure, the Bank of England forced BCCI to close in July 1991. In their report to the Committee on Foreign Relations, American Senators John Kerry and Hank Brown delivered the final condemnation of BCCI when they wrote that BCCI “constituted international financial crime on a massive and global scale.”<sup>116</sup>

What did the failure of BCCI and Al Baraka mean for the prospects of Islamic banking in the UK and Western Europe at large? The closures meant that financial regulatory authorities throughout Western Europe were deeply suspicious of Islamic banks, financial institutions targeting Muslims, and banks that worked internationally in the Middle East. Thus, regulatory mood in London can perhaps be best described through a comment from the managing director of the Bank of England, just after BCCI Closed: “Al Baraka and any bank from the Middle East became questionable in the UK.”<sup>117</sup> Yet, suspicion and greater inquiry into capital sources of Islamic banks did not mean that the British financial regulatory establishment was opposed to Islamic finance on a principle.

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114. Warde, *Islamic Finance in the Global Economy*, 84.

115. Joseph J. Trento, *Prelude to Terror: Edwin P. Wilson and the Legacy of America's Private Intelligence Network* (New York: Carroll and Graf, 2005), 370.

116. The report stated that “BCCI’s criminality included fraud by BCCI and BCCI customers involving billions of dollars; money laundering in Europe, Africa, Asia, and the Americas; BCCI’s bribery of officials in most of those locations; support of terrorism, arms trafficking, and the sale of nuclear technologies; management of prostitution; the commission and facilitation of income tax evasion, smuggling, and illegal immigration; illicit purchases of banks and real estate; and a panoply of financial crimes limited only by the imaginations of its officers and customers.” John Kerry and Hank Brown, “The Origins and Early Years of BCCI,” *The BCCI Affair: A Report to the Committee on Foreign Relations, United States Senate* (102nd Congress 2nd Session, Senate Print, December 1992).

117. Yusuf Karbhari, Kamel Naser, and Zerrin Shahin, “Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK,” *Thunderbird International Business Review*, 4 (2004): 531.



At the time of Al Baraka's closure, the Bank of England touted two main lines of rhetoric. First, the BoE gave general support for Islamic finance because the bank believed in making available financial services that are consistent with British citizens' religious persuasions. In a press release, it said that "in principle, there is no conflict between Islamic banking and the Banking Act," and noted instead that the decision to close Al Baraka was reached because the bank's management and ownership structure had failed to meet new international finance guidelines.<sup>118</sup> Yet, some in the BoE were more suspicious of Islamic finance, such as Robin Leigh-Pemberton, former governor of the Bank of England, who stated less than two years later that Islamic finance is "a perfectly acceptable mode of investment, but it does not fall within the long-established and well understood definition of what constitutes banking in this country."<sup>119</sup>

## II. MUSLIM INTEREST GROUP RESPONSES TO THE CLOSURES

Al Baraka and BCCI's Islamic Banking Unit interestingly did not emerge in a bottom-up fashion: established *foreign* institutions opened both without significant domestic Muslim community lobbying. Al Baraka Investment Company in Saudi Arabia and BCCI opened their Islamic units because of the (accurately) perceived demand for Islamic financial products, and because the generally liberal business regulations in the UK provided what seemed like a more flexible environment than much of Europe. Largely, the British Muslim community itself was silent during these developments.

It was not until the closures of Al Baraka and BCCI that there was a groundswell in the Muslim community. At the time, Keith Vaz, a Labour MP, who had come to represent British

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118. Peter Rodgers, "Depositors Refuse to Cash In: MP Criticises Bank of England as Albaraka Closes," *The Independent*, April 2, 1993.

119. Ibrahim Warde, "Global Politics, Islamic Finance and Islamist Politics Before and After 11 September 2001," in *The Politics of Islamic Finance*, eds. Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004). 51.

South Asian and Muslim interest in Parliament, raised objections to how the Bank of England had ‘criminalized’ banks specializing in serving Asian customers.<sup>120</sup> Housby (2011) writes that the closure of Al Baraka in 1993 caused considerable “resentment” among British Muslims. Like Vaz, British Muslims felt that the financial regulatory system in the United Kingdom was harsher on Islamic banks than conventional banks.<sup>121</sup>

Thus, public discussion on the injustice of the regulatory system spurred more community organization for the cause of Islamic banking. It is also plausible that British Muslims did not ‘know’ to organize for Islamic banking before Al Baraka and BCCI. Both banks introduced Islamic financial services to the market for the first time in Britain. It is likely that many Muslims did not know that there were financial products that allowed them to avoid paying interest and investing in *haram* (forbidden) industries indirectly.<sup>122</sup> Al Baraka and BCCI introduced this knowledge but then disappeared from the market, taking *shari’ah*-compliant services with them, and leaving a hole in the market. Thus, both large organizations like the Muslim Council of Britain and small city-level organizations adopted the cause of lobbying for financial institutions to fill the hole left by the Bank of England’s ‘unjust’ closure of Al Baraka and BCCI.<sup>123</sup>

This chapter began by exploring how Islamic finance had failed in the United Kingdom. The illegal practices and lack of ability to meet basic banking regulations (which were not related to Islamic finance) were the reasons for BCCI and Al Baraka’s failure. In this sense, their closures and tense deliberations with officials in the Bank of England cannot be considered

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120. Malory Nye, *Multiculturalism and Minority Religions in Britain: Krishna Consciousness, Religious Freedom and the Politics of Location* (Richmond: Curzon Press, 2001), 146.

121. Housby, *Islamic Financial Services in the United Kingdom*, 27.

122. Such as gambling, pornography, alcohol, tobacco, speculative transactions.

123. Shah M. Nizami, “Islamic Finance: The United Kingdom’s Drive to Become the Global Islamic Finance Hub and the United States’ Irrational Indifference to Islamic Finance,” *Suffolk Transnational Law Review* (Boston: Suffolk University Press, Winter 2011: 34), 11.

indicative of the British regulatory system's attitude of and approach to Islamic finance. Most regulatory officials in the BoE, HM Treasury, and the FSA remained open to the possibility of an Islamic financial sector emerging within their jurisdiction. Yet, no matter the actual position of financial regulatory officials, the result of the two closures was clear: after a decade of a multi-financed Britain for a multi-cultured Britain, the country returned to a single financed banking system. The perception of this quick opening and closing to Islamic finance as almost a 'bait-and-switch' situation ultimately provided the domestic pressure from Muslim organizations and citizens generally to lobby for the expansion of *shari'ah*-compliant services in Britain. The following chapter explores how the regulatory establishment in London and Paris reacted to subsequent license applications from Islamic banks in the mid-1990s. Generally, applications for Islamic banking licensing in London were met with wide support from the BoE, HM Treasury, and the FSA.

## CHAPTER V: AUTHORIZATION & BANK LICENSING

The previous chapters discussed how the growth of Muslim populations in France and the United Kingdom has intensified demand for Islamic financial products by means of an increased market size and through the increased influence by way of interest groups. This chapter continues in discussing how state authorities in France and the UK responded to this growth in demand. Specifically, I compare the interests of state regulators concerning bank authorization and licensing for fully *shari'ah*-compliant banking institutions between France and Britain.

The most critical institutional aspect of financial regulatory systems in determining the emergence and development of Islamic finance in Western Europe is banking authorization and licensing. Amid the widely publicized closures of BCCI and Al Baraka Bank in London in the 1990s, Western European financial authorities became deeply suspicious of Islamic financial institutions and their ability to function legally and competitively alongside conventional financial institutions. This suspicion led the FSA in London and the Banque de France and the Comité des Établissements de Crédit et des Entreprises d'Investissement (CECEI) in Paris to tighten banking licensing processes for Islamic institutions. Consequently, it became much more difficult for Islamic bankers to gain banking licenses and to open their institutions in Paris and London.

Investors and bankers seeking to establish fully-*shari'ah*-compliant banks have faced the challenge of convincing financial authorities in France and Britain that there are fiscal and social benefits to a multi-financed society, much like progressive lawmakers have worked to convince governments that multiculturalism is an achievable and worthy goal. Interest groups and

individuals have lobbied for banking authorization with two main arguments. First, they have argued that regulatory institutions should authorize Islamic banks because these banks open up a profitable untapped market: Western European Muslims who either previously did not use (conventional) banking services or had severely limited their banking activity as to be as *shari'ah*-compliant as possible. Prospective banks, Muslim organizations (like the Muslim Council of Britain), and law firms (like Norton Rose) have made these arguments for both Islamic retail and Islamic wholesale banks. The second argument these interest groups have made is that the exclusion of a group from taking part in commerce and banking based on their religious belief is a violation of their rights, and that, conversely, they have rights to have access to a financial system that complies with their religious persuasions.

It would be plausible to assume that this second argument would not be salient in the meeting rooms of the FSA, AMF, or the CECEI. And this assumption has remained true in France where arguments based on the claim that a religious group may have its own particular and singular rights have not been salient whatsoever. Yet, in Britain, this argument has had considerable traction. It is difficult to trace the argument's British origin exactly, but the Muslim Council of Britain used it widely in reports in the early 2000s.<sup>124</sup> But the most consequential voices speaking for "an inclusive model of financial citizenship," have been governmental financial branches, such as Her Majesty's Treasury, which stated in 2008 that it had sought to encourage Islamic finance in Britain over the past eight years in order "to ensure that nobody in the UK is denied access to competitively priced financial products on account of their faith."<sup>125</sup>

Thus, the authorization or censorship of fully *shari'ah*-compliant banks and, ultimately,

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124. Muslim Council of Britain, *London and Islamic Finance: Briefing Paper for the Mayor of London* (London: Muslim Council of Britain, 2009).

125. Her Majesty's Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective* (London: Her Majesty's Treasury, December 2008), 5.

the emergence of an alternative financial system hinges on the salience of these arguments in the minds of financial regulatory authorities. This chapter, consequently, explores how French and British regulatory institutions reacted to licensing applications and the related challenges Islamic bankers have faced in convincing financial authorities that Islamic finance can be integrated into Western conventional financial markets.

### I. ECONOMIC LIBERALISM & BRITISH OPENNESS TO ISLAMIC FINANCE

As Chapter VII covers in detail, the story of Islamic finance in Britain shifted in the early 2000s from a period forced-closures of banks like Al Baraka to a period of dynamic legal reform for the inclusion of Islamic finance on high street. Islamic finance morphed from being a topic linked to terrorism and fraud in the meeting rooms of the FSA to a topic associated with economic inclusion and economic development. There are two reasons for the change. First, as discussed in Chapter III, interest groups formed during the mid-1990s began pressuring the FSA to open up to Islamic finance. Organizations like the Muslim Council of Britain were critical in this grassroots campaign. Moreover, the groundswell of Muslim community support for Islamic banking that emerged after the closures of BCCI and Al Baraka indicated strongly to regulatory officials in the FSA, the BoE, and the Treasury that there was a domestic market and need for *shari'ah*-compliant services.

Second, the government was never opposed to Islamic banking on principle; it sought mainly to ensure that banks established in Britain were 1) not engaging in illegal behavior, and 2) able to guarantee their funds without considerable risk to customers. BCCI and Al Baraka, respectively, were not able to meet these standards. Yet, when the Bank of England began receiving more applications for bank authorization in the late 1990s and the early 2000s, it began reviewing these applications more positively. These prospective banks did not suffer from the

same unique faults that BCCI and Al Baraka had. Thus, the Bank of England was ready to enthusiastically support Islamic finance as long as prospective banks met established criteria. This was consistent with the BoE's statement that "in principle, there is no conflict between Islamic banking and the Banking Act."<sup>126</sup>

While there were certainly financial regulatory officials in London that were suspicious of Islamic finance like Robin Leigh-Pemberton, a former governor of the Bank of England, the British regulatory institutions were very open to the prospects of developing an Islamic financial sector in the UK. Perhaps more so than the Bank of England, the FSA and the Treasury were particularly flexible partners with prospective Islamic bankers. Their attitude was consistent with British economic liberalism: in brief, they were open to exploring new ways of banking and would provide the necessary accommodations for such experiments. The most critical of these accommodations was bank authorization and licensing. This flexible regulatory approach joined with longstanding economic liberalism and openness to innovations made London a prime destination for investors in Islamic finance in the early 2000s. Essentially, the effects British capitalism has attracted continued Islamic investor interest in London.<sup>127</sup>

## II. LICENSING & FRENCH OBJECTIONS TO ISLAMIC FINANCIAL INSTITUTIONS

When French financial regulatory authorities first received a licensing application for an Islamic bank in 2005, their reaction was lukewarm. Fehmy Saddy, a Syrian investor and former executive at the Islamic Development Bank in Jeddah, had submitted the application and was optimistic that his long-held interest in establishing the first independent *shari'ah*-compliant

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126. Rodgers, "Depositors to Cash In."

127. Shyamantha Asokan, "UK Leads in Sowing Seeds for a Sector," *Financial Times*, June 19, 2008.

bank in France to serve “underbanked” Muslims would soon be realized.<sup>128</sup> Yet, shortly after negotiations between Fehmy and the Banque de France had begun, the bank signed a “memorandum of understanding,” which included an unexpected stipulation for Saddy and his bank, which was to be called Tayssir Bank.<sup>129</sup> The unexpected stipulation came in a clause in the document stating that Tayssir Bank had to have majority French-ownership in the capital structure in order for the bank to consider authorization.<sup>130</sup>

This account of Fehmy’s first interaction with the Banque de France is typical of interactions between Islamic bankers and the governing financial institutions in France, which traditionally place stipulation upon stipulation for prospective Islamic banks. A 2008 *Moody’s* report on Islamic finance in France found that French regulators had not yet been persuaded that Islamic banks were “creditworthy” and that if France was indeed committed to developing an Islamic financial sector, regulators needed “to reduce banking protectionism.”<sup>131</sup> French financial regulators have not authorized any *shari’ah*-compliant banks in France due to three core reasons: bank ownership structure, capital guarantee for deposits, and *shari’ah* advisory councils.

### III. THE OBSTACLE OF BANK OWNERSHIP IN FRANCE

First, Islamic investors face the problem of needing a French bank to have at least partial shareholding, the problem that Saddy and Tayssir Bank faced. The bank would function as a guarantor or a sponsor (*parrain*). Since Tayssir submitted its first application for authorization in 2005, the Banque de France and the AMF changed the percentage of share ownership a French bank had to hold. When Tayssir first submitted its application, French authorities required at

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128. Fehmy Saddy, “Vers la Création de la Première Banque Islamique en France: Tayssir Bank,” *Revue Bancaire et Financiere*, July 2007.

129. Some sources spell the bank’s name as Tayseer or Taysir.

130. Philip Alexander, “France and Canada Target Islamic Markets,” *The Banker*, November 24, 2010.

131. Hassoune, “Islamic Finance in France,” 3.



least 50 percent French bank ownership for the authorization of an Islamic bank, but this percentage has shifted erratically since 2005 from 20 percent to 33 percent and back to 50 percent.<sup>132</sup>

This inconsistency is difficult to trace. The varying regulations are not based on ownership and shareholding policies from the regulatory authorities. Instead, the AMF, the Banque de France, and the Comité des Établissements de Crédit et des Entreprises d'Investissement (CECEI)<sup>133</sup> have shifted requirements for individual license applications.<sup>134</sup> Whether a product of planned policy or merely changing regulations, inconsistency in shareholding requirements remains off-putting to investors in Islamic finance who already view the requirement of having a French bank as a sponsor to be a major obstacle. Largely, such inconsistency contributes to investors' perceptions that French authorities remain uncommitted to Islamic finance and that French *dirigisme* is not open to innovative alternative finance.<sup>135</sup>

Regardless of the percentage of 'French sponsor ownership,' the task of recruiting established French banks to fund an Islamic bank has been very difficult for prospective Islamic bankers in France. French banks have avoided sponsoring Islamic banking ventures for several reasons. First, they have expressed reservation about being associated with an institution created mainly to serve Muslims. In addition to fearing that established clients would not approve of such association, French banks have "expressed the general view than an explicitly designated

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132. Saddy, "Vers la Création de la Première Banque Islamique en France: Tayssir Bank"; and Mohammad Farrukh Raza, "Islamic Finance Regulation Mechanisms in Post-Crisis Period: Regulation of Islamic Finance in the UK and France" (presentation, 3rd Astana Economic Forum, July 2, 2010).

133. The Comité des Établissements de Crédit et des Entreprises d'Investissement (CECEI) handles banking authorization for new banking institutions in association with the Banque de France. The AMF is generally less involved with actual authorization and licensing as it is with regulation and taxation of existing banks. The CECEI also authorizes shareholder changes and mergers of established banks.

134. Christophe Arnaud, "The French Licensing Authority Faced with the Globalisation of Islamic Finance: A Flexible Position," in *Islamic Banking and Finance in the European Union: A Challenge*, eds. M. Fahim Khan and Mario Porzio. (Northampton, Mass.: Edward Elgar Publishing, 2010), 169.

135. DTZ Asset Management and Norton Rose, *Islamic Finance and Real Estate in France: A White Paper* (Paris: DTZ, 2010).

Islamic bank... would be clearly in conflict with the concept of *laïcité*.<sup>136</sup> Second, conventional bankers, whether in France or elsewhere, associate Islamic banking with ‘terror-financing,’ money laundering, and other illegal banking behavior.<sup>137</sup> Third, while a French bank’s sponsorship may only constitute a one-third ownership of the Islamic banking institution, contracts drawn up by French regulatory authorities make the sponsoring institution 100 percent responsible in case of bank failure and bankruptcy. Thus, considering this responsibility and risk, potential bank sponsors are typically more interested in funding a fully *shari’ah* compliant bank solely by themselves so they can realize full profit, instead of profit proportional to their initial investment.<sup>138</sup> The preferable option, of course, for established conventional French banks was to offer Islamic financial products and services within their established banking systems without opening a new bank, whether as a the sole shareholder or a sponsor (partial) shareholder.

The Tayssir investor Fehmy Saddy recalled in a 2010 interview in *The Banker* that he “approached all of [the major French banks], but they decided that their major clients would not want them to be involved in Islamic banking activity for political reasons.”<sup>139</sup> Every bank he tried to recruit was concerned that “catering to the needs of Muslims” would hurt its image. Saddy continued working with French authorities and in 2009 licensing prospects seemed more promising. The Banque de France had conceded somewhat to allow Saddy to partner with a “reputable” bank from outside France. Yet, what could have been a major regulatory opening turned out to be a largely symbolic and empty gesture as none of Saddy’s partners sufficiently met the Banque and AMF’s capital expectations. Thus, Tayssir Bank still has not opened, 7 years

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136. Saddy, “Vers la Création de la Première Banque Islamique en France.”

137 Associating Islamic finance with illegal banking behavior is often the product of information from the Office of Assets Control of the United States Department of Treasury. See Mark Potts, Nicholas Kochan, & Robert Whittington, *Dirty Money: BCCI: The Inside Story of the World’s Sleaziest Bank*, (Washington: National Press Books, 1992).

138. Saddy, “Vers la Création de la Première Banque Islamique en France.”

139. Philip Alexander, “France and Canada Target Islamic Markets,” *The Banker*, November 24, 2010.

after its initial application.<sup>140</sup>

#### IV. CAPITAL GUARANTEES ON SAVINGS ACCOUNTS IN FRANCE & THE UK

The second regulatory obstacle that has stood in the way of bank authorization and licensing for Islamic financial institutions in France is the capital guarantee for banking products. The CECEI and the Banque de France require all banks in France to have a “capital guarantee” for savings (deposit) accounts for the protection of clients. British regulators require the same capital guarantee in the United Kingdom. Since Islamic savings accounts have traditionally been structured on *mudaraba*<sup>141</sup> contracts, complying with a capital guarantee would mean that the savings account service would *not* be *shari’ah* compliant. This is because inherent shared risk is considered a fundamental part of Islamic financial products in traditional interpretation of Islamic financial law. In sum, if a bank were to guarantee that it could repay the capital on client demand, regardless of bank solvency, that action would be considered *haram* (forbidden) by most scholars of Islamic law.<sup>142</sup>

Thus, French financial regulators and prospective Islamic banking investors have not found a compromise where both parties feel the savings product sufficiently *halal* (permissible). The result has been that French authorities have refused to give authorization to Islamic banks that refuse to be ‘non-*shari’ah*-compliant’ on this single issue.<sup>143</sup> Since this authorization problem centers on savings deposit accounts it has likely had a much larger affect of the (lack of) growth in Islamic *retail* banking than wholesale banking in France.

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140. Ibid.

141. *Mudaraba* contracts are between a capital owner (customer) and an investment manager (bank) where one partner receives profit based on their capital investment while the other party receives profit based on their labor or management of the venture. Loss must be shared in proportion to capital contributions, which means that only the capital owner (the bank) is responsible for direct financial loss.

142. World Savings Banks Institute and European Savings Bank Group, *Islamic Banking and Finance: Insight on the Possibilities for Europe*, Perspectives series, no. 60 (Brussels: WSBI/ESBG Publishing Office, October 2009). 84.

143. Raza, “Islamic Finance Regulation Mechanisms,” 10,13.

As mentioned, Islamic banks in the United Kingdom faced the same authorization obstacle of the capital guarantee.<sup>144</sup> The Financial Services Authority (FSA) and HM Treasury held a series of consultations and meetings in order to establish a framework that both state regulators and Islamic bankers could support. The result of these debates was a clause that the Islamic banks would add to their Terms & Conditions for savings deposit accounts. The clause stated that in case of loss, the banking customer would have the choice to either accept the loss or to be reimbursed by the bank.<sup>145</sup> This section option met the FSA’s capital guarantee requirement. The language of the newly drafted Terms & Conditions stated that the second option was not *shari’ah*-compliant. This solution was very controversial among segments of the Islamic scholarly community, but it ultimately allowed the Islamic Bank of Britain to launch the first Islamic savings accounts in the UK in 2005.<sup>146</sup>

The issue was resolved even further when the FSA approved the provision of ‘capital protection’ using savings accounts structured on *wakala* contracts.<sup>147</sup> This provided additional flexibility for Islamic banks in Britain.

Largely, investors did not see the FSA’s capital guarantee requirement as a major hurdle for bank authorization in the United Kingdom. The FSA had approached the capital guarantee as an area needing addressing, but not as a major challenge, and certainly nothing to prohibit their authorization of an Islamic bank. This ‘steady-hand’ and confident approach alleviated most

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144 Following the 2008 financial collapse, the FSA increased the amount it required banks to cover through a capital (deposit) guarantee to the first £50,000 of a customer’s funds. The state guarantees that this much will be returned to the banking customer in case of bank failure, even if governmental intervention is needed.

145. Housby, *Islamic Financial Services in the United Kingdom*, 54-55.

146. Raza, “Islamic Finance Regulation Mechanisms,” 10.

147. A *wakala* contract is structured similarly to a *mudaraba* contract. Using a *wakala* contract, the banking customer gives capital to an investor (bank) to use for a venture or to hold. The profits (if any) are shared between the customer and the bank (the *wakil*) in agreed upon proportions. An important aspect of *wakala* is the legal relationships between parties. In the *wakala* as governed by UK tax law, the *wakil* is understood to be acting legally as an agent to the banking customer. Thus, the capital never becomes the bank’s property. The customer, meanwhile, is understood to be the party that deposits funds. In case of insolvency, the *wakala* customer has legal claim to the underlying commercial venture, which he does not under a *mudaraba* contract. See Humayon A. Dar and Umar F. Moghul, *The Chancellor Guide to the Legal and Shari’a Aspects of Islamic Finance* (New York: Chancellor Publications, 2010) 82-83.

investor concerns. And while the issue of incomplete *shari'ah*-compliance on savings accounts remained, it had not diminished demand for Islamic savings accounts. The UK's flagship retail Islamic bank, the Islamic Bank of Britain, recorded that its deposits had reached £186.6 million by the end of 2009.<sup>148</sup> IBB has since developed a wide line of savings account services (see Figure 1). Chapters VII and VIII cover issues in Islamic retail banking in the UK and France more fully.



**Figure 1:** Islamic savings account services featured on the Islamic Bank of Britain. Source: Islamic Bank of Britain.

## V. BANK MANAGEMENT & SHARI'AH ADVISORY BOARDS IN FRANCE

The third major reason why French financial regulators have given for not authorizing any Islamic banks in France has been the role of *shari'ah* advisory boards.<sup>149</sup> During the process

148. Housby, *Islamic Financial Services in the United Kingdom*, 58.

149. Chapter II provides an examination of *shari'ah* advisory councils. French authorities are not interested in theological concerns pertaining to whether a given product was *shari'ah*-compliant or not; rather, they were concerned that Islamic scholars could not appropriately manage a bank and meet expectations held for conventional banks in France. Likewise, the FSA said that it is “a secular and not a religious regulator. It would not be appropriate, even if it were possible, for the FSA to

of bank authorization, the Banque de France issues approval to the bank's chairperson and the chief executives. But in the case of Islamic banks, the Banque has refused on multiple occasions to grant this same approval to *shari'ah* advisory boards since the state cannot give approval to any religious body according to the principles *laïcité*.

Norton Rose, a law firm with a specialization in Islamic financial law, and individual Islamic banking investors lobbied for the Banque and the CECEI to grant approval to *shari'ah* advisory boards, arguing that the boards played a more consultative role rather than a “decisive operational role” in Islamic banks.<sup>150</sup> The CECEI, however, was never convinced that *shari'ah* advisory boards did not provide operational and management services. In addition to objecting to approve a religious body, both regulatory institutions were concerned that these boards could not provide sufficient oversight and management of the firms' products and services if they were functioning in a management role. The CECEI in particular was suspicious of the banking qualifications of potential members of *shari'ah* advisory boards<sup>151</sup> Correspondingly, the Banque has not been willing to approve any banks that use a *shari'ah* advisory board to date.<sup>152</sup>

The CECEI and the Banque de France's objection to *shari'ah* advisory boards is not, however, a consistent policy. French banks like BNP Paribas and Société Générale offer a limited number of Islamic banking services mostly relating to project financing and these services are reviewed and approved by Islamic scholars. Consequently, though they have not tolerated *shari'ah* advisory boards in full Islamic banks, the CECEI and the Banque have allowed a degree of influence of *shari'ah* scholars in these large conventional banks. This sheds light on how French regulatory authorities are more comfortable with large, established banks

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judge between different interpretations of Sharia law.” Financial Services Authority *Islamic Finance in the UK: Regulation and Challenges* (London: FSA, November 2007), 13.

150. DTZ and Norton Rose, “Islamic Finance and Real Estate in France,” 48.

151. Arnaud, “The French Licensing Authority Faced with the Globalisation of Islamic Finance,” 171-172.

152. DTZ and Norton Rose, “Islamic Finance and Real Estate in France,” 48.

offering Islamic products than institutions dedicated to Islamic finance, which, regulatory authorities argue, are more influenced by Islamic scholars.

#### VI. POLICY PATTERNS: BRITISH TOLERANCE & FRENCH SKEPTICISM

While being inconsistent, the CECEI and the Banque de France's objections to *shari'ah* advisory councils for fully-*shari'ah* compliant banks like Tayssir Bank were based largely on lack of information and assumptions that bank management would not have the appropriate skills and 'final say' in corporate decisions. In reality, the role of *shari'ah* advisory councils is limited to vetting financial products and services, as it has been in Islamic banks in Britain. While their decisions will predictably influence which products a bank promotes and how the bank markets them, this influence is only indirect and secondary.

In the United Kingdom, the FSA had some similar concerns over the relationship between bank governance and *shari'ah* advisory boards, but after consultations with Islamic bankers, board members, and community leaders, the FSA stated that it was open to authorizing Islamic banks with the boards intact, as long as they did not "interfere with the management of the firm."<sup>153</sup> Thus, while it was concerned about the qualifications and influence of *shari'ah* advisory boards, the FSA showed considerable openness to learning about an unfamiliar system of internal regulation. Once officials in the FSA had weighed their concerns with their new understanding of the process of *shari'ah* compliance review, the body also showed that it was flexible in working with the banks to ensure that management expectations would be met after authorization and licensing.<sup>154</sup>

The attitude of the FSA and the Bank of England toward the authorization of fully-

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153. FSA, *Islamic Finance in the UK: Regulation and Challenges*, 13.

154. *Ibid.*

*shari'ah*-compliant banks can be summed up by the word tolerance. The institutions were open and willing to tolerate both the 'learning-curve' of a new financial system and to tolerate a different financial system functioning parallel to the system that had been established in London for a century. Prevailing in the financial regulatory system's approach to Islamic finance reforms, these politics of inclusivity emerge as a product of Britain's liberal practice of multicultural policies, especially under the Labour Party's rule from 1997 to 2010.<sup>155</sup> More broadly, institutional tolerance of banking difference is the product of British economic liberalism, which stresses the open accommodation of innovation.

French institutions, meanwhile, have remained hostile toward licensing Islamic banks. The Banque de France and the CECEI have said that they welcome applications for Islamic banks, but have shown much less interest in learning the nuances of Islamic finance as their British counterparts have across the Channel.<sup>156</sup> This objection to including fully *shari'ah*-compliant banks on the French banking market next to conventional institutions has led to a broad underdevelopment in Islamic finance from the state. Christine Lagarde's ambition to make Paris rival London as the Islamic financial capital of Western Europe cannot be realized without the authorization of full Islamic banks, which provide sector depth unoffered by Islamic 'windows' at conventional banks like Société Générale.

This chapter has argued that the development of Islamic financial sectors hinges on the authorization of fully *shari'ah*-compliant banks. When these institutions are censored and only conventional banks offer Islamic financial services, Islamic financial sectors do not emerge strongly or completely, as this chapter's analysis of France has demonstrated. Individuals and

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155. The Economist, "Muscle v. Multiculturalism: David Cameron Challenges Radical Islamists to a Contest of Ideas," *The Economist*, February 10, 2011, Print Edition; Tom Whitehead, "Labour Wanted Mass Immigration to Make UK More Multicultural, Says Former Adviser," *The Telegraph*, October 23, 2009.

156. Thierry Dissaux, "French Initiatives for Islamic Finance" (presentation, Islamic Financial Intelligence Summit, Paris Europlace, London, November 3, 2010).



interest groups lobbying for the authorization of such institutions must convince state financial authorities that the existence of a dualistic, multi-financed banking sector is in the interest of the state. Building on this chapter's analysis of the need for fully *shari'ah*-compliant banks, the next chapter examines how the structure and makeup of Islamic financial sectors influences their development, looking mainly at the different French and British regulatory preferences concerning retail- and wholesale-driven financing.

## CHAPTER VI: SECTOR STRUCTURES & STATE PREFERENCES

“The crux of the problem is that nobody wants [Islamic finance] and the Muslims have no power in France. They are not organized enough and have no lobbying power to see Islamic retail banking see the light of day.”  
– Anonymous French banking industry expert in Reuters.<sup>157</sup>

State regulatory bodies and private banking corporations design the structures of their financial sectors based on collective preference and will. The same is true for Islamic financial sectors. Building upon the previous chapter’s analysis of processes for authorization and bank licensing, I explore how different regulatory authorities have shaped the different structures of Islamic financial sectors based on their political and economic preferences. The majority of this chapter examines how the resulting structures influence the general extent of development of Islamic finance in the two countries. I analyze the difference between diversified Islamic financial sectors and those that are built solely on wholesale banking and argue that London’s primacy, as Western Europe’s Islamic banking capital, owes much to the British regulatory system’s commitment to diversified Islamic financial product offerings.

In 2008, *Moody’s* Investors Service published a report stating that the absence of a governmental focus on Islamic *retail* banking for ordinary French Muslims was a key obstacle for the sector’s growth in France. The report then stated that “even while seeking to attract Gulf money, France runs the risk of erecting barriers to establishing its own market for Islamic finance.”<sup>158</sup> This observation is right in understanding that the French state’s advancements in Islamic finance, if limited, have not focused on French Muslims. As discussed, this is especially

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157. Tamora Vidaillet, “Retail Questioned as France Pushes Islamic Finance,” *Reuters*, Septemebr 9, 2009.

158. Hassoune, “Islamic Finance in France,” 2.

significant since France has the largest number of Muslims of any European country. Instead of encouraging *shari'ah*-compliant financial services like mortgages, savings accounts, and mutual funds for its own citizens, the government has been mainly concerned with using tax and structural changes to gain “access to some of the vast liquidity that the [Gulf’s] oil kingdoms have accumulated.”<sup>159</sup> Consequently, the state and its financial regulatory system have pursued Islamic financial services and products like product financing and *sukuk* (bonds), which will attract foreign capital and foreign investment. This wholesale-centric banking approach contrasts strongly with the UK’s diversified sector that offers Islamic college ‘loans’ at the same banking counters as it offers venture capital funds.

In this chapter, I compare how different preferences among governmental financial regulatory officials have led to very different Islamic financial sectors in France and Britain. I explore how the French one-sided approach has led to an underperforming Islamic financial sector in France that focuses solely on wholesale banking. I then analyze how the interests of French state actors and French banks compare with the interests of state and private actors in the UK, which has developed a much more diverse Islamic financial sector. In respect to France, I am concerned with how the French state has pursued Islamic finance for the inclusion of foreign beneficiaries—banks and investors—while simultaneously excluding its domestic Muslim citizenry from participating in the developing Islamic financial sector. For the United Kingdom, I examine how British regulatory officials have instead sought to allow, encourage, and establish a diversified and dynamic financial sector that captures both domestic and foreign clients.

#### I. MUSLIM DEMAND FOR ISLAMIC RETAIL BANKING, ADVERTISING, & KNOWLEDGE

A lack of demand from ordinary French Muslims is a possible explanation for the

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159. Hassoune, “Islamic Finance in France,” 3.

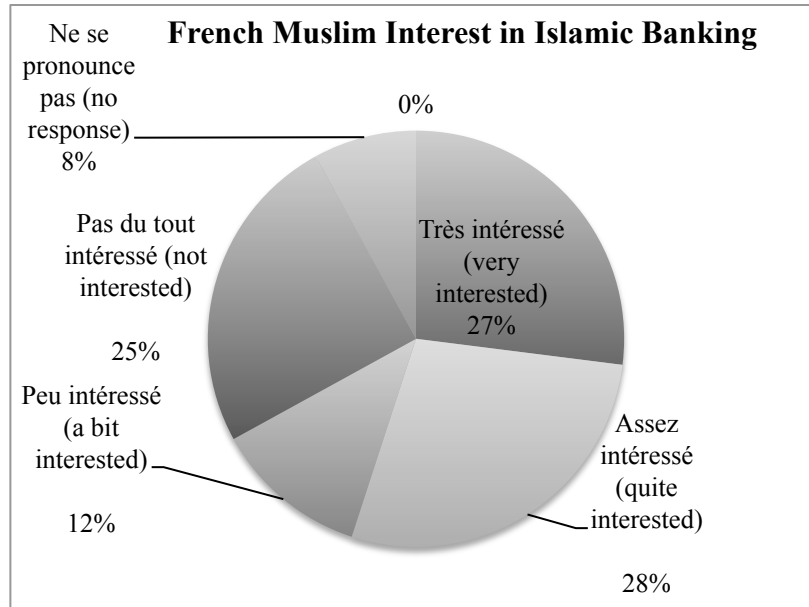
absence of a French governmental initiative for Islamic retail banking. Yet, this is not accurate. As a 2008 survey showed, French Muslims are interested in *shari'ah*-compliant alternatives for ordinary banking products like credit cards, mortgages, and savings accounts. AIDIMM and IFAAS, two European Islamic (and alternative) banking interest organizations,<sup>160</sup> commissioned the Institut Français d'Opinion Publique (IFOP) to conduct a market research survey to explore whether there was a market for retail Islamic banking in France (see graph). The study used a representative sample of 530 individuals self-identifying as Muslim.<sup>161</sup> IFOP interviewed survey respondents in person and found that more than half (55 percent) of respondents said that they would be interested in *shari'ah*-compliant banking services if they were available (27 percent were very interested, and 28 percent were quite interested). Additionally, 12 percent said that they were a bit interested (*peu intéressé*), 25 percent were not at all interested, and 8 percent did not respond.<sup>162</sup>

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160. AIDIMM is the Association d'Innovation pour le Développement Économique et Immobilier and IFAAS is Islamic Finance Advisory & Assurance Services.

161. Mohammad Farrukh Raza, "Does Islamic Finance Have A Room to Thrive in Europe?," Islamic Finance & Real Estate Conference, Islamic Finance Advisory & Assurance Services (IFAAS), November 4, 2008, 15.

162. AIDIMM & IFAAS, "Finance Islamique: Quels Marchés et Quelles Opportunités pour les Banques de Détail?," 2011.



These figures measuring level of interest for Islamic banking should be considered conservative for two related reasons. First, there are no Islamic retail banks in France and few Islamic financial products being marketed by conventional banks. As IFAAS notes, marketing Islamic financial products remains very challenging and complicated in France.<sup>163</sup> Although there are not laws against private sector promotion of religiously-affiliated items, French bankers have to decide how to brand products like Islamic mortgages and savings accounts as being *shari'ah*-compliant in order to gain customers but without being overly religious in a generally *laïque* environment. This is not the case in the United Kingdom where the political culture has not inhibited the established physical, urban, and public presence of Islamic banks (see Figure 1).

163. Raza, "Is There a Room for Islamic Finance In Europe?," 17.



**Figure 1:** An Islamic Bank of Britain branch. Source: *Financial Times*<sup>164</sup>

Second, as a consequence, it is likely that many French Muslims are not aware of Islamic banking in Europe. Further, scholars have theorized that many Muslims are not aware of the financial and commercial components of Islamic law,<sup>165</sup> including the ban on *riba* (usury) and *gharar* (speculative gain). This forms a circular structure of disinvestment where France’s basic lacking of Islamic banks leads to a lack of education among Muslims that Islamic finance exists or could exist in France. This in turn leads to an often perceived under-demand for Islamic financial products and services, which finally discourages the establishment of Islamic banks in France (see Figure 2).

**Figure 2: Cycle of Disinvestment in Islamic Finance in France**



164. David Oakley, “Sukuk Required to Secure Pole Position,” in *Special Report Islamic Finance 2011*, *The Financial Times*, December 14, 2011.

165. Emilie Cailleau, “Finance Islamique: ‘Une Manifestation Formidable de l’Intégration,’” *L’Express*, April 9, 2009.

Yet, even from IFOP's conservative estimates from its 2008 market research survey, we can conclude that there is a sizable demand of at least 55 percent of France's Muslim community (which is made up of over 6 million people) for *shari'ah*-compliant banking. Thus, it is very notable that actors working on the development of Islamic finance in the UK—whether the Ministry of Finance, the financial regulators, major banks—have not sought to capitalize on this considerable market.

## II. RETAIL V. WHOLESALE ISLAMIC BANKING

Yet, regardless of 'bottom-up' demand, French approach to Islamic finance has centered mainly upon wholesale banking<sup>166</sup> instead of retail banking.<sup>167</sup> The state and the country's banks have been primarily interested in establishing a structure for 'French-style' *sukuk* (Islamic bonds), which the state hopes would draw in Gulf liquidity. In nearly every speech and release, the French state—mostly during Finance Minister Christine Lagarde's tenure—has spoken of Islamic finance only in the light of investment capital.

This approach is markedly different than the British approach. Governmental and banking actors in United Kingdom have pursued Islamic finance in a multi-tiered fashion, seeking to capitalize a diverse portfolio of Islamic financial services from checking accounts and mortgages to project financing and bonds.<sup>168</sup> The Financial Services Authority (FSA) and government agencies' four-tiered strategy has addressed retail banking, wholesale banking, Islamic insurance (*takaful*) and Islamic bonds (*sukuk*). *Moody's* Investors Service reported in 2008 that the FSA's approach to Islamic finance, and in particular Islamic retail banking, was "consistent with the fundamental principle that all UK citizens should be included in the

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166. Wholesale banking is defined here as a set of banking services and products offered to major clients instead of consumers. These include large corporations, government departments, and other banks.

167. Raza, "Islamic Finance Regulation Mechanisms."

168. Hassoune, "Islamic Finance in France," 5.

financial system, or, to be more accurate, should not be denied banking services.”<sup>169</sup> Thus, the FSA has sought to include individuals and communities in the banking system no matter of the reason for their exclusion, whether poverty, lack of geographic access, or religion. *Moody’s* credited this liberal approach for leading to the establishment and regulatory authorization of fully *shari’ah*-compliant banks, such as the Islamic Bank of Britain. HSBC Amanah, Lloyds TSB, National Westminster Bank (Natwest), and the Arab Banking Corporation and others have also contributed as major international conventional banks offering Islamic retail banking at branches across the UK.<sup>170</sup>

### III. ANALYSIS: GOVERNMENTAL AND BANKING INTERESTS AND PREFERENCES IN FRANCE

There are four related explanations for why the French state has pursued mainly wholesale over retail Islamic finance. First, financing a major construction project for an Emirati corporation, for example, will bring attract more capital to both the bank and the state than financing a mortgage for a French Muslim customer in Marseille through an Islamic home purchase plan (IHPP). Reaching legal reforms for Islamic finance is lengthy and calls for significant investment from the Banque de France and the Autorité des Marchés Financiers (AMF) and other related parties; consequently, it is logical that governmental agencies and banks would be primarily interested in enacting reforms that would yield the highest capital gain.

Second, the political climate in France has not been amiable for reforms for the inclusion of most anything related to Islam. As discussed in Chapter III, French coolness to religiously associated social services has deep historical and political heritage; to consider the French approach to be merely discriminatory would be to ignore particular national traditions of

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169. *Ibid.*

170. Raza, “Does Islamic Finance Have a Room to Thrive in Europe?,” 3.



liberalism and Republicanism. For the purposes of this paper, given the political climate, these reforms are difficult to pass in France whether they are drafted and enacted by the AMF, require review by the courts, or need parliamentary approval from elected public servants. Thus, arguments within these venues for Islamic financial services can be salient only if they can be argued along the lines of economic development and the attraction of capital for ‘the good of the Republic’ Conversely, arguments for Islamic banking that stress how personal banking services help French Muslims are not salient since they draw too much attention to the ‘question of Islam.’<sup>171</sup>

Wholesale finance, however, circumvents the heated ‘question of Islam’ since it provides services for foreign investors and corporations rather than France’s own Muslim citizens. Remaining an extremely controversial topic in popular and political French discourse, the Islamic component of ‘alternative’ finance is difficult for bankers to overcome politically.<sup>172</sup> In general, pursuit of Islamic wholesale banking can be advocated for within the framework of preserving Paris as a global financial capital, ‘a major player in world finance affairs.’

Across the Channel, the Conservative Party in the UK has used similar lines of rhetoric that downplay the social aspects of retail Islamic banking while speaking to how Islamic finance benefits the country and government economically. Yet notably, this economics-based reasoning for Islamic finance is predominant on Britain’s political right, but not the center-left. The Labour Party has remained vocal in its increasingly liberal vision of providing financial services to all British citizenry regardless of the reason for their financial exclusion.<sup>173</sup>

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171. Arabic Knowledge @ Wharton, “Finding a Home for Islamic Finance in France,” *Arabic Knowledge @ Wharton*, Wharton School of the University of Pennsylvania, November 2, 2010.

172. Hassoune, “Islamic Finance in France,” 5.

173. Shyamantha Asokan and Ester Bintliff, “France and the US Vie for the UK’s Crown,” *Financial Times*, May 6, 2009, 5; Gillian Tett, “Regulator to Keep Pace with Growth in Islamic Finance Industry,” *Financial times*, June 14, 2006, 2; and Shyamantha Asokan, “UK Leads in Sowing Seeds for a Sector,” *Financial Times*, June 19, 2008, 6.

Third, wholesale financing is institutionally more feasible for French banks. While they are not the only actors involved in promoting the development of Islamic finance in France or anywhere in Europe, the interests of banks cannot be ignored.<sup>174</sup> Since established conventional banks in France have begun offering some limited Islamic financial services (instead of full Islamic banks emerging), it has been easier for banks institutionally to offer wholesale Islamic finance than retail banking. French banks have been able to offer Islamic project financing ‘in house’ without incurring major additional costs. It would be much more costly to open ‘Islamic division’ branches across Paris and Marseille for retail banking as HSBC Amanah has done in London and Birmingham. As *Moody’s* noted in 2008, French bankers have been very open in questioning whether dividing banking services based on community is a good idea.<sup>175</sup> This situation might be different if France had an actual full Islamic bank. Fourth and last, it can be argued that it has made the most market sense for France and its banks to pursue Islamic banking first through large scale wholesale banking instead of retail banking. If wholesale banking were to prove sufficiently lucrative, French banks might consider expanding into retail banking.

Thus, the underdevelopment of retail banking within France’s Islamic financial sector has prevented the sector as a whole from developing fully. It would be implausible that French banks could sustain an Islamic financial sector without capturing at least part of the domestic Muslim population. Moreover, French Muslims face the consequences of the state’s disinvestment in retail banking since the Ministry of Finance and French banks have forced them to assimilate into conventional banking practices. In turn, British Muslims have access to *shari’ah*-compliant retail banking services because of initiatives at the hands of the FSA and other financial agencies. This right of access is consistent with the FSA and HM Treasury’s more open attitude

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174. Hassoune, “Islamic Finance in France,” 3-5.

175. *Ibid.*

of tolerating different, parallel banking systems. Finally, the interest and investment of banks and governmental bodies in developing Islamic retail banking has led to a more diversified Islamic financial sector that provides banking services for mortgage clients and investors alike.

Beginning with Chapter VII, Part II of this paper examines how governmental bodies have worked to development Islamic finance through critical legal and tax reforms, including reforms for Islamic retail banking.

## PART II

### LEGAL REFORMS FOR A MULTI-FINANCED ECONOMY

*How has the difference of enacted and enforced reforms for Islamic finance influenced the divergent development of Islamic financial sectors in Britain and France?*

“All these [Islamic finance developments] represent a major move towards financial inclusion – as well as to the ending of a barrier between communities which, like other barriers, we need to eliminate. Although the FSA has no statutory duty to promote financial inclusion, we are very pleased to have been able to make such a substantial contribution to this end.”

– Callum McCarthy, Chairman of the Financial Services Authority (UK)<sup>176</sup>

"We don't create fiduciary regimes for Jews, Catholics or Buddhists. France sends soldiers to Afghanistan to prevent people from dying under sharia law. But when big money is involved, we forget all that ... In the second reading, we discovered an amendment we cannot accept. This subject is too delicate to be voted furtively."

– French Socialist Party Deputy Jérôme Cahuzac<sup>177</sup>

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176. Callum McCarthy, “Regulation and Islamic Finance,” (speech, Islamic Finance and Trade Conference, Muslim Council of Britain, London), June 13, 2006.

177. Tom Heneghan, “France Opts for Legislative Juggling to Allow Islamic Finance,” *Reuters*, September 21, 2009.

## **CHAPTER VII: TAX REFORMS FOR ISLAMIC ‘MORTGAGES’**

This chapter shifts from an analysis of the institutional aspects of the inclusion of Islamic finance to the legal reforms necessary for such inclusion in French and British conventional banking markets. I argue in that the reforms instituted by financial regulatory bodies are the building blocks for dynamic development of Islamic financial sectors. Reforms for Islamic retail banking services are among those critical for the development of Islamic financial sectors. Thus, this chapter explores why and how government regulators introduced reforms in the United Kingdom that enabled Islamic retail banking services. I compare reforms that enabled Islamic ‘mortgages’ to function competitively on the market next to conventional mortgages in France and Britain. Following chapters examine reforms of the tax code for other retail banking services, wholesale banking, and Islamic bonds.

### I. A RISKY ENDEAVOR: THE ISLAMIC INVESTMENT BANKING UNIT'S ‘MORTGAGES’ IN LONDON

After the closure of two banks offering Islamic financial services in London in the early 1990s, the story of Islamic finance in the UK shifted into a period of dynamic legal reform for the inclusion of Islamic finance on high street beginning around 2000. To capture how and why the Treasury and the FSA drafted liberal reform for Islamic finance, I begin by examining how Islamic ‘mortgages’ were disadvantaged due to discriminations in the British tax code on the structural differences of Islamic finance. This combined with lobbying and interest from the government led to reforms that provided a level tax playing field for Islamic ‘mortgages’ to function on a parallel track to conventional mortgages.

As the UK’s first two experiments with Islamic finance (Al Baraka and BCCI) began to

collapse under pressure from the American intelligence community and British financial regulators, the United Bank of Kuwait<sup>178</sup> began to consider the risky venture of opening a special branch of its British bank for Islamic finance. Eventually, in 1991, bank management decided to open the Islamic Banking Unit<sup>179</sup> in London.<sup>180</sup> By 1995, the largely autonomous unit had a presence on Baker Street and continued to brand itself strongly as an *Islamic* bank.<sup>181</sup> Then in 1997, as Al Baraka Bank had pulled out of the Islamic housing market in the UK, the Islamic Investment Banking Unit began offering Islamic home purchase plans (IHPPs), or ‘mortgages.’<sup>182</sup>

The Unit’s IHPPs were called Manzil<sup>183</sup> home ownership plans and used *murabaha* contracts until later offering *ijara* contracts.<sup>184</sup> Manzil plans were based on purchase and sale contracts, where payment was deferred until an agreed upon date. At contract signing, the customer agrees to the purchase price with the seller, but the bank purchases the property. The bank then turns around and sells the property to the customer in installments at the agreed upon mark-up price.<sup>185</sup>

The introduction of the Manzil plans released “considerable pent-up demand” for IHPPs among British Muslims.<sup>186</sup> After the bank had aired a single television advertisement announcing the Manzil plans, the IHPP department of the bank was flooded with requests for these new Islamic ‘mortgages,’ which took the department weeks to process.<sup>187</sup> While Manzil plans were

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178. After some name changes and mergers, the United Bank of Kuwait is now known as the Al Ahli United Bank.

179. It was later renamed the Islamic Investment Banking Unit (IIBU).

180. Housby, *Islamic Financial Services in the United Kingdom*, 25

181. Instead of simply ‘alternative’ bank. Rodney Wilson, “Islamic Banking in the United Kingdom,” in *Islamic Banking and Finance in the European Union: A Challenge*, eds. M. Fahim Khan and Mario Porzio. (Northampton, Mass.: Edward Elgar Publishing, 2010), 214.

182. Wilson, “Islamic Banking in the United Kingdom,” 215

183. *Manzil* means dwelling or dwelling place in the Arabic.

184. For a more detailed description of what constitutes a *murabaha* contract and an *ijara* contract, see Section IV of Chapter II.

185. Rodney Wilson, “Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience,” *Islamic Economic Studies* 7, no. 1 and 2 (October 1999 and April 2000): 35-59.

186. Housby, *Islamic Financial Services in the United Kingdom*, 28

187. Keith Leach, “Islamic Home Finance in the UK.” *New Horizon*, July-August 2006.

available for all customers, two factors kept them from being accessible for lower- and middle-class British Muslims, the groups that needed *shari'ah*-compliant mortgages most since wealthy Muslims could already avoid *haram* interest by paying for their houses outright without a payment plan.

First, the bank was lending only 80 percent of the total value of the home purchase, making customers responsible for the remaining 20 percent. For many British Muslims this was an impossible amount to have upfront and, thus, the Manzil plans could not compete on any level with the mortgage options available on the conventional market. Second, monthly repayment rates on Manzil plans were higher than those on conventional mortgages.<sup>188</sup>

## II. THE OBSTACLE OF DOUBLE TAXATION IN THE UK

What had largely made Manzil plans so costly for both the Islamic Investment Banking Unit and its customers was that the transactions fundamental to the Islamic contracts were taxed twice by the UK financial regulatory system.<sup>189</sup> British tax law states that a stamp duty must be paid on completion of a purchase of property over a certain value.<sup>190</sup> The tax is a percentage of the price of purchase and it increases in higher sale ranges<sup>191</sup> Islamic banks—the Islamic Investment Banking Unit, particularly—were at a disadvantage because this tax stamp was applied *twice* to their *murabaha* contracts and later their *ijara* contracts.

In detail, under a *murabaha* contract, the legal title of a purchased item (a house) is transferred twice, which twice triggers a stamp tax: first when the bank purchases the house, and second when it resells the house to the customer. Thus, under English law, the stamp tax was

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188. Housby, *Islamic Financial Services in the United Kingdom*, 29, and Andrew Verity, “UK to Encourage Islamic Mortgages,” *BBC News*, February 18, 2002.

189. Rodney Wilson, “Islamic Finance in Europe” (paper, Robert Schuman Centre for Advanced Studies Policy Papers, 2007), 10.

190. BBC News, “Muslims Tackle Mortgage Hurdles” *BBC News*, October 16, 2002.

191. A house going for auction between £200,000 and £250,000 is an example of a sale range.

levied twice, incurring great cost on the bank and the customer. Moreover, the second stamp tax was levied at an even higher rate since resale prices are higher. The situation for *ijara* (lease-to-buy) contracts was relatively similar; the contract was taxed first when the bank purchased the house and second when the title of the house transferred to the customer upon completion of payments.<sup>192</sup>

The mood from Islamic banks and the British Muslim community was frustration. Many felt that the existing legal framework was fundamentally discriminatory against Islamic financial products and services. Although the community was relieved that Islamic financial products were again on the market after Al Baraka and BCCI’s closure, Muslim organizations voiced concern that the services were still hugely incomplete and did not address the right of the ‘underbanked’ to have access to banking services. Fundamental financial services like home financing, while being allowed within the UK financial sector, were out of reach for most British Muslims; most of the customers of Manzil plans were wealthy foreign Arabs who sought to invest UK property.<sup>193</sup> Islamic banking had seemingly hit another impasse like where the sector was at as the financial regulatory apparatus had shut down both BCCI and Al Baraka.<sup>194</sup> Yet, in 2003 events began to unfold which would change Islamic finance’s course of success in the United Kingdom and the West entirely, setting a precedent for inclusionary financial policies.

### III. THE BRITISH WORKING GROUP’S LOBBYING & REFORMS

Beginning in 2001, the Muslim Council of Britain (MCB)<sup>195</sup> began lobbying heavily on

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192. Housby, *Islamic Financial Services in the United Kingdom*, 25

193. *Ibid* 29.

194. Wilson, “Islamic Banking in the United Kingdom,” 215

195. The Muslim Council of Britain (MCB) was founded in 1997 in Wembley by representatives of more than 250 Muslim organizations from all parts of the UK including Northern Ireland. Today, it is an organization of over 500 affiliated national, regional, and local organizations, mosques, charities, and schools. Together, they encourage Muslims to “play a full and participatory role in public life.” More information about the MCB can be found on its website: <http://www.mcb.org.uk/>



behalf of both British Muslims and Islamic financial institutions in the UK that were facing ‘regulatory discrimination,’ such as the Islamic Investment Banking Unit. MCB was met with wide support from conventional and Islamic banks alike, as well as finance law firms. But the most critical support came from the British regulatory system. Edward George, then governor of the Bank of England (BoE) joined in consultations with MCB and the two formed a working group called the Islamic Finance Experts Working Group. The group’s aim was to devise a framework for how the UK financial regulatory system could better accommodate Islamic financial products and services while avoiding increased risk to the stability of the UK financial sector and economy as a whole.<sup>196</sup>

The impressive working group was comprised of experts and representatives from Her Majesty’s Treasury, the Financial Services Authority (FSA), the Council of Mortgage Lenders, various banks and Muslims organizations, and individual scholars. It also received considerable support from Barclays Chairman and BoE Director Andrew Buxton and then Chancellor of the Exchequer (finance minister) Gordon Brown.<sup>197</sup>

The efforts of this diverse working group led to unprecedented reforms in the legal language in the Finance Act of 2003 for ‘alternative finance.’<sup>198</sup> In brief, Her Majesty’s Treasury

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196. Islamic banks and financial institutions have widely been found to be riskier and generally less stable than their conventional counterparts. See Clement M. Henry, “Islamic Versus Conventional Banks,” in *The Politics of Islamic Finance*, eds: Clement M. Henry and Rodney Wilson (Edinburgh: Edinburgh University Press, 2004), and Rima Turk Ariss, “Competitive Conditions in Islamic and Conventional Banking: A Global Perspective,” *Review of Financial Economics*, 19.

197. Housby, *Islamic Financial Services in the United Kingdom*, 35.

198. The Islamic Finance Experts Working Group and particularly the FSA, HM Treasury, and the Bank of England were very particular at the time to say that “special provisions” were not being made for Islamic financial institutions, only that the playing field was being leveled. This is evident in how the Finance Act of 2003 referred *only* to ‘alternative finance,’ not Islamic finance. In a 2008 report on *Islamic finance*, HM Treasury stated, “It is important to note that the legislation [of the Finance Acts] uses the term alternative finance arrangements rather than specifically referring to Islamic finance... This means that changes are not exclusively for Islamic arrangements. In practice it is likely that arrangements falling within the legislation will generally be Shariah compliant, but it is not the concern of the tax authority whether they are or not.” See Her Majesty’s Treasury, *The Development of Islamic Finance in the UK: The Government’s Perspective* (London: Her Majesty’s Treasury, December 2008), 16. At the same time that the FSA and its governmental counterparts took a step backward from mentioning Islamic finance in the law, rhetoric surrounding the reforms was scattered with similar mentions to leveling out the playing field. This is important because it begins to play into a language of ‘rights,’ of which access to financial services that are compliant with one’s particular religion may be a civil right.

removed the liability for a double stamp duty tax<sup>199</sup> by amending the law to say that where “change of ownership was merely a technical aspect of the financing arrangement, it would not attract duty.”<sup>200</sup> If the mood from Islamic banks and the British Muslim community had been frustration, the Finance Act of 2003 reestablished hope in the government’s interest (and now commitment) to inclusive policies for Islamic finance and banking. The Act marked the “first major change” made by the government to the regulatory obstacles faced by Islamic financial institutions within its jurisdiction.<sup>201</sup>

#### IV. REMOVING DOUBLE TAXATION: HM TREASURY’S FINANCE ACT OF 2003

In more detail, in the Finance Act of 2003 replaced the existing stamp duty (which had been applied twice to ‘alternative’ land transactions<sup>202</sup>) with the stamp duty land tax (SDLT).<sup>203</sup> Where the legal language mattered most was in Section 72 and 73 where the Act describes the types of partners in an *ijara* contract for land sold to a financial institution and leased to an individual. The Sections state that tax exemptions apply to the first transaction of a contract if “entered into by an individual and a financial institution<sup>204</sup> under which the institution

(a) purchases a major interest in land (“the first transaction”), (b) grants to the individual out of that interest a lease (if the interest acquired is freehold) or a sub-lease (if the interest acquired is leasehold) (“the second transaction”) and (c) enters into an agreement under which the individual has a right to require the institution or its successor in title to transfer the majority

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199. Jane Pollard and Michael Samers, “Governing Islamic Finance: Territory, Agency, and the Making of Cosmopolitan Financial Geographies,” *Annals of the Association of American Geographers*, 2011, 8, and International Financial Services London (IFSL), *Islamic Finance 2010* (London: IFSL Research Publications, January 2010): 7.

200. Housby, “Islamic House Purchase Loans,” *International Institute ISIM Review*, 2006, 28.

201. Housby, *Islamic Financial Services in the United Kingdom*, 25.

202. Section 43(1) defined a land transaction as “an estate an estate, interest right or power in or over land in the United Kingdom or the benefit of an obligation, restriction or condition affecting the value of any such estate, interest, right or power; other than an exempt interest.” Finance Act 2003, Section 43(1) and Section 48(1), HM Treasury; and Registers of Scotland, “Registers Update: Stamp Duty Land Tax,” *Registers of Scotland, Executive Agency*, 2004.

203. Shah M. Nizami, “Islamic Finance: The United Kingdom’s Drive to Become the Global Islamic Finance Hub and the United States’ Irrational Indifference to Islamic Finance,” *Suffolk Transnational Law Review* (Boston: Suffolk University Press, Winter 2011: 34), 12.

204. The same section of the Act gives three possible definitions of a financial institution: “(a) a bank within the meaning of section 850A of the Taxes Act 1988, (b) a building society within the meaning of the Building Societies Act 1986 (c 53), or (c) a wholly-owned subsidiary of a bank within paragraph (a) or a building society within paragraph (b). More can be read in Section 72(7) of the Finance Act of 2003.

interest purchased by the institution under the first transaction.<sup>205</sup>

Alternatively, the Act allows that the second transaction can be exempt from charge instead if it meets the same requirements stipulated for the first transaction to be exempt.<sup>206</sup> The act did this without precisely using the contract term, any Arabic, or any other ‘Islamic finance language.’

Section 73 similarly removed the double tax for *murabaha* IHPP contracts.<sup>207</sup> Using language flexible enough to avoid using the terms ‘*murabaha*,’ ‘*ijara*,’ or Islamic, the FSA and Treasury’s reforms recognized the structural difference of Islamic finance. Section 73(2) states that “the first transaction is exempt from charge if the vendor is (a) the individual concerned,

or (b) another financial institution by whom the interest was acquired under other arrangements of the kind mentioned in section 72(1) entered into between it and the individual.<sup>208</sup>

The second transaction (between bank and individual) is “exempt from charge if the financial institution complies with the provision of this Part relating to the first transaction (including payment of any tax chargeable.)”<sup>209</sup> Thus, these provisions allowed for one of the two transactions to go ‘untaxed.’

In sum, the Finance Act of 2003 ultimately meant that ownership of property in the UK could pass from the financier to the home buyer both without having to go to a notary public and—critically—without having to pay taxes twice. The practical ramification was that the Islamic Investment Banking Unit (and other banks) could now offer its *ijara*- and *murabaha*-based Manzil home purchase plans to customers at lower repayment rates. It also enabled Islamic banks to provide more capital to the client than the 80 percent of value previously allotted. Ultimately, it led to more affordable IHPPs for ordinary British Muslims and amounted to a

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205. Finance Act 2003, Section 72(1)(a), (b) and (c).

206. Ibid, Section 72(3)

207. Section 73 dealt with financing for land sold to a financial institution and re-sold (instead of leased as in Section 72) to an individual. Financial institution is defined the same way in this section as in Section (72). See footnote number 25.

208. Finance Act 2003, Section 73(2)

209. Ibid, Section 73(3)

major step in inclusionary banking policies in the UK. This was a markedly early allowance made for Islamic finance in comparison to other European states, such as the Netherlands, where, as Hans Visser and Herschel Visser note, “every transport of ownership of part of a home requires the services of a notary public, plus payment of a stamp duty.”<sup>210</sup>

#### V. INSTITUTIONAL PREFERENCES FOR ECONOMIC & SOCIAL INCLUSION IN BRITAIN

Why did the FSA draft the reforms and why did HM Treasury implement them? How were they convinced that the arduous process of tax code reform was worthwhile? Critical speeches and publications from both Her Majesty’s Treasury and the FSA shed light on the institutional preferences and ideologies that drove these reforms. A year before HM Treasury released the 2003 Finance Act, Sir Howard Davies, then Chairman of the FSA, gave a speech in Bahrain proclaiming that UK Islamic banks were “good for Muslim customers, good for innovation, and diversity in [UK] markets, and good for London as an international financial centre.”<sup>211</sup> Davies’ first point—that Islamic banks were good for Muslim customers—carried through to the 2003 reforms as an unexpected source of motivation for inclusionary regulatory policy. From 2002 on, speeches and releases from the FSA and the Treasury recall how the institutions’ “emphasis on the need to combat social and financial exclusion” drove their intricate 2003 changes of the tax code.<sup>212</sup> Thus, when the Islamic Finance Experts Working Group identified the tax discriminations levied on Islamic ‘mortgages,’ the FSA placed Islamic home purchase plans within this progressive framework and labored to remove the tax mechanisms, which had caused IHPPs to be prohibitively expensive.

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210. Hans Visser and Herschel Visser, *Islamic Finance: Principles and Practice* (Northampton, Mass.: Edward Elgar Publishing, 2009), 111.

211. Howard Davies, “Islamic Finance and the UK Financial Services Authority” (Presentation, Conference on Islamic Banking and Finance Bahrain), March 2, 2002; and John Duckers, “FSA Gives Support to Islamic Banks Bid,” *The Birmingham Post*, September 21, 2002.

212. Clive Briault, “London: Centre of Islamic Finance?” (speech, Industry Forum, London, October 17, 2007).

It is useful to examine why it *did not* make sense for the FSA and HM Treasury to draft and implement inclusive reforms for this paper's analysis of comparative institutional preferences. The fact that both institutions decided to push for Islamic 'mortgages' and other retail services is notable because Islamic retail banking is not especially lucrative. These institutions knew that Islamic retail banking would not be as profitable for the economy as Islamic wholesale banking and Islamic bonds<sup>213</sup> would for a number of reasons.

First, there are 2.9 Muslims in the UK, making up less than 5 percent of the country's population. In 2002, as the FSA evaluated its priorities in Islamic banking, it estimated that UK Muslims have, "in total, savings of approximately £1 billion."<sup>214</sup> Mobilizing the capital of even a large proportion of this total through *shari'ah*-compliant retail services would not compare with the more lucrative options of wholesale banking and bonds. As Chapter X describes, the FSA's reforms and institutional arrangements for Islamic bonds led to the listing of \$19 billion on the London Stock Exchange across 31 *sukuk* structures.<sup>215</sup>

Second, even though the capital reserves of Muslims across the UK may not have been wholly mobilized through existing retail services, their income and spending already were already contributing to the UK economy. Consequently, the expansion of Islamic retail banking would not bring in much capital that was not already present in the UK. Thus, wholesale banking and *sukuk* were still the more profitable options for the government to pursue.

Third, the interest of Islamic banks in *shari'ah*-compliant retail services was not guaranteed. As discussed in the previous chapter, retail banking services are costly for banks to offer. Unlike wholesale services, banks have to offer Islamic 'mortgages,' current accounts, and

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213. This paper discusses these in Chapters IX and X.

214. Davies, "Islamic Finance and the UK Financial Services Authority."

215. Duncan McKenzie, *Financial Market Series: Islamic Finance* (London: The City UK Publishing Office), May 2011, 6.

student loans at established physical branches with a staff trained in Islamic financing at each branch. It is also expensive for banks to spend time, manpower, and resources, developing new *shari’ah*-compliant products. Thus, it was very possible that banks would have chosen not to offer Islamic retail services because of related costs and risk despite the FSA and HM Treasury’s major investment in reforms.

#### VI. BRITISH LIBERALISM & REGULATORY SUPPORT DESPITE COSTS

State actors in the Treasury and the Financial Services Authority did not have to instate reforms that would give British Muslims access to banking services that complied with their faith. No legal precedent mandated that the FSA, HM Treasury, and the Bank of England must give Muslims particular banking rights. It was also not in the direct objective interest of the government to promote Islamic retail banking since the effort was risky and that it would contribute less to the economy than other sectors of Islamic finance. But these institutions did draft, instate, implement, enforce, and encourage these inclusionary reforms. Why?

This paper argues that the answer to this puzzle lies in liberalism. British regulatory officials justified their support for Islamic retail banking using a liberal discourse that the inclusion of a different financial system was ‘just the right thing to do.’<sup>216</sup> Under the vanguard of liberalism, state actors stand by positions that are non-obligatory in the law, but are understood to be in the spirit of the law: equality, equal access, tolerance. Giving a Muslim family access to an affordable *shari’ah*-compliant mortgage or college loan would not profit the state, but would benefit society and, in particular, the British Muslim community. This tolerance and empathy

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216. Much of this paper’s inquiry into ideas of liberalism and decency owe to work done by Andrei Markovits on the “new discourse of empathy.” Markovits writes that this tradition of liberal discourse was developed and normalized in the period after the late 1960s student uprisings. Under the discourse of empathy, “disempowered and discriminated individuals were to be treated fairly, represented and fought for by those with the strength to help them.” See Andrei Markovits, “Changing Discourse of Empathy with Canine Rescue in the United States,” (unpublished manuscript); and Markovits and Robin Queen, “Women and the World of Dog Rescue: A Case Study of the State of Michigan,” *Society and Animals* 17 (2009), 325-342.

toward difference is consistent with political traditions of individualism and notions that economic liberalism should include a degree of social justice. Thus, liberalizing reforms like those included within the Finance Act of 2003 can be understood within a broader framework of multicultural policy—that tolerating and recognizing distinct cultures forming one diverse nation-state is for the good of the nation.

The Britain that has emerged from these policies is a multi-financed Britain where two separate and parallel systems of banking are available to consumers. It is difficult to overstate how radical this theoretical and observed result is. London, the financial capital that has perhaps most defined interest-based banking in the modern era, suddenly has a dualistic banking system featuring two distinct methods of mobilizing funds. In this new dualistic system, religious affiliation and background has formed the difference between consumer bases. Thus, the new multi-financed Britain is for a multi-cultured Britain.

Opponents of Islamic banking have used the same arguments traditionally levied against policies of multiculturalism. They have argued that Islamic retail banking is, in fact, a source of social exclusion for British Muslims, just as opponents to multicultural policies argue that Urdu classes at British primary schools cement the social and linguistic exclusion felt by young British Muslims. Islamic finance's critics reason that because customers will frequent different banks with different contracts in different neighborhoods, they will fail to ever fully assimilate into British culture. These arguments are correct on their most basic level; Islamic finance does create banking cleavages, which could be interpreted as sources for exclusion. But a more farsighted perspective reveals that the ability to bank, regardless of the location or affiliation of the bank itself, enhances an individual's chance of taking part in the broader social framework of British society, attending university, buying a home, and managing a small business.

Financial regulators at the FSA, HM Treasury, and the Bank of England have continued to promote Islamic retail banking within this broader conception of social inclusion. They have given little credence to the arguments of opposing politicians whose argument continues to center on the contested difference between cultural integration and cultural assimilation. Regulators have held to the first set of policies, drafting reforms making it possible to integrate banking cultures together into a diverse financial system. ‘Banking assimilation,’ consequently, is not necessary because prevailing authorities are willing and open to tolerate different financial traditions.

#### VII. ISLAMIC ‘MORTGAGES’ & TAXATION IN FRANCE

As noted throughout this paper, French interest in Islamic finance has centered nearly exclusively on attracting Gulf liquidity through the issuance of Islamic bonds (*sukuk*) and wholesale *shari’ah*-compliant project financing.<sup>217</sup> This has meant that French financial authorities have spent significantly less time and political energy on reform for *retail* Islamic banking. This section describes the need for tax reform in France and examines the reforms that the Autorité des Marchés Financiers has instated for Islamic ‘mortgage’ tax relief. Interestingly, the reforms were incomplete and the AMF has not enforced them. Thus, I analyze why they have not led to any development in Islamic retail banking in France.

On many fronts, Islamic banking contracts for home purchase plans and other retail products have suffered discrimination in the French financial regulatory system similar to that in the British system due to their structural differences.<sup>218</sup> Just as in the UK, when a bank in France would purchase an asset (such as a house) from a vendor and re-sell it to a customer at an

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217. Christophe Arnaud, “The French Licensing Authority Faced with the Globalization of Islamic Finance: A Flexible Position,” in *Islamic Banking and Finance in the European Union: A Challenge*.

218. Qatar Islamic Bank, December 5, 2008, 4.



agreed-upon higher price, both transactions would be taxed under the French tax code.<sup>219</sup> The tax code stipulated that registration duties must be paid on each transfer at 4.89 percent of the total sale price.<sup>220</sup>

However, in September 2009, the French regulatory system (headed by the AMF) revised the tax code to exempt the financing partner (the banking institution) from registration tax duties upon the asset's first acquisition.<sup>221</sup> Under the AMF's new legal arrangement, the state taxes the asset when it transfers to the final customer. This tax duty collects also the margin of re-sale (the bank's profit), which the AMF treats as effective interest under the new law.<sup>222</sup>

#### VIII. UNSUCCESSFUL IMPLEMENTATION IN FRANCE

With this change, French banks could theoretically offer project financing structured on *murabaha* that were competitive with conventional counterparts for the first time. But this did not happen. Since the 2009 reform, not a single bank has begun offering Islamic home purchase plans. The lack of Islamic 'mortgage' offerings rests on three institutional factors that have consistently been obstacles for Islamic finance in France: 1) bank authorization and licensing, 2) comprehensiveness of reforms, and 3) the timing of the reforms.

First, Islamic retail banking relies on the establishment of institutions devoted to offering *shari'ah*-compliant retail services. Generally, only fully *shari'ah* compliant banks have enough commitment to retail banking to develop the sector in a non-Muslim-majority country. France

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219. Elyes Jouini and Olivier Pastre, "Enjeux et Opportunités du Développement de la Finance Islamique pour la Place de Paris: Dix Propositions pour Collecter 100 Milliards d'Euros," Paris Europlace, December 8, 2008, 107

220. Additionally, the AMF levees a remuneration of the notary fee at 0.825 percent. See Gilles Saint Marc, "Islamic Finance and French Law," (presentation, Paris Europlace International Finance Forum, July 2, 2008), 21.

221. Bakyt Azimkanov, "IFR Islamic Finance Report 2009: Islamic Issuance Spreads" *International Financing Review*, 2009.

222. The AMF's reforms include a number of minor qualifications to help to ensure that only *murabaha* contract products will benefit instead of providing loopholes for non-Islamic products. Also, the language requires that the contract must state that the financing partner acquires the asset for the sole purpose of re-selling it to a particular second party. The re-sale must also occur within 6 months of the original purchase. Finally, the mark-up cost must be clearly stated in the purchase contract. See Nicholas Jacquot, "Tax Guidelines Boost Islamic Finance in France," *International Tax Review*, May 2009.

does not have any fully *shari’ah*-compliant banking institutions because the Banque de France and CECEI have not authorized any. This indicates that there is a lack of agreement on Islamic finance between the AMF and Lagarde’s Ministry of Finance on one side and the Banque de France and CECEI on the other.

Established French (conventional) banks have always avoided offering Islamic financial products for non-corporate customers because retail banking compromises their image politically through public association with Islamic finance.<sup>223</sup> This is especially notable since the majority of major French banks are involved in Islamic retail banking outside of France (in the Gulf and Francophone Africa).<sup>224</sup> The Banque de France and CECEI’s inflexibility invalidated the few liberal measures the AMF took to encourage Islamic retail banking. Consequently, even before the AMF instated the 2009 reforms, it was likely that they would be ‘parchment laws,’ meaningless because there were no real banks to which they applied.

Second, the AMF did not comprehensively address the tax obstacle faced by Islamic bankers with its 2009 reforms. Led by Christine Lagarde in the Ministry of Finance and the AMF, the French approach to Islamic finance has been marked by incomplete accommodation. The 2009 reforms gave tax exemptions to the *murabaha* contract type, but not other *shari’ah*-compliant contracts used for home purchase plans. The *ijara* contract for IHPPs did not receive the same tax exemptions until 2010. Furthermore, as detailed in Chapter II, scholars of Islamic law have widely discouraged the use of *murabaha* contracts because they consider *murabaha* the least *shari’ah*-compliant of all Islamic financial methods.<sup>225</sup> This had led to fewer consumers (and banks) being interested in using *murabaha*-based financing.

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223. Retail banking is much more public than wholesale banking. Chapter V provides a detailed analysis of authorization and a discussion on how conventional French banks have not wanted to associate with Islamic finance.

224. Raza, “Islamic Finance Regulation Mechanisms.”

225. Islamic jurists widely object to how closely the markup fees resemble interest under a *murabaha* contract.

Moreover, the AMF acted late. Its 2009 reforms for *murabaha* came six years after the FSA had provided both *murabaha* and *ijara* contracts with tax exemptions in Britain in its 2003 Finance Act. Thus, for French bankers, the 2009 reforms were a matter of ‘too little, too late’: reforms to the tax code that offered few gains in product diversification and flexibility at a time when the European market had already been captured by Britain’s highly flexible and diversified Islamic banks.

This leads into the third factor contributing to why banks have not offered Islamic ‘mortgages’ in France. By the time the 2009 tax reforms were in place, three UK banks had already exported their Islamic financial services to France, including retail banking services. The FSA had outlined this as a major innovation for growth for its Islamic financial sector in a report two years before the AMF’s 2009 reforms:

UK-authorized institutions may offer products throughout the European Union without the need to have separate authorization in each country. This means that Islamic institutions that ‘passport’ would have access to an estimated 15 million potential customers.<sup>226</sup>

The Bank of London and the Middle East was the first UK Islamic bank to ‘passport its services to France and the European Union broadly. Subsequently, two other UK Islamic banks also exported their services to the EU.<sup>227</sup>

Organizations like the Association d’Innovation pour le Développement Économique et Immobilier (AIDIMM) and the Islamic Finance Advisory & Assurance Services (IFAAS) attempted to encourage retail development alongside Islamic wholesale and bond development in France with their offices in Paris, but their efforts yielded little influence over banks.<sup>228</sup> It is

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226. Michael Ainley, Ali Mashaykhi, Robert Hicks, Arshadur Rahman, & Ali Ravalia, “Islamic Finance in the UK: Regulation and Challenges,” Financial Services Authority (FSA), November 2007, 28

227. Raza, 2010, 11

228. See IFAAS France at <http://www.ifaas.fr/> and AIDIMM at <http://aidimm.com>

notable that even the findings from their 2008 survey conducted in conjunction with the Institut Français d'Opinion Publique, which found that 55 percent of French Muslims were interested in *shari'ah*-compliant banking services did not convince French banks to offer IHPPs.

In addition to the three factors described above, it is likely that established French banks felt contradictory political pressure on the issue of Islamic finance. There were voices like Lagarde's from within the government encouraging French bankers to open up their services to Islamic finance, but with the caveat that those services should not be for French Muslims, especially not for average, working- and middle-class Muslims in France, who were the very source of the Sarkozy administration's campaign for harsher integration and assimilation policies. Logically, French bankers took these mixed signals from the government to mean that they should focus their (limited) efforts on corporate and investment financing rather than banking for ordinary French (Muslim) citizens.

We can conclude from this examination that the AMF's reforms for Islamic 'mortgages' were a hollow symbol of Lagarde's campaign for Islamic finance in France. The authorization of full Islamic banks was a prerequisite for the success of the reform, and when the Banque de France and CECEI's continued rejection of such applications crippled any attempt for *shari'ah*-compliant retail banking in France. This is the product of a lack of coordination and agreement between different regulatory and financial establishments in the more *dirigiste* French economy.<sup>229</sup> Despite her enthusiasm and political will, Lagarde's campaign could not undo the competitive damage incurred during years of French regulatory authorities' intolerance of Islamic banking. Being incomprehensive, too far delayed, the few reforms passed in 2009 and 2010 remained parchment reforms without interest from banks or enforcement from the government. The net

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229. See Chapter IX for a larger discussion on Islamic wholesale banking.

effect of the AMF's unfulfilled reforms has been that French Muslims still lack access to *shari'ah*-compliant mortgages in addition to other retail products like current accounts, student loans, debit cards, and small-business financing.

#### IX. IMPLEMENTATION OF & INTEREST IN BRITAIN'S INCLUSIONARY TAX REFORMS

The lack of implementation, interest, and ultimately the lack of products offered in response to the 2009 tax reforms in France contrasts starkly with the response to the similar reforms introduced in the UK in 2003. Once the British reforms were identified and drafted by the Islamic Finance Experts Working Group led by the Muslim Counsel of Britain and the Bank of England's Edward George, Her Majesty's Treasury installed the reforms in the form of the Finance Act released in December 2003.<sup>230</sup> The reforms were publically announced a short while later by Gordon Brown then Chancellor of the Exchequer (the equivalent of finance minister) when he presented the 2004 budget.<sup>231</sup>

As the reform was publicized, it quickly became much bigger than a mere reform for a particular bank, the Islamic Investment Banking Unit. Instead, the reform became a critical turning point for the whole sector of Islamic banking—a sector that now had more space within the state's regulatory framework. Prospective investors in Islamic finance began thinking of the United Kingdom as a more credible destination for opening an Islamic bank. Established, non-Islamic banks, such as HSBC, began making moves to open Islamic 'windows' of their flagship institutions. The entire industry was changing and becoming more competitive with *shari'ah*-compliant housing finance at the forefront of product development and competition.<sup>232</sup> Fully implemented, encouraged, and enforced, the reforms were hugely successful. In July 2002, a

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230. New Horizons Islamic Banking, "The Politics of Islamic Finance," *New Horizons*, April 1, 2005, accessed January 26, 2012 at <http://www.newhorizon-islamicbanking.com/index.cfm?section=features&action=view&id=11202>

231. Wilson, "Islamic Finance in Europe," 10.

232. *Ibid.*

year before the reform, there was only one financial institution in the UK offering Islamic home purchase plans. By the end of 2005, five UK banks were offering the plans.<sup>233</sup>

X. THE UK’S SUPPORT FOR ISLAMIC FINANCE: COSTS & OPPORTUNITIES

When it was drafting the reforms for the Finance Act, Her Majesty’s Treasury and the government generally did not know that the industry would expand with such depth and speed. Thus, when considering the impact of the reform as a whole, it is remarkable for two reasons that the governmental regulatory agencies supported (and still supports) the Finance Act of 2003. First, it is incredible that the state supported the reforms in 2003 even with the knowledge that it would lose tax revenue as a direct result of the reform. With the introduction of the Finance Act, Her Majesty’s Treasury lost the second set of taxes that had previously been accrued from *murabaha* and *ijara* IHPPs. It is likely that the rationale for this lost revenue was that the Act would encourage the growth of the IHPP sector and that the state would eventually more than recoup lost revenue based on the new structure.

Second, considering cost and benefit in hindsight, it is significant that the state has *continued*<sup>234</sup> its support for the reforms of the Finance Act even as the state has incurred some considerable costs as a direct result of the implementation of the reforms. While Edward George’s Islamic Finance Experts Working Group was devising a way to remove double stamp duties on IHPPs, there were dissenting voices from others in the regulatory community and the press saying that the inclusionary reform would lead to a tax loophole.<sup>235</sup> The dissenters argued

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233. Nickolas C. Jensen, “Avoiding Another Subprime Mortgage Bust through Greater Risk and Profit Sharing and Social Equity in Home Financing: An Analysis of Islamic Finance and its Potential as a Successful Alternative to Traditional Mortgages in the United States,” *Arizona Journal of International & Comparative Law*, 2008(25)3, 851.

234. The British state has, in fact, more than continued its support of the Finance Act of 2003. As subsequent chapters will demonstrate, the state has actually strengthened the language of subsequent Finance Acts to be even more inclusive of these types of Islamic financial contracts.

235. Jane Pollard and Michael Samers, “Governing Islamic Finance: Territory, Agency, and the Making of Cosmopolitan Financial Geographies,” *Annals of the Association of American Geographers*, 2001, 8.

that the proposed language in the law was too neutral (lacking reference to its actual subject being *Islamic* banking in order to be more inclusive). This neutral language would create an opportunity for homebuyers of *non*-Islamic mortgages to avoid paying the stamp duty land tax at all.<sup>236</sup> Ultimately, the dissenters' fears were realized. By 2011, Her Majesty's Revenue and Customs (HMRC) was trying to track down £35 million in unpaid taxes that were the product of "tax planning" and "mitigation schemes." While Internet "tax planners," who had assisted over 1,200 people avoid the tax, described their actions as within the law, the HMRC said that "the schemes rely on an interpretation of law that produces an outcome different from that envisaged when the law was enacted, and that the HMRC does not accept."<sup>237</sup>

Thus, it is interesting and significant that British regulatory officials responded to interest groups and supported Islamic home purchase plans and *shari'ah*-compliant retail banking. This chapter has demonstrated that reforms for Islamic retail banking were not in the objective interest of the government. Financial authorities in the Treasury and the FSA pursued and instated reforms for Islamic retail banking even though they knew that their efforts would not yield a significant profit for the state and that the state would lose some tax revenue as the direct result of the reforms. These reforms constitute liberal policy for the inclusion of a minority within a policy framework of multiculturalism and liberalism. *Shari'ah*-compliant financing for investors and corporations through wholesale banking and bonds is a much more lucrative choice for the government. Thus, it remains significant that the British regulatory bodies chose to draft and enact the reforms even before they pursued Islamic wholesale banking and *sukuk*.

Yet as this section has demonstrated, it is also very significant that the government has

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236. Her Majesty's Revenue & Customs (HMRC), "Preventing Avoidance: Stamp Duty Land Tax," HMRC, March 23, 2011, accessed January 25, 2012 at <http://www.hmrc.gov.uk/budget2011/sdlt-avoidance-5595.pdf>

237. Nicola Pearson, "Worries over Stamp Duty Avoidance," *BBC News Business*, October 28, 2011, accessed January 25, 2012 at <http://www.bbc.co.uk/news/business-15479321>

*continued* supporting Islamic ‘mortgages’ and retail banking even in the light of the loss of £35 million in unpaid taxes. In the end, the government’s commitment to ‘leveling the playing field’ for British Muslims and Islamic banks trumped the costs incurred in the reform process and tax evasions.<sup>238</sup> This view is shared by HM Treasury, the FSA, HM Revenue & Customs, and the Bank of England.<sup>239</sup> Perhaps the most eloquent summary of these institutions’ unwavering support for providing British Muslims with basic banking services is from a speech given in 2006 by Callum McCarthy, Chairman of the FSA. McCarthy spoke to an audience of bankers and Muslim community leaders saying that “It would have been an invidious form of social exclusion for regulation to have prevented the development of financial products which conformed with [Muslim] religious beliefs, and therefore to have condemned them to a position where religious beliefs prevented them from accessing financial services.”<sup>240</sup>

Financial regulatory officials have rarely used the language of activism and equal rights of access that McCarthy employed. Yet this perspective has become a dominant discourse in discussions on regulating Islamic finance in the UK, as it is shared by authorities in the Treasury and the Bank of England alike. McCarthy’s views of the “importance of preventing this form of exclusion from the benefits of the financial system” have led to progressive reforms for products like Islamic ‘mortgages’ that are as much about the tax code as they are about devising an equitable system of banking that meets the needs of a diverse Britain.<sup>241</sup> Advocating for inclusion of difference rather than assimilation into established ‘tried and true’ forms of banking, the

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238. Financial Services Authority, *Islamic Finance in the UK: Regulation and Challenges* (London: FSA, November 2007), 13.

239. While remaining supportive, the Bank of England has played a smaller role in the development of Islamic finance after 2000 since the government transferred many of its regulatory duties to the FSA in the late 1990s.

240. Callum McCarthy, “Regulation and Islamic Finance” (speech, Muslim Council of Britain, Islamic Finance and Trade Conference, London), July 13, 2006.

241. McCarthy, “Regulation and Islamic Finance.”



British regulatory approach to Islamic retail banking is founded on liberal notions of inclusion as sources of motivation instead of capital gain.

This chapter has compared French and British regulatory approaches to reforms for *shari'ah*-compliant 'mortgages' and has found that the emergence and success of the British Islamic retail banking sector is due to the longstanding openness of British regulators to parallel Islamic-conventional banking systems and a strong commitment to providing banking services to the 'underbanked.' In this chapter's comparative analysis of France, meanwhile, I have demonstrated that French financial authorities lacked a comparative longstanding commitment to providing banking services to Muslims and that any tax reforms were crippled by the government's overriding opposition to giving banking licenses to Islamic banks. The next chapter analyzes the continued development of Islamic retail sectors in the United Kingdom in order to demonstrate the government's comprehensive approach.

## **CHAPTER VIII: COMPREHENSIVE RETAIL DIVERSIFICATION IN BRITAIN**

The previous chapter compared British and French approaches to the regulatory inclusion of Islamic home purchase plans (IHPPs). I examined the extent to which the AMF and the French Ministry of Finance have accommodated *shari'ah*-compliant retail banking and argued that the lack of French development on retail banking is due to institutional and legal factors. These include the late and partial institutional flexibility, incomprehensive tax provisions, lack of implementation and support from regulators, and the influence of the pervading French political culture within the AMF and the Ministry of Finance. This chapter turns to an analysis of the United Kingdom to demonstrate how the FSA and HM Treasury's commitment to providing British Muslim with religiously-appropriate financial services has continued to drive the development of a diverse and successful Islamic retail banking sector in London.

The story of inclusionary legal reforms for Islamic finance in the UK can be read as a compounding narrative of reforms building upon one another. This section begins in explaining how the reforms of the Finance Act of 2003, detailed in the previous chapter, led to the considerable and dynamic growth of the UK's Islamic financial sector. I argue in this chapter that the expansion of Islamic retail banking led to demands from banks and the British Muslim community for the provisions eventually offered in the Finance Acts of 2005. I also argue that the British state financial regulatory establishment was open to these reforms in a number of ways that were starkly lacking from the French regulatory establishment's treatment of Islamic finance. This chapter continues to explore the legal, political, and institutional framework surrounding attempts at financial regulatory inclusion. Finally, I show that the FSA and HM

Treasury's inclusive approach to Islamic retail banking extended well beyond the 2003 reforms. Moreover, Islamic banks have been able to diversify their product and service lines directly because of the FSA and Treasury's longstanding efforts through reforms, promotion, education, and encouragement of Islamic finance.

### I. ISLAMIC 'WINDOWS' AT HSBC & LLOYDS TSB

Once the British regulatory establishment had allowed for Islamic 'mortgages' using *ijara* and *murabaha* Islamic contracts to have equal tax treatment in 2003, Islamic financial services in the United Kingdom expanded greatly.<sup>242</sup> There was a sense in both the Muslim and non-Muslim banking and investment community that the state had finally unequivocally opened its doors to Islamic finance and that now innovations could be had for Islamic financial services.<sup>243</sup> Following the Finance Act of 2003, the market was stimulated to expand Islamic financial services in two ways, which would prove critical for the broad success of Islamic banking in the UK in comparison to France.

First, the reforms encouraged non-Islamic financial institutions to reconsider the prospects of Islamic finance in the UK.<sup>244</sup> Quickly, more and more very established, high street non-Islamic banks began expanding to include Islamic financial services. In July 2003, HSBC established HSBC Amanah,<sup>245</sup> a branch of the huge international bank completely devoted to Islamic financial services and products.<sup>246</sup> Long having an international presence throughout the Muslim world, HSBC was perhaps uniquely prepared to open such a division in the UK. Shortly, HSBC

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242. Nickolas C. Jensen, "Avoiding Another Subprime Mortgage Bust Through Greater Risk and Profit Sharing and Social Equity in Home Financing: An Analysis of Islamic Finance and its Potential as a Successful Alternative to Traditional Mortgages in the United States," *Arizona Journal of International and Comparative Law*, 2008: 25, 852.

243. Housby, *Islamic Financial Services in the United Kingdom*, 35.

244. Rodney Wilson, "Islamic Banking in the United Kingdom," in *Islamic Banking and Finance in the European Union: A Challenge*, eds. M. Fahim Khan and Mario Porzio. (Northampton, Mass.: Edward Elgar Publishing, 2010), 218.

245. *Amana* means trust (secondarily honesty and fidelity) in Arabic.

246. To ensure *shari'ah*-compliance, HSBC Amanah's capital reserves were completely separate from the bank's conventional financing divisions. See Housby

Amana introduced an Islamic home purchase plan (IHPP) and an Islamic current account in the UK.<sup>247</sup>

Meanwhile, another huge international bank with a high street presence based in the UK, Lloyds TSB, began exploring the opportunity of expanding into the Islamic financing market. Eventually, in what would be called a “milestone” for the development of Islamic finance in the UK, Lloyds TSB opened its own Islamic finance division in February 2005.<sup>248</sup> Rivaling HSBC, this signaled that Britain, unlike any other state in Europe and the West, had developed a diverse Islamic financial services sector that was attracting banks of various sizes, target consumer profiles, and financial products offered.<sup>249</sup> This diversification of Islamic finance relatively early in the sector’s development would not have occurred without the regulatory establishment’s legal reforms on stamp taxes in the 2003 Finance Act.<sup>250</sup> Consequently, such diversification as a product of state inclusion and planning came to further encourage sector development through subsequent legal reforms in 2005 and 2006.

It was at this point of excitement for industry insiders and Muslim customers that Islamic finance began to receive considerable media coverage for the first time. It is also important to note that the media coverage and public (non-industry) discourse for the first time in the West was not discussing Islamic finance in relation to ‘terror-financing’ as it had in the era of BCCI and Al Baraka Bank.<sup>251</sup> For example, HSBC’s marketing campaign (see figure 1) for its Amana division demonstrates both the degree to which Islamic finance had entered the public sphere and

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247. Initially, HSBC’s IHPP was available only in England and Wales.

248. BBC News, “Islamic Mortgage Market to Expand,” *BBC News*, July 28, 2005, <http://news.bbc.co.uk/2/hi/business/4725459.stm>

249. Housby, *Islamic Financial Services in the United Kingdom*, 32.

250. Wilson, “Islamic Banking in the United Kingdom,” 218; Islamic Finance Information Service (IFIS), “Lloyds TSB Moves into Islamic Home Finance,” *ISI Emerging Markets*, March 22, 2005.

251. See Chapter III, Section II and Mark Potts, Nicholas Kochan, & Robert Whittington, *Dirty Money: BCCI: The Inside Story of the World’s Sleaziest Bank*, (Washington: National Press Books, 1992), 77-8, and Joseph J. Trento, *Prelude to Terror: Edwin P. Wilson and the Legacy of America’s Private Intelligence Network* (New York: Carroll and Graf, 2005), 370.

the sense of liberty to emphasize the *religiosity* of Islamic finance.



**Figure 0:** HSBC Amanah advertisement, which appeared in the Financial Times in 2011. See Financial Times, “Special Report: Islamic Finance,” *Financial Times*, May 12, 2011, 3.

Islamic finance had arrived the UK in a very tangible, visible way. Banks opened their Islamic branches between grocery stores and clothing retail outlets on both high street and in poorer, immigrant districts. With a very visible presence in the urban environment in London and Birmingham, Islamic banks and branches offered a wide variety of services from checking accounts to mortgages to student loans. British Muslims and non-Muslims drawn to ‘ethical banking’ now had access to a diverse collection of banking institutions offering an expanding number of services to choose from.

## II. THE ISLAMIC BANK OF BRITAIN

In addition to established (non-Islamic banks) flocking to Islamic finance, investors who thought of Islamic finance as a more holistic practice saw the reforms of the Finance Act of 2003 as an indication that the UK would be open to authorizing independent fully *shari’ah*-compliant banks. Essentially, the 2003 Act had given investors prospectively interested in opening Islamic

banks in the UK the assurance that they could have a market alongside conventional banks.<sup>252</sup>

Consequently, in August 2004, the Financial Services Authority (FSA) approved the authorization of the Islamic Bank of Britain (IBB). The first time an independent Islamic bank had opened in the United Kingdom, this was a milestone for state actors hoping their reforms would encourage Islamic finance in Britain, British Muslims who had long waited their own national Islamic bank, and investors who finally felt welcomed in a regulatory system marked by flexibility and innovation. In a 2005 speech, FSA Chairman Callum McCarthy recalled the authorization and opening of IBB as a major success of the FSA.<sup>253</sup> The Islamic Bank of Britain was also very pleased with working with the FSA on the process of authorization and bank licensing. The executive director of IBB said that the FSA “[took] an incredibly constructive approach” and that the “FSA clearly desired finding a way to make it work.”<sup>254</sup>

IBB offered a wider range of *shari’ah*-compliant banking services and products than any other bank in UK history. The bank’s headquarters were located in Birmingham, its London branch was on Edgware Road,<sup>255</sup> and it had seven branches by 2006.<sup>256</sup> In October 2004, IBB was launched on the London Stock Exchange and has thus accrued more capital through its bonds.<sup>257</sup> To McCarthy and the many financial regulators, IBB’s establishment and the products it offered “represented a major move towards financial inclusion, as well as the ending to a barrier between communities.”<sup>258</sup> Largely, the opening of IBB signaled the beginning of London’s uncontested primacy as the Islamic financial capital of Europe and the West. Britain’s Islamic financial sector

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252. BBC News, “Islamic Mortgage Market to Expand,” 2005

253. Callum McCarthy, “Addressing the Issue of Financial Inclusion,” (speech, London: Toynbee Hall, January 31, 2005). Financial Services Authority.

254. Anna Bradley, “Launch of Fair Finance, a Community Development Finance Institution” (speech, Fair Finance Launch, Docklands, UK, April 6, 2005). Financial Services Authority.

255. Housby, *Islamic Financial Services in the United Kingdom*, 31.

256. Callum McCarthy, “Regulation and Islamic Finance” (speech, Muslim Council of Britain Islamic Finance and Trade Conference, London, June 13, 2006). Financial Services Authority.

257. Housby, *Islamic Financial Services in the United Kingdom*, 31.

258. McCarthy, “Regulation and Islamic Finance.”

now served both investor and ordinary consumer with both objective and charitable interests.

This strong growth of Islamic finance in the UK of Islamic ‘windows’ (HSBC, Lloyds TSB), full Islamic banks (IBB), and the greater array of government-supported Islamic financial products consequently meant two things. First, the growth meant that the (now) very diverse British Islamic financing community had much greater leverage for legal reform than it did before. While having figures like Barclays Chairman Andrew Buxton in the public-private Islamic Finance Experts Working Group had helped make the 2003 reforms possible,<sup>259</sup> the presence of John Bond, then chairman of HSBC, as an ‘Islamic banker’ forever changed the spirit and the power dynamics of regulatory negotiations.<sup>260</sup>

Second, the growth and diversification of the Islamic financial sector meant that banks now lobbied for an ‘equal playing field’ for additional Islamic contract types. Established by investors from the Gulf, the Islamic Bank of Britain sought to operate like the Islamic banks typical of the Gulf such as the Dubai Islamic Bank, the Noor Islamic Bank, or the Bahrain Islamic Bank. To resemble these banks with a host of financial services, they needed to be able to offer Islamic banking contract types at an affordable rate compared to their conventional counterparts. Many contract types were still left heavily taxed due to the innate structural difference of Islamic finance. The major conventional banks like HSBC and Lloyds TBS that now offered Islamic products wanted largely the same thing, but were less driven on personal financial products than the IBB. Instead, they focused more on encouraging the state to introduce national Islamic bonds (*sukuk*), which are discussed in Chapter X.

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259. Robin Matthews, Issam Tlemsani, and Aftab Siddiqui, “Recent Developments in the Market for Islamic Mortgages,” *Review of Islamic Economics*, 2003(14).

260. Islamic Finance News, “Islamic Finance News Guide 2006,” *Islamic Finance News*, 2006, 85, <http://www.islamicfinancenews.com/guidepdf/tn6.pdf>

III. NON-INTEREST AS INTEREST: PROVISIONS IN THE FINANCE ACT OF 2005

As a result of the Islamic financing community's increased negotiation leverage and the financial regulatory system's cemented commitment to the sector, there was wide momentum for the reforms for 'alternative finance' established in Her Majesty's Treasury's Finance Act of 2005. The FSA and HM Treasury formed a second Islamic Finance Experts Working Group that was similar to Bank of England Director Edward George's 2001-2003 working group. Led by the FSA and the Treasury, this working group was comprised of private banks, Muslim organizations, industry insiders, and Islamic legal scholars. The group aggregated and articulated the interests of the multiple distinct sectors each member represented. Their combined goal was to expand Islamic banking services through more comprehensive reforms.<sup>261</sup>

In brief, Sections 46 through 49 of the Finance Act of 2005 tackled the structural differences of 4 additional Islamic commercial and banking contracts in order to integrate them into the UK's tax law framework. The Act addressed *murabaha* (purchase and resale), diminishing *musharaka* (diminishing shared ownership), *mudaraba* (depositing) and *wakala* (profit-sharing agency).<sup>262</sup>

For example, Section 47<sup>263</sup> of the Finance Act of 2005 refers to both *murabaha* and diminishing *musharaka*. The section stated that when a bank purchases a house, a car, or some

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261. The particularities of the legal changes were developed by the FSA and implemented by HM Treasury in consultation between these financial regulators and groups such as the Islamic Finance Experts Group and the Tax Technical Working Group. See Jane Pollard & Michael Samers, "Governing Islamic Finance: Territory, Agency, and the Making of Cosmopolitan Financial Geographies," *Annals of the Association of American Geographers*, 2011, 9; and "The City: UK Excellence in Islamic Finance," UK Trade and Investment, 2007, 13; and "The Development of Islamic Finance in the UK: The Government's Perspective," *Her Majesty's Treasury*, December 2008, 16.

262. Nicholas Jessop and Susan Bell, "Islamic Finance: A Key to London's Prosperity?," *Tax Planning International* (Arlington, Virginia: Bureau of National Affairs, 2009), 9, accessed January 27, 2012, at <http://www.freshfields.com/publications/pdfs/2009/jan09/TPIR0109.pdf>

263. The language of Section 47 of the Act stated that provisions apply to contracts between two persons when (a) a person ("X") purchases an asset and sells it, either immediately or in circumstances in which the conditions in subsection (2) are met, to the other person ("Y"), (b) the amount payable by Y in respect of the sale ("the sale price") is greater than the amount paid by X in respect of the purchase ("the purchase price"), (c) all or part of the sale price is not required to be paid until a date later than that part of the sale, and (d) the difference between the sale price and the purchase price equates, in substance, to the return on investment of money as interest.<sup>263</sup>



other product with the intent to resell the product to customer, the second sale can be immediate or can be delayed but for the intended purpose of reselling.<sup>264</sup> The customer can then buy the product at a higher price than the amount the bank originally purchased it for. Most critically, subsection (d) stated that this monetary difference (a return on investment) is to be treated as interest in the law.

This scenario constituted the Islamic commercial contract *murabaha*. Subsection (c) allowed for the customer to pay the sale price in increments, until having full ownership of the product. This slight addition to the *murabaha* contract description would constitute a diminishing *musharaka* contract. Finally, Section 77(8) allows for the banking institution's return on investment to be treated as interest by state regulatory powers when it is applied to diminishing *musharaka* installment financing.<sup>265</sup>

Section 49 of the Finance Act dealt with establishing another contract, the *mudaraba*, within the UK financial framework in respect to interest. This section allowed for Islamic banks to take and treat deposits in a similar matter to their conventional counterparts.<sup>266</sup> In more detail, 'alternative banks' are permitted under the Act to take the monetary deposits of a customer and, just like a conventional bank, they can put individual deposits into a pool of capital that goes into funding loans for other clients and also investing generally in *halal*<sup>267</sup> investments. Section 49 of the Finance Act is very significant because it treated the "credit" payments that the customer

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264. Finance Act 2005, Section 47(2)(b), HM Treasury, 2005.

265. Finance Act 2005, Section 47(2) and Section 47(8), HM Treasury, 2005.

266. Finance Act 2005, Section 49, HM Treasury, 2005. The Act stated that "(a) person ('the depositor') deposits money with a financial institution, (b) the money, together with money deposited with the institution by other persons, is used by the institution with a view to produce profit, (c) from time to time the institution makes or credits a payment to the depositor in proportion to the amount deposited by him, out of any profit resulting from the use of the money, and (d) the payments so made or credited by the institution equate, in substance, to the return on an investment of money as interest."

267. The definition of *halal* (permissible) investments varies between different banks and different Islamic legal scholars. Generally, *halal* investments are investments that do not profit from time-based interest and but instead from purchase and resale investment (*murabaha*). Most critically, perhaps, is that these investments must be made in industries and firms that do not provide *haram* (illicit) products or services. Interpretation of licit and illicit products and services likewise vary but generally *haram* products and services include prostitution, alcohol, pornography, gambling, financial services based on interest, and sometimes weapons and tobacco.

receives in annual installments as if they were interest payments from the bank, instead of “investment payments,” which are not recognized in UK tax and commercial law. Thus, the Act allowed their “deposits” to be taxed as if they were actually deposits in structure rather than being taxed at higher rates for “investment payments.”

Section 49(2) extended this definition of what is to be treated as interest to also include returns from profit sharing financial products.<sup>268</sup> This section referred to *wakala*, a profit sharing agency contract often used for savings accounts. For these, a customer (often investor) deposits capital with a bank and the bank acts as an agent for the customer. The bank then uses the capital deposits to finance commercial ventures. Profits from the commercial venture are then shared between the investor and the bank in proportions agreed-upon at contract signing.<sup>269</sup>

These several sections of the Finance Act of 2005 made the critical and strategic advancements for Islamic finance that the Islamic Finance Experts Working Group had lobbied for in the United Kingdom. Most simply, the reforms allowed for Islamic banks to utilize four core financial contracts (*murabaha*, *mudaraba*, *wakala*, and *musharaka*) at a level playing field with conventional counterparts. These contracts could be used for several different retail financial products and a couple wholesale financial products. *Murabaha* is used most often for mortgages and corporate property financing, *mudaraba* and *wakala* for deposit savings accounts, and *musharaka* for general loans. British Muslims did not have access to products using *musharaka* or *wakala* contracts before the reforms, and the uses of *murabaha* and *mudaraba* were limited because of how costly taxation was for banks and customers. Thus, the 2005 reforms again supplied British Muslims with access to *shari'ah*-compliant equivalents to

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268. Finance Act 2005, Section 49(2), HM Treasury, 2005.

269. Muslim Council of Britain, *London and Islamic Finance: Briefing Paper for the Mayor of London* (London: Muslim Council of Britain, 2009), 14.

conventional products. Even more critically, the provisions in the reforms allowed banks to experiment and design new banking products for their customers from traditional contract arrangements.

After consultations with Islamic banks and community leaders, authorities in the FSA concluded that the effect of commercial arrangements should be the basis for regulation and taxation, not the arrangements' mechanisms. This perspective allowed the FSA to draft alternative commercial arrangements in the law code that identified the mechanisms within Islamic financial contracts that *acted like* interest and then to treat them as if they were interest.

#### IV. ISLAMIC RETAIL BANKING AS MULTICULTURAL SOCIAL POLICY

The previous chapter examined the United Kingdom's 2003 reforms that removed the double stamp tax on Islamic 'mortgages' and argued that the reforms constituted a breakthrough for Islamic finance in Western Europe. The FSA and HM Treasury's flexible approach to drafting the most useful and innovative inclusionary reforms had the momentous affect of launching the first-ever Islamic 'mortgage' market in the West. The larger affect, however, has been the regulatory establishment's long term development of retail banking as the larger category including home purchase plans. For Islamic finance development to succeed and to sustain, more work was necessary than the 2003 reforms.

Financial regulatory authorities like FSA Chairman Callum McCarthy could have stopped after the Finance Act of 2003 and left Islamic retail banking to sink or swim. This approach would mirror the French regulatory approach, as typified by the AMF's inaction. After French financial institutions passed the reforms for Islamic 'mortgages' in 2009, they decided not to implement them or to take any measures to promote 'alternative' or Islamic retail banking. Yet, contrary to France's inaction, British regulatory institutions have decidedly not passed parchment

reforms. Instead, since the early 2000s, HM Treasury and the FSA in particular have taken a hyperactive approach to developing Islamic finance in the UK.

What this chapter argues is that instead of withdrawing from the development of Islamic finance in the UK, the FSA and the Treasury have driven it. This approach of comprehensive accommodation is evidenced by the continued efforts that the two institutions and related agencies have committed themselves to. They have continued to hold conferences and workshop and to schedule meetings with the Islamic Finance Experts Working Group to identify more ways that the government could include British Muslims in the financial and commercial of the previously singularly financed economy. Most critically, the FSA and the Treasury have built on the 2003 reforms with additional arrangements for the optimal and most equal tax treatments for Islamic banking procedures.

The FSA's method for reaching the 'underbanked' in Britain in 2005 was to cast the widest possible net. By this, I mean that the FSA sought to accommodate each and every Islamic commercial structure and supply this wide collection of contract types to Islamic banks as options for retail banking. The FSA and HM Treasury were agreeable and open to every *shari'ah*-compliant structure—be it a *wakala* contract or a *mudaraba* contract—so long as they could insure that customers would be at as little risk possible. In practice, this meant state-encouraged product diversification in the product offerings of Islamic banks.

In theory and policy, the degree to which the Treasury and the FSA were hyperactive in removing obstacles to Islamic barriers and accommodating financial difference constituted an engagement in liberal social policy within the policy framework of multiculturalism. The FSA and the government in general were able to gain access to British Muslim communities in a way that national social policy perhaps had failed. With Islamic retail banking, the FSA could

encourage economic development on a grassroots basis in a method that was culturally and religiously conscious. In effect, the FSA and Treasury's series of initiatives for Islamic retail banking constituted a policy of multiculturalism that addressed both social needs relating to access to finance and economic development of minority communities, and cultural needs relating to the recognition of culturally distinct groups within Britain.

This chapter continued the examination of the inclusion of *shari'ah*-compliant retail banking. Specifically, I demonstrated that the FSA and HM Treasury approached the development of an Islamic retail banking sector with reforms aimed at comprehensive product diversification to optimize the social impact of increased access to finance for British Muslims. The comprehensiveness and accommodation-focused nature of the FSA and HM Treasury's actions are critical factors that enabled Islamic finance to bloom and succeed in the London. The next chapter moves from retail banking to wholesale banking. I compare French and British efforts to develop *shari'ah*-compliant wholesale banking services such as project and property financing. The chapter demonstrates that French and British regulatory bodies are both motivated to develop these services in order to attract Gulf liquidity.

## **CHAPTER IX:** ***SHARI'AH*-COMPLIANT WHOLESALE BANKING**

The development of wholesale Islamic banking in the United Kingdom has trailed slightly behind the development of retail Islamic banking services. Three factors explain this. First, as this paper has discussed, the British state and its financial regulatory arm headed by the FSA have long prioritized reforms for Islamic retail banking and Islamic bonds over wholesale banking. Second, as this chapter will reveal, the state regulatory establishment recognized that the tax code modifications it passed Islamic retail banking services would benefit wholesale services generally in the same structural ways. Third, by focusing first on retail banking, financial authorities in the UK and were able to develop the market for *shari'ah*-compliant banking services in the few years between each sector's expansion. Many of the Islamic wholesale banking services available to consumers upon the implementation of particular tax reforms were small in nature, servicing small firms and short-term investment plans. But as corporations, particularly non-Muslim corporations, began to warm to the idea of investing through or being through an Islamic bank, the sector's clientele diversified extensively.

Across the Channel, the development of Islamic wholesale banking in the French Republic has followed a much different trajectory. Long held with Islamic bonds (*sukuk*) as one of the Christine Lagarde and Nicholas Sarkozy's dual priorities for the development of Islamic finance, Islamic wholesale banking has acquired a greater presence in the spotlight of tax reforms in France. Yet, given France's priorities and interests in Islamic wholesale banking in comparison to the priorities of the British state, it is interesting that the UK sector has still experienced greater growth.

Thus, this chapter explores the development of Islamic wholesale banking in both countries. Drawing first from reform in tax and commercial law and then from analyses on state directives and interests, this chapter compares two very different Islamic wholesale banking sectors. In terms of the chronology of reforms for the inclusion of Islamic finance in Western Europe, the interests of banks and the nature of the services they offer become increasingly important for this paper's analysis of public-private interactions. Consequently, this chapter will include a larger discussion on how banks have sought to use reforms for retail banking for their new wholesale banking purposes.

This paper defines wholesale banking as financial and banking services offered by banks to large-scale entities, such as other banks, corporate clients, mid-sized firms, investors, real estate developers, and state governments. Due to the nature of the development of Islamic finance in Western Europe, this paper includes banking services supplied to small firms within the broader category of wholesale banking as well; small firms use the same products and services, which are the key source of this chapter's inquiry, as their larger counterparts.

#### I. REFORMS FOR *SHARI'AH*-COMPLIANT WHOLESAL FINANCING IN THE UK

The previous chapter showed that the FSA and the Treasury's motivation for cultivating an Islamic retail banking sector was (and has been) a liberal motivation owing to the pervading perspective in both institutions that it was their civic duty to end the financial exclusion of the 'underbanked' regardless of reason for exclusion. This chapter and the following chapter on Islamic bonds demonstrate the FSA, Treasury, and Bank of England showed similar openness to Islamic wholesale banking and flexibility in reforming the law and existing institutions. However, their motivation for introducing these *shari'ah*-compliant products and services for firms and corporate entities on the London market was more about capital gain and cementing London as a

global financial center than access to finance. The FSA confirmed this motivation in its 2007 report on the regulatory challenges of Islamic banking where it concluded that “If there is future growth in [the Islamic finance] market, it should benefit UK consumers and develop London further as an international financial centre.”<sup>270</sup> HM Treasury echoed the FSA’s perspective in a 2008 report on “the Government’s perspective.” In the report, the Treasury listed its two core objectives for the development of Islamic finance in the UK:

- ♦ to enhance the UK’s competitiveness in financial services by establishing the UK as a gateway for international Islamic finance,
- ♦ [and] to ensure that everybody, irrespective of their religious beliefs, has access to competitively priced financial products.<sup>271</sup>

While regulatory officials and institutions used certain elements of the access to finance argument in relation to servicing small businesses, the inclusion of Islamic finance as a prudent choice for the economy argument remained the dominant discourse on wholesale development.

As early as 2000, the Bank of England (BoE) showed interest in expanding the regulatory framework for wholesale banking. The BoE had established the Islamic Finance Experts Working Group that year with HM Treasury and the FSA to “investigate the obstacles facing the industry.”<sup>272</sup> As Chapter VII and VIII demonstrated, the majority of the working group’s efforts concerned establishing tax structures for Islamic retail products.<sup>273</sup> Initially, the working group’s efforts did not yield reforms for wholesale banking since the tax exemptions in the 2003 Finance Act applied only to individuals, not corporations. Even the subsequent reforms on *musharaka* in 2005 lacked provisions for corporate entities.<sup>274</sup>

Thus, it was not until 2006 that the working group was able to draft tax provisions for

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270. Financial Services Authority, *Islamic Finance in the UK* (London: FSA, November 2007), 30.

271. Her Majesty’s Treasury, *The Development of Islamic Finance in the UK*, 2008, 13.

272. *Ibid* 14.

273. Housby, *Islamic Financial Services in the United Kingdom*, 35.

274. *Ibid*, 160.



wholesale banking products in the Finance Act of 2006. The Finance Act extended the double stamp tax exemption in the purchasing of property to corporations. Section 95(4) stated that for the “treatment of alternative finance arrangements,” the Treasury would insert the following provisions After Section 50(2) of the Finance Act of 2005:

(2A) Where a company is a party to arrangements falling within section 49A, Chapter 2 of Part 4 of FA 1996 (loan relationships) has effect in relation to the arrangements as if (a) the arrangements were a loan relationship to which the company is a party, (b) the amount provided under the arrangements were (i) in relation to a company which is the principle under the arrangements, the amount of a loan made by the company to the agent, and in relation to a company which is the agent under the arrangements, the amount of a loan made to it by the principle, and (c) profit share return payable to or by the company under the arrangements were interest payable under that loan relationship.<sup>275</sup>

Thus, building upon the 2003 and 2005 reforms, provisions in the Finance Act of 2006 allowed both for ‘alternative home business finance’ to include business properties in addition to homes and for the purchase of properties that are homes, but that are owned by corporations.<sup>276</sup>

In practice, the FSA’s efforts with the Islamic Finance Experts Working Group enabled banks to offer *shari’ah*-compliant financing to corporate clients for the purchase of buildings and properties and for building projects for the first time. While they were meant for personal banking, the FSA was also able to apply the 2005 reforms for deposit accounts to corporate entities without any additional change in the law. The FSA and HM Treasury then combined these property financing and investment and deposit accounts services with debit card and checking account services (which had never required any special reforms or arrangements) to form a bundle of wholesale products for Islamic banks. The combination of reforms was essential as a way for the FSA and the working group to assure banks that they would have access to as many *shari’ah*-compliant products as possible if they chose to open an Islamic wholesale banking branch.

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275. Finance Act 2006, HM Treasury, 2006.

276. Housby, *Islamic Financial Services in the United Kingdom*, 160

II. WHOLESALE ISLAMIC BANKING SERVICES IN THE UK

Generally, by their nature, *shari'ah*-compliant wholesale financing for commercial property in the UK is more flexible for banks and customers alike than retail financing. Individual contracts are usually drawn up for individual financing cases since this is more in the interest of the customer (corporation) and, oftentimes, the bank. This section examines how the FSA and HM Treasury's 2006 reform for corporate property financing plans led directly to the large expansion of wholesale banking services. It is notable that the regulatory reforms led to a multitude of competing banks offering *shari'ah*-compliant wholesale products instead of one bank holding a monopoly on the sector.

One example is Ahli United Bank (formally known as the United Bank of Kuwait). Ahli's Manzil home purchase plans, which Chapter V discussed, have been available only for residential property purchasing, but the bank also offers buy-to-let financing plans for commercial purchasing by corporate entities. The bank structures these wholesale plans on *murabaha* and *ijara* contract types.<sup>277</sup>

The Bank of London and the Middle East (BLME), an Islamic wholesale bank, also offers corporate *shari'ah*-compliant property financing based on *murabaha* and *ijara* contracts.<sup>278</sup> BLME generally finances captures the Islamic large-scale financing market over other banks. It is able to do this by providing both its own funds to its clients and by using funds from outside investors. British firms have used these banking products for both financing new developments and for refurbishing properties. The bank's recent high profile projects have included apartment financing in the "Golden Postcode" area of London, financing for a construction project in the

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277. Housby, *Islamic Financial Services in the United Kingdom*, 160

278. Bank of London and the Middle East, "Corporate Banking," Bank of London and the Middle East. <http://www.blme.com/corporatebanking.php>.

South End, and hotel development.<sup>279</sup> Perhaps most noticed in the British media was BLME's £6.8m financing contract with the Petersborough Garden Parks.<sup>280</sup>

The Islamic Bank of Britain (IBB) offers financing particularly designed for small-scale commercial property purchasing by firms. Using *ijara* contracts, the plans can be used for refinancing and equity release as well as purchasing. IBB's repayment period is also flexible and can be any duration between one year and 25 years. Unlike many of the other wholesale and investment Islamic banks in the UK, IBB is unique for targeting small business owners, rather than those who wish to "build up a portfolio" of physical assets. As Metcalf et al. (1996) note, a larger percentage of British Muslims (South Asians in particular) are self-employed than the general population.<sup>281</sup> Thus, IBB's services fulfill a particular banking need in the British Muslim community that had previously been unmet. Through IBB's services, established British Muslims could open expand their businesses using *shari'ah*-compliant services and new entrepreneurs could open businesses for the first time. The bank's financing plans range from £100,000 to £2.5 million, although it has had less demand for the higher range. It financed its first £1 million property purchase in 2006.<sup>282</sup>

As one final example, Gatehouse Bank, a fully *shari'ah*-compliant wholesale bank, offers mainly asset management services but also a line of property fund structures. These services are offered more internationally through 'passporting' than the wholesale project financing services of other UK Islamic banks. Gatehouse's international portfolio includes wholesale financing of student housing centers in Texas, a major Rolls Royce manufacturing facility in Glasgow, a U.S. Veterans Affairs Clinic in San Diego, and the new Proctor and Gamble UK headquarters in

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279. Nigel Denison, "Islamic Asset Allocation in the Current Environment," *Investment Week*, September 22, 2010.

280. Bank of London and the Middle East, "Corporate Banking."

281. Discussed widely in Hilary Metcalf, Tariq Modood and Satnam Virdee, *Asian Self-employment: The Interaction of Culture and Economics in England* (London: Policy Studies Institute, 1996).

282. Housby, *Islamic Financial Services in the United Kingdom*, 162

London (see Figure 1).<sup>283</sup> By the end of 2011, it was estimated that Gatehouse had financed over £280,000,000 in real estate.<sup>284</sup>



**Figure 1.** The UK headquarters of Procter and Gamble in London, financed by Gatehouse Bank.  
*Source:* Gatehouse Bank

Outside of the realm of commercial project financing, numerous Islamic banks in the United Kingdom offer business bank accounts. With a branch specifically devoted to commercial services in Birmingham that opened in 2007, the Islamic Bank of Britain has spearheaded business bank account services in the UK. It offers both current and savings accounts for businesses with a variety of attached services, such as direct debits and standing orders, debit cards, foreign currency services, and checkbooks. Originally, IBB's business banking services were geared toward mosques and charities, but the bank's clients have expanded greatly in the past 5 years to include more small business owners. IBB uses *mudaraba* structures for its savings accounts and for a profit-and-loss sharing account, while personal savings accounts at IBB usually use a *wakala* structure.<sup>285</sup>

Other UK Islamic banks, such as United National Bank, offer accounts used by businesses, but their services are less developed in comparison to IBB and they generally lack

283. Gatehouse Bank, "Products and Expertise: Real Estate."

284. Global Islamic Finance Magazine "Gatehouse Bank Leading the UK in Shariah Real Estate," *Global Islamic Finance Magazine*, 2011.

285. Housby, *Islamic Financial Services in the United Kingdom*, 157-158.

full-fledged business accounts divisions.<sup>286</sup>

In summary, key legislation in Her Majesty's Treasury's Finance Act of 2006 provided the legal frameworks for financing, equity and property funds, project finance plans, and corporate trade and finance in the United Kingdom. The FSA and the Treasury built upon the retail banking foundation in the 2003 and 2004 acts and consulted constantly with banking experts and Muslim community leaders in the Islamic Finance Experts Working Group.<sup>287</sup> The FSA and Treasury approached wholesale banking with the same openness and flexibility that characterized their Islamic retail banking efforts, and argued for the development of wholesale banking because it was economically in the interest of the UK. Wholesale banking, they claimed, would both bring in more capital from foreign investors and it would enhance London's competitive edge in comparison to other global financial capitals.

### III: INTERNATIONALIZATION & CAPITALIZATION FOR LONDON AS AN ISLAMIC FINANCIAL GATEWAY

A year before he became prime minister, Chancellor of the Exchequer Gordon Brown, called on London to become the Islamic finance "gateway" between the Muslim-majority countries and the rest of the world.<sup>288</sup> Channels of foreign investment from the Gulf and South East Asia were critical for Brown's vision of London, just as they were critical for the FSA and Treasury's similar objective to capture Gulf liquidity through wholesale Islamic banking. It was the Finance Act of 2005—a year before the main wholesale-related reforms—that provided the legal framework to internationalize London's Islamic financial center and consequently cement its status as an international financial capital of both conventional and Islamic banking.

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286. Ibid 159.

287. Mohammad Farrukh Raza, "Islamic Finance: The UK Experience" (presentation at the International Islamic Finance Forum, October 13, 2008).

288. BBC News, "UK's Brown Backs Islamic Finance," *BBC News*, June 13, 2006.

The questions of foreign banks and foreign currencies are very salient for Islamic banks and bankers for several factors. First, the majority of start-up capital for Islamic banks has come from the Gulf and South East Asia. Second, Islamic banks in the UK facilitate a considerable amount of trade and investment from these foreign regions. Third, the issuance of *sukuk* is dependent on the investment of Gulf capital on the London Stock Exchange.<sup>289</sup>

Section (48) of the 2005 Finance Act specifies a procedure for dealing with alternative financial services conducted in a currency other than pound sterling. In these cases, the effective ‘interest’ from the financial agreements should be calculated in the foreign currency for each payment return and then exchanged into pound sterling at the rate the “spot rate” on the day the payment was made.<sup>290</sup> Second, the section also clarifies that foreign banks, companies, or individuals who receive a return on an alternative financial product in the UK are not considered as having permanent establishment in the country in the legal record.<sup>291</sup>

While not innovative in the way other sections of the 2005 Finance Act integrated ‘alternative finance’ into the UK financial regulatory framework, the structural and legal clarifications for foreign institutions, currencies, and citizens reveal details about the position of the state. Clearly HM Treasury and the state at large have in mind the fact that the inclusion of Islamic finance into the existing financial sector means increased interaction with the Islamic sectors of foreign states, primarily those from Bahrain, the United Arab Emirates, Qatar, and Malaysia. Consequently, Section 49 of the Finance Act is evidence that the state prepared institutionally and legally to capitalize on increased trade and investments from these regions at the same time as it enacted inclusionary reforms for Islamic finance. Preparation to capitalize on

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289. The following chapter examines *sukuk* (Islamic bonds) in France and the UK.

290. Finance Act 2005, Section 48(1), HM Treasury, 2005.

291. Finance Act 2005, Section 48(2), HM Treasury, 2005.

these investments took the form of internationalizing and liberalizing London's already very international financial regulations. Through this measure, the FSA and the Treasury could both encourage the establishment of Islamic banks in London since the start-up financing would likely originate in the Gulf and it could secondarily assure prospective Islamic bankers that they could coordinate and partner easily with foreign Islamic banks in the Gulf and South East Asia.

Thus, provisions for wholesale finance in the 2005 and 2006 Finance Acts carry a theme of internationalization as Her Majesty's Treasury enacts reforms to bolster London as the capital of Islamic finance for all the West and to therefore capture all major trade in *shari'ah*-compliant products passing between the Islamic World and Europe and the Americas.

#### IV. WHOLESALE ISLAMIC BANKING SERVICES AND REFORMS IN FRANCE

In the French Republic, banks have faced the same challenge of not being able to offer project and real estate finance plans at rates competitive with conventional products due to tax laws. In August 2010, on Christine Lagarde's initiative, the Autorité des Marchés Financiers (AMF) made progress on wholesale Islamic banking products with a new rule on products structured on *ijara* contracts (financing by leasing and renting) and *istisna* (shared financing for construction). The reform changed value-added taxes and registration fees so that Islamic project financing for a construction project or a real estate acquisition could be more competitive.<sup>292</sup>

Along with reforms for Islamic bonds (*sukuk*), which I discuss in the next chapter, these reforms have been the center of Finance Minister Christine Lagarde's campaign for an Islamic finance sector in France.<sup>293</sup> The Ministry of Finance hoped that the 2010 AMF reforms would attract investors from the Islamic World who wanted to invest in equities and real estate to

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292. Arabic Knowledge @ Wharton, "Finding a Home for Islamic Finance in France," Wharton School of the University of Pennsylvania, November 2, 2010.

293. Raza, "Islamic Finance Regulation Mechanisms."

Paris.<sup>294</sup> Yet, unlike the UK, France's progress has paradoxically not yielded increased foreign investment. As the *Financial Times* noted, Muslim investors who have assets in London have shown "reluctance" to switch their investments across the Channel, where bankers and investors have perceived the tax and commercial structure as being more complicated.<sup>295</sup> Even Thierry Dissaux, the French Finance Ministry's Islamic finance specialist, has conceded that the system in France "could be more rigid" than that of the United Kingdom.<sup>296</sup>

Compounding on perceptions of how open the French regulatory establishment may be to Islamic finance, numerous industry experts have attributed the lack of Gulf investment in France's just-opening Islamic financial sector to the country's general non-inclusive attitude toward Islam. Farmida Bi, a finance lawyer at Norton Rose in London, said that the "headscarf issue is emotive [for investors]," and that it has "discouraged some Muslim investors from Paris."<sup>297</sup>

#### V. INSTITUTIONAL CONSTRAINTS FOR WHOLESALE ISLAMIC BANKING IN FRANCE

From this paper's comparative analysis of French and British reforms for wholesale banking, it is clear that France's reforms have not been as comprehensive for Islamic wholesale banking as reforms in the UK. This incomprehensive approach to inclusionary reforms for wholesale banking directly mirrors the French approach to retail banking as discussed in Chapter VII. Because the AMF and Ministry of Finance have not instated comprehensive reforms, banks have not been able to offer diversified lines of wholesale products compliant with the *shari'ah*, and consequently, banks have not opened for business in France since they are not confident they would be able to offer enough products to stay open. Thus, the lack of state-led comprehensive

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294. Hassoune, "Islamic Finance in France."

295. David Oakley, "London and Paris Battle for Business," *Financial Times*, December 13, 2010.

296. Arabic Knowledge @ Wharton, "Finding a Home for Islamic Finance in France."

297. Oakley, "London and Paris Battle for Business."



reforms is the first factor that has crippled the development of Islamic wholesale banking in France.

The second factor that has inhibited *shari'ah*-compliant wholesale banking from emerging in France is the relationship between reform and state treatment of that reform. The reforms to the French tax code that the AMF and Lagarde's Ministry of Finance instated are few but could, theoretically, have been sufficient to stimulate a gradual emergence of an Islamic wholesale financial sector in France. But both institutions have failed to adequately implement the reforms. Implementation in this case would comprise of enforcement, publicity, working groups with Islamic banks and Muslim communities, and continued regulation and evaluation.

Similar to Lagarde's approach to Islamic retail banking, she and the AMF have not gone to sufficient lengths to convince investors that the reforms are broad enough to support an Islamic market *and* that Paris is a welcoming destination for Islamic investment.<sup>298</sup> Christine Lagarde and her team in the French Finance of Ministry have a difficult job of convincing investors that France is, in fact, interested in Islamic finance. Under an administration that promotes the integration of Islamic bonds in France while banning Islamic headscarves, the Finance Ministry and the AMF face the challenge of showing a France that is not 'two-faced.'<sup>299</sup>

Islamic investors have no doubt paid attention to internal debates within France on the integration of Islamic finance. In a 2009 political controversy over Islamic bonds (*sukuk*) in the French Parliament, members of the Socialist Party were incredulous that the administration was now positive toward Islam. One party member remarked drying that "suddenly, having 6 million

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298. Oakley, "London and Paris Battle for Business."

299. DTZ Asset Management and Norton Rose, *Islamic Finance and Real Estate in France: A White Paper* (Paris: DTZ, 2010), 40.

Muslims is a great advantage.”<sup>300</sup> Thus, contradictions within state approaches to Islam and Muslim citizens in France have complicated the picture of the ‘open’ and ‘neutral’ French financial regulatory system that Lagarde and investment groups like Paris Europlace are trying to promote. Investors have paid attention to internal controversies, such as the ‘*burqa* ban,’ and domestic pressure from groups like the Socialists has forced the regulatory establishment to be more cautious and slow on both reforms and enforcement of reforms. Across the Channel, however, state regulators in the United Kingdom have not faced such domestic allegations of ‘installing *shari’ah* law.’ Instead, as *Moody’s* notes, their relatively controversy-free, confident, and inclusive approach to treating critical tax reforms has been marked by liberalism, common sense, opportunism, and farsightedness.<sup>301</sup>

Thus, France’s political culture and controversies on Islam in France have influenced the development of Islamic banking through two routes. First, French political climate has influenced the (non-) development of Islamic finance through perception and reputation. As described in this section, French national preference for assimilation over inclusion raises doubts in the minds of Islamic investors and bankers, who question whether a country that bans the *burqa* is really committed to developing a vibrant and successful Islamic financial sector.<sup>302</sup>

Second, the pervading political climate has influenced the decisions of state financial regulatory bodies like the AMF and the Ministry of Finance. A democratic tradition fundamentally opposed to the recognition and (more so) the encouragement of distinct cultural, ethnic, or religious groups or associations is deafening to calls for the inclusion of different,

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300. The Economist, “Sharia Calling: A Political Row about Muslim Law,” *The Economist*, November 12, 2009.

301. Hassoune, “Islamic Finance in France: Strong Potential but Key Obstacles Persist.”

302. Oakley, “London and Paris Battle for Business.”

religiously-based banking.<sup>303</sup> Moreover, even the Ministry of Finance's arguments emphasizing the economic benefit of the inclusion of Islamic finance for France to gain credence have difficulty gaining credence in this environment. Consequently, the French regulatory officials like Christine Lagarde and Thierry Dissaux who have pushed for reforms are constrained by the ideologies of the larger institutions around them.

It can be easy to understand French Republicanism and French *laïcité* merely as ideologies and miss the manner in which both concepts have been engrained in French institutions to form normative procedures and preferences. When Islamic finance collides with Republicanism and *laïcité*, it clashes with the accepted, uncontested ways that French democracy has functioned since the Revolution. The clash is not about a difference in ideologies as much as it is about a difference in practice and means of practice. Thus, the AMF, the Ministry of Finance, and the CECEI are constrained institutionally by the inherent market inflexibility of the *République laïque*. Reform and inclusion, even if they are for the economic benefit of the Republic, can only go so far before they become institutionally and politically unfeasible.

This chapter continued a demonstration of how regulatory institutions matter for the development of Islamic finance in Western European states. Specifically, I have argued in this chapter that France and the UK had the same basic institutional preferences for *shari'ah*-compliant wholesale banking: that the development of this sector through inclusionary tax code reforms would benefit their countries economically by attracting Gulf liquidity and enhancing

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303. Michael Walzer's book *On Toleration* includes an excellent analysis of how French Republican ideology strongly discourages secondary associations, especially those based on perceived social, religious, ethno-racial, or cultural differences. Walzer (1997) traces the "French hostility to strong secondary associations that differentiate and divide" citizens to Rousseau's treatment of the Legislative Assembly's debate over the emancipation of Jews in 1791. At the debate, a speaker for the majority declared that "One must refuse everything to the Jews as a nation, and give everything to the Jews as individuals." Walzer, *On Toleration* (New Haven: Yale University Press, 1997), 39.

the profiles of Paris and London as financial capitals. I have shown that the British FSA and Treasury was not limited in its reforms by institutional constraints and maintained a highly open, flexible, market-oriented, and constructive approach to Islamic finance. Contrasting with this, I have shown that the French AMF and Finance Ministry were highly constrained by the pervading institutional preference for secular republicanism in governmental bodies.

In the next chapter, I discuss how these two institutions approached the regulatory inclusion of *sukuk* (Islamic bonds) again from the same economic preferences, but with different institutional constraints. The following chapter is this paper's final chapter before its conclusion.

## **CHAPTER X:**

### **THE *SUKUK* PROJECT: ISLAMIC BONDS IN BRITAIN AND FRANCE**

In this chapter, I discuss Islamic bonds, which have been central to both the British and French approach to developing Islamic financial sectors. Known within the industry as *sukuk*, Islamic bonds are certificates issued by a government, bank, or firm that promise repayment of borrowed capital on a specified date and at a specified value.<sup>304</sup> State financial authorities backing Islamic finance in both France and the United Kingdom have promoted *sukuk* development and issuance as a way to attract Gulf liquidity to their respective banking capitals. Thus, this chapter builds upon Chapter IX's argument that state financial authorities and regulators have pursued Islamic wholesale banking as a method of enhancing the status and competitive edge of their financial capitals. Along with general *shari'ah*-compliant wholesale banking services, the pursuit of 'French-style' *sukuk* has driven Christine Lagarde's approach to Islamic finance. British regulators in the FSA and Her Majesty's Treasury were initially more focused on retail banking, but have turned much of their efforts to Islamic bonds since 2007.

#### I. THE DEVELOPMENT OF ISLAMIC BONDS IN THE UNITED KINGDOM

Although the legal and institutional inclusion of Islamic bonds (*sukuk*) had been part of the British state's initiative to develop Islamic finance in the UK since 2006, it was only after the state and its financial regulatory system had firmly established retail and wholesale Islamic

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304. Chapter II (Section IV) explains the structure of Islamic bonds in more detail. Munawar Iqbal, "Development, History, and Prospects of Islamic Banking," in *The Foundations of Islamic Banking: Theory: Practice and Education*, eds. Mohamed Ariff and Munawar Iqbal (Cheltenham, UK: Edward Elgar, 2011), 72.

banking in the British Isles that they began a comprehensive initiative to introduce *sukuk*.<sup>305</sup> In April 2007, an Islamic Finance Experts Working Group was established by multiple interested parties to create a plan for the development of *sukuk* in the UK. In coordination, Her Majesty's Treasury published a report on the plan and requested input from representatives from the banking industry, its now established Islamic subsector, and the British Muslim community.<sup>306</sup> The Treasury then published a second report covering the content of the responses to the consultation in June 2008.<sup>307</sup> Finally, the Treasury held a second series of consultations on the nature of particular legal reforms for *sukuk*, which were compiled and reported upon in a document released in 2009.<sup>308</sup>

Spearheaded by HM Treasury, this longstanding effort demonstrates three key aspects of the British approach toward the inclusion of Islamic finance.<sup>309</sup> First, it demonstrates that the state had a strong interest in enacting reform to introduce *sukuk*, an interest strong enough to merit multiple years of consultation and multiple revisions in the legal code. Second, the longstanding effort shows that the state sought not only to introduce *sukuk*, but to introduce *sukuk* 'in the right way.' This in turn meant three things. It meant first that the state predictably wanted to install *sukuk* using the most effective legal structure; it also meant that the state desired to introduce the type of *sukuk* that would yield the most economic benefit for the UK; finally, it meant that the state sought to introduce *sukuk* in a way that would please the British Muslim

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305. Housby, *Islamic Financial Services*, 142.

306. Her Majesty's Treasury, *Government Sterling Sukuk Issuance: A Consultation*, (London: HM Treasury, November 2007).

307. Her Majesty's Treasury, *Government Sterling Sukuk Issuance: A Response to the Consultation*, June 2008.

308 HM Treasury and Financial Services Authority, *Legislative Framework for the Regulation of Alternative Finance Investment Bonds (Sukuk): Summary of Responses* (London: HM Treasury, October 2009).

309. Housby (2011) notes that the process of consultation between HM Treasury and interested parties on the issue of *sukuk* development "was generally known and followed in the world of Islamic banking, not just in the United Kingdom but internationally." She writes that the "prospect of a British government issuance of *sukuk* was eagerly anticipated," even though *sukuk* have not yet taken a sovereign governmental form in the UK. The *New Horizon* publication on Islamic banking particularly covered the developments. See Housby, *Islamic Financial Services*, 143.

community and make them feel included in the British bonds sector.

The third and most consequential aspect of the British approach to Islamic finance that has been particularly evident in the HM Treasury's *sukuk* consultations, is that governmental and regulatory bodies have demonstrated considerable openness and tolerance toward outsider perspectives and input on the issues of Islamic finance in general and *sukuk* specifically. This welcoming of diverse points of view, especially from religious leaders, is notable absent from *dirigiste* French initiatives for the integration of Islamic finance in the French Republic. It should be noted that the factor of *laïcité* prohibits most governmental consultation with religious authorities, while the same is not true in Britain: state 'non-secularism' allows for extensive coordination with religious bodies. These aspects of the UK's approach are discussed later in this chapter in comparison to France.

In coordination with its series of consultations, HM Treasury made its first major public move on the issue of *sukuk* in the UK in its 2007 budget, where it announced a series of measures to facilitate the introduction of *sukuk*. Legally instated several months later in the Finance Act of 2007, the measures allowed *sukuk* to be treated as conventional bonds with the same tax treatments as conventional bonds.<sup>310</sup> This meant that when a *sakk* (singular of *sukuk*) was issued, the asset (or capital) payable by the issuer to the holder would be deducted under a loan-relationship regime. The Treasury then taxes the asset as interest once it is in the hands of the *sakk* holder.<sup>311</sup>

The 2007 Finance Act states that this tax exemption was conditional upon several

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310. Her Majesty's Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective* (London: Her Majesty's Treasury, December 2008), 1.

311. Puzant Merdinian, "Islamic Finance Legislation – Selected UK Experience" (presentation, East & Central Africa Conference on Islamic Banking, April 2009), 8.

qualifications. Typical of the state's method in its treatment of 'alternative' finance, the qualifications sought to ensure that provisions would be offered for *sukuk* but not any other form of bond- or bill-like structure. Here, the legal jargon meant to limit the possibilities that banking institutions could receive the provisions for non-Islamic products. The Finance Act stated that first, the contract must provide for one entity (the bond holder) to pay capital to a second entity (the bond issuer). Second, the contract must also stipulate that the bond issuer will acquire the assets of the bond to generate gains of some sort, whether direct or indirect. Third, the contract must have a defined bond term agreed-upon at contract signing by both bond issuer and bondholder. Finally, the bond issuer is required in the law to dispose of any bond assets at the end of the bond term, repay capital at the end of the term, and pay any other additional payments to the bond holder by the end of the term.<sup>312</sup> Thus, it is notable that the Act defined and qualified the bond-like structures so completely in a manner that reduced the risk for non-Islamic arrangements to benefit.

While the reforms for *sukuk* in the Finance Act of 2007 signaled a major step for the inclusion of Islamic financial products in the United Kingdom and investors and proponents like the Muslim Council of Britain were very pleased,<sup>313</sup> several technical issues remained for bond issuer.<sup>314</sup> Significantly, the government—not interest groups or Islamic financial institutions—was the first to publically recognize the remaining obstacles for *sukuk* in a 2008 report from HM Treasury.<sup>315</sup> This is further evidence of the British financial regulatory establishment's strong initiative and commitment to comprehensive legal treatments for Islamic finance.

The Treasury's report noted that since *sukuk* often involved multiple transfers of

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312. Finance Act 2007, Section 53, HM Treasury; and Merdinian, "Islamic Finance Legislation," 9.

313. Muslim Council of Britain, *London and Islamic Finance: Briefing Paper for the Mayor of London* (London: Muslim Council of Britain, 2009).

314. Deloitte, "Islamic Finance: Alternative Finance Investment Bonds – Sukuk," 2009, accessed February 17, 2012.

315. HM Treasury, *The Development of Islamic Finance in the UK*, 1.



ownership, they were taxed on each transfer. Like the other Islamic commercial contracts that were taxed twice, this taxation made *sukuk* prohibitively expensive to issue since issuers had to raise the ‘interest’ (fees) to greater levels than conventional bonds. Her Majesty’s Revenue and Customs publically recognized this twice in a 2007 report and a 2008 report.<sup>316</sup> Thus, in 2008, HM Treasury’s next move was to reconcile this structural difference found in *sukuk* by removing double taxation in that year’s Finance Act. The state addressed this much in the same way that it addressed double tax duties applied to Islamic home purchase plans (IHPPs) in the Finance Act of 2003.<sup>317</sup>

In brief, the 2008 Finance Act extended stamp duty land tax exemptions to issuers and transfers of *sukuk*.<sup>318</sup> Section 154 (2) built off of Section 78(7) of the Finance Act of 2007 to instate an amendment to the Finance Act of 2005. This amendment covered tax exemptions for “any capital raised under arrangements which fall within section 48A of the Finance Act 2005.” Said “capital raised” provided for “alternative finance investment bonds,” what the Finance Act of 2008 called *sukuk*.<sup>319</sup>

HM Treasury then released additional provision for *sukuk* in its Finance Act of 2009. The Act introduced relieving measures for capital allowances rules, capital gains, and taxes relating to *sukuk*. Under the new amendment, the transfer of ownership is essentially ignored in terms of taxation and the original issuer is taxed as though they continue to hold the assets. These additional reforms, incrementally building on the 2007 and 2008 tax code modifications, enabled British corporations to hold, issue, and trade *sukuk* without incurring corporate taxes and SDLT

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316. HM Revenue & Customs, *Budget 2007: Regulatory Impact Assessment*, Her Majesty’s Revenue & Customs, 2007; and HM Revenue & Customs, *Stamp Duty Land Tax: Commercial Sukuk: Consultation Document*, June 26, 2008.

317. See Chapter VII, Section II, on IHPP double stamp land tax duties in the UK.

318. Jessop and Bell, “Islamic Finance: A Key to London’s Prosperity?,” 11

319. Finance Act 2008, Section 154, HM Treasury.

beyond charges they would incur with conventional bonds.<sup>320</sup>

## II. *SUKUK* ISSUANCE ON THE LONDON STOCK EXCHANGE

This series of incremental tax reforms spearheaded by Her Majesty's Treasury over a handful of years led to exponential growth in *sukuk* issuing in the United Kingdom. In comparing Britain to France, it is important to recognize that British regulatory officials like FSA Chairman Callum McCarthy firmly enforced and institutionalized the major reforms it enacted through the Finance Acts. In no way have the reforms sat as parchment reforms (as many have in France). Instead, institutionalized and enforced, private sector actors such as major banks and corporations have met the reforms with great interest and have issued over 22 *sukuk*.<sup>321</sup>

By the end of 2007 alone, 14 issuers had chosen to list their *sukuk* on the London Stock Exchange, raising over £5 billion.<sup>322</sup> By 2009, over \$11 billion (USD) had been raised through 22 issues of *sukuk* on the London Stock Exchange.<sup>323</sup> Perhaps the most significant finding is that *sukuk* issuance on the London Stock Exchange is exceeded *only* by Dubai Nasdaq's *sukuk* listings.<sup>324</sup> Among the issuers, the Government of Bahrain had launched its first European *sakk* at \$750 million in June 2009. The *sakk* listings on the London Stock Exchange constituted "the world's first secondary market for *sukuk* offerings," and the unquestionable capital for *sukuk* in Western Europe and the entire West.<sup>325</sup>

## III. 'FRENCH-STYLE' *SUKUK*

Across the Channel, the development of Islamic bonds has followed a much different

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320. Deloitte, "Islamic Finance."

321. Adnan Trakic, "Europe's Approach Toward Islamic Banking and Finance: A Way Forward" (presentation paper, Kuala Lumpur: International Islamic Banking, Finance, and Investment Conference, December 19-20, 2011), 6.

322. UK Trade & Investment, *The City: UK Excellence in Islamic Finance*, 2007, 14.

323. UK Trade & Investment, *Strength in Partnership: UK Islamic Financial Services* (report, 16th Annual World Islamic Banking Conference, 2009), 23.

324. Trakic, "Europe's Approach Toward Islamic Banking and Finance," 6.

325. Nizami, "Islamic Finance."

trajectory. Christine Lagarde made concerted but slow progress on installing a *sukuk* market in France. In 2007, Lagarde spoke for Nicholas Sarkozy's administration in outlining the president's priorities and plans for Islamic finance in France. Most of the government's plan related to wholesale banking and Islamic bonds. Even as the state saw *sukuk* as the future pillars of a future French Islamic financial sector, they remained difficult to introduce in France. In comparing the development of Islamic bonds in France and the UK, it is significant to note that both governments began pursuing *sukuk* development in 2007, the same year. It was only the UK, however, that was establishing regulatory structures for Islamic bonds atop the useful foundation of reforms for Islamic retail and wholesale banking.

Initially, French financial regulators at the Autorité des Marchés Financiers (AMF) and strategists on Lagarde's team found it difficult to introduce *sukuk* because the French finance and commercial law lacked concepts of trusts and trust management. These concepts form the institutional basis of *sukuk* in Islamic commercial law. Based on the Civil Code, French law does not differentiate between 'legal ownership' and 'beneficial ownership,' unlike UK Common Law. This non-differentiation made it impossible for *sukuk* to be developed because their underlying assets could not be 'externalized.'<sup>326</sup> On this matter, the United Kingdom had a considerable advantage. Long established in both British commercial custom and law, the English Trust provided a framework that was negotiable and flexible enough to facilitate *sukuk*, an Islamic cousin *per se*, with the tax reforms detailed in this chapter's previous section.

Lagarde and the AMF worked to resolve this legal obstacle in February 2007 with the introduction of the *fiducie* (a trust), which was modeled after the English Trust.<sup>327</sup> The main difference between the *fiducie* and the English Trust was that both legal and beneficial

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326. Raza, "Islamic Finance Regulation Mechanisms."

327. Hassoune, "Islamic Finance in France: Strong Potential but Key Obstacles Persist."

ownership—their French differentiation having just been introduced—were transferred to the ‘*fiduciary*,’ the trustee.<sup>328</sup> Some scholars of Islamic law in France, however, objected to the *fiducie*, stating that several technicalities rendered its *shari’ah*-compliance very questionable.<sup>329</sup> Particularly, some *shari’ah* councils were concerned with how the trustee (*fiduciary*) held beneficial ownership, and what the trustee’s rights of asset disposal were. These difficulties in the development of a framework for *sukuk* were hardly unexpected as the concept of *fiducie* was new in France and was “actively being debated particularly by those who [saw] it as a potential loophole for tax evasion.”<sup>330</sup> But even if expected to a certain extent, these obstacles continued to slow down the AMF’s process of establishing an appropriate French structure for Islamic bonds.

Debates and discussions on how to better integrate *shari’ah*-compliant measures into French law were mainly driven by the government, but some non-state actors such as Gilles Saint Marc, a tax lawyer specializing in Islamic finance at Gide Loyrette Nouel, spoke to the Sénat to “propose necessary arrangements to enable the development of assets or projects [under the Civil Code and Monetary and Finance Code] compatible with the *shari’ah*.”<sup>331</sup> Others, such as Mohammad Patel, of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) argued for the reforms as a way for Paris to ‘catch-up’ to London.<sup>332</sup> Yet, the small degree of consultation with non-governmental entities did not compare to HM Treasury’s longstanding and comprehensive consultation with banks, Islamic scholars, and Muslim organizations in the UK.

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328. Ibrahim Zeyyad Cekici, “Développement de la Finance Islamique en France: Les Premiers pas de l’Administration Fiscale,” *Lamy Droit des Affaires*, February 2009(35), 79-80; and Bryan A. Garner, *Black’s Law Dictionary* (St. Paul, Minn.: West Group Publishing, 1999, Seventh Edition), 1513.

329. Philippe Henry, “Islamic Finance in France: New Developments,” Paris Europlace & HSBC, July 7, 2010.

330. Raza, “Islamic Finance Regulation Mechanisms in Post-Crisis Period” 130.

331. Sénat Français, “La Finance Islamique en France: Quelles Perspectives? Première Table Ronde: L’intégration de la Finance Islamique dans le Système Financier Global: Quels Enjeux pour la France?” May 13, 2008.

332. Tân Le Quang, “La Fiducie Française Ouvre la Voie à la Finance Islamique,” *L’Agefi*, September 18, 2009.

This lack of consultation has remained a theme of the AMF's approach to reform for *sukuk* and Islamic finance in general. Backed by Lagarde and Thierry Dissaux, the AMF's method of drafting and instating legal arrangements and reforms for Islamic banking has been decidedly state-driven to the extent that the French regulatory institutions have excluded many interested private parties and has not formed working groups similar to the FSA's Islamic Finance Experts Working Group in Britain. This approach has stemmed from Lagarde's commitment to non-conformist, 'French-style versions of Islamic financial products.'<sup>333</sup>

#### IV. A POLITICAL ROW OVER ISLAMIC BONDS IN FRANCE

The AMF sought to resolve many of the objections to the *fiducie* structure for *sukuk* within a March 2009 finance bill in the French Parliament.<sup>334</sup> The bill was about increasing access to credit for small and medium-sized French firms, but it included Article 16, which added 16 paragraphs to further define the French *fiducie*. Articles 14 and 16 stated that "the 'fiduciaire' (settler) acting for the 'fiducie' can, in an agreement with the trustees, issue financial instruments which represent the ownership of assets included in the holdings of the 'fiducie.'" This provision was one of many in the bill's additional 16 paragraph which redefined *fiducies* in order to gain support from Islamic scholars.

In discussion in the Sénat and the Assemblée Nationale, there was general support from Members of Parliament (MPs) for Islamic finance. Hassan and Mahlkecht (2011) note that the Parliament of France's "growing interest for this [Islamic] economic system" focused only on

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333. DTZ and Norton Rose, *Islamic Finance and Real Estate in France*, 51; and Hassoune, "Islamic Finance in France."

334. Assemblée Nationale and the Sénat, Loi n° 2009-1255 tendant à favoriser l'accès au crédit des petites et moyennes entreprises et à améliorer le fonctionnement des marchés, October 19, 2009.

*sukuk*.<sup>335</sup> Although there was general support for the *sukuk* and *fiducie* reforms leading up to the 2009 bill, it should be noted that the Socialists strongly dissented, calling the reforms an encroachment of Islamic law into French *laïcité*.<sup>336</sup>

This was the first time that reforms in France (or the UK) elicited a major controversy. Henri Emmanuelli, a deputy in the Socialist Party, decried the draft bill as an “introduction of *sharia* into French law.”<sup>337</sup> Several members of President Sarkozy’s own center-right party, the Union pour un Mouvement Populaire (UMP) diverged from the party and opposed the vote.<sup>338</sup>

Following this political row on Islamic finance in Parliament, the narrative of the reforms for the *fiducie* structure took an unexpected turn. The bill, with the reforms included, passed in Parliament, but in October 2009, France’s highest court, the Conseil Constitutionnel, threw the individual reforms (Article 14 and 16) out. The Conseil stated that

[The] provisions [of Article 14 and Article 16], which have no connection, however indirect, with those contained in the proposed bill to increase access to credit for small and medium enterprises, were adopted by a procedure contrary to the Constitution that, therefore, it is necessary to declare them unconstitutional.<sup>339</sup>

The Conseil’s rationale that Article 16 had no link with the bill’s subject was a procedural or technical objection and did not constitute an objection necessarily to the substance of the Articles.<sup>340</sup> Procedurally, the articles should have been submitted to parliamentary review on their own instead. Nevertheless, the damage to the development of Islamic finance in France was done, and members of Muslim and Islamic banking communities in France began to refer to the Conseil’s decision as a French governmental “censorship” of Islamic finance.<sup>341</sup>

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335. Kabir Hassan and Michael Mahlkecht, *Islamic Capital Markets: Products and Strategies* (Hoboken, New Jersey: John Wiley and Sons, 2011), 268.

336. Azimkanov, “IFR Islamic Finance Report 2009: Islamic Issuance Spreads.”

337. Al Kanz “Finance Islamique: Colère de Deux Députés Socialistes,” September 9, 2009.

338. The Economist, “Sharia Calling: A Political Row about Muslim Law.”

339. Conseil Constitutionnel, Décision n° 2009-589 DC, October 14, 2009.

340. Hassan and Mahlkecht, *Islamic Capital Markets: Products and Strategies*, 269.

341. Loubna Zrari and Farid Mehboobhai Tai, “Sukuk et Fiducie: Retour sur une Problématique d’Intégration,” Association d’Innovation pour le Développement Économique et Immobilier (AIDIMM), 2009; Hanah Ben Rhouma, “Finance

Led again by Christine Lagarde and Thierry Dissaux, the Ministry of Finance attempted to rescue the reforms, but the effort was halfhearted and not long lived.<sup>342</sup> Momentum for reforms for further reforms for *sukuk* stalled. The government made little more effort for *fiducie* reforms and Lagarde's attention shifted. This end—perhaps a temporary end—to the French state's active Islamic finance initiative is striking. Since it seems coincided with heated debates in Parliament over whether Islamic finance had a place in the *laïque* (secular) Republic, it is difficult to separate the question of *sukuk* development from France's growingly hostile political climate toward Muslims and immigrants and the broader question of *laïcité*.

From outside the government, DTZ Asset Management and Norton Rose attempted to address concerns over Islamic finance's compatibility with French *laïcité* in a 2010 white paper. The real estate advising company and law firm wrote that Islamic investors “observe the conflicting discourse that gives the impression of a ‘schizophrenic’ France, torn between a desire to welcome new investors and its difficulty in finding a place for religion in society.” The two firms, who had worked closely with Dissaux on Islamic finance development, admitted that a banks' association with Islamic finance or a politician's support for tax reform favorable for Islamic bankers would lead to losses in clients and voters.<sup>343</sup>

Why then did the government halt its initiative for French *sukuk* development, an initiative that started so strongly? It is plausible that Sarkozy's administration, of which Lagarde's Ministry of Finance was a branch, decided that it had pursued reforms for *sukuk* enough and that provisions made would be sufficient in gradually cultivating a French *sukuk* market. It must have been increasingly difficult for the government to advocate for inclusionary reforms for a

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Islamique: La Censure du Conseil Constitutionnel: Comment Financer les PME,” *SaphirNews*, October 16, 2009; “Le Conseil Constitutionnel Censure la Finance Islamique,” *La Croix*, October 14, 2009; Samir Kabach, “Finance Islamique: Le Conseil Constitutionnel Français n'en Veut pas,” *YabLadi Magazine*, October 15, 2009.

342. Zrari and Tai, “Sukuk et Fiducie.”

343. DTZ and Norton Rose, *Islamic Finance and Real Estate in France*, 40-51.

particular Islamic commercial instrument while also spearheading one of the most landmark state policies toward European Muslims in the 21<sup>st</sup> Century, the French ban on face coverings in public spaces, which criminalized the wearing *burqas* and *niqabs*.<sup>344</sup> The ‘*burqa* ban,’ as the media called it, was introduced in the Assemblée Nationale a mere nine months after the Conseil Constitutionnel’s rejection of Articles 14 and 16 of the financing bill. Nevertheless, it is clear that the AMF and the Ministry of Finance had lost much of the political will that had driven their initiatives in the past. Without implementation and support from these financial authorities, it was impossible for investors to list any *sukuk* on the French bond market. Thus, the efforts of the Ministry of Finance and the AMF yielded only a skeletal structure for *sukuk* issuance, which has remained unless without further regulatory action.

This chapter has examined efforts in the UK and France to establish markets for Islamic bonds. The two approaches originated from the same core motivations: to attract Gulf liquidity and to diversify the financial portfolios of their banking capitals, London and Paris. Yet the two state efforts yielded very different results. London’s *sukuk* market on the London Stock Exchange has expanded extraordinarily and now competes with the largest *sukuk* listing in the world, Dubai Nasdaq. France’s *sukuk* market has never gotten off the ground. The reasons for this divergence between results on Islamic bonds relates to the institutions that drove the development for Islamic bonds: Her Majesty’s Treasury and the Financial Services Authority in London, and the Autorité des Marchés Financiers and the Ministry of Finance in Paris.

The AMF and French Ministry of Finance lacked the UK’s strong footing in successfully established and regulated Islamic retail and wholesale banking sectors. The two French

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344. Assemblée Nationale, “Projet de Loi: Interdisant la Dissimulation du Visage dans l’Espace Public,” Texte Adopté n° 524, July 13, 2010.



institutions were also unable to circumnavigate the pervading political culture in France, which saw publicly demonstrated Islam generally as incompatible with French Republicanism. The Lagarde ‘French-style’ approach under which Islamic products must themselves conform to French institutional standards and not the reverse damaged the regulatory establishment’s relationship with prospective Islamic banks and investors. And without strong and continued leadership from the AMF and the Ministry of Finance, progress for *sukuk* has floundered.

Across the Channel, regulatory officials like Callum McCarthy used a calculated, gradual, and comprehensive approach to *sukuk* integration. The extensive consultations between state officials and banking and investing figures meant that the British initiatives had a strong and participatory industry base to carry out and implement the reforms. Finally, the FSA and the Treasury were able to avoid political contestation over the reforms. Members of the press strongly criticized the reforms with arguments of assimilation and secularism, but the two regulatory institutions were able to retain control and continue to drive the discourse on a liberal, inclusive and innovative London banking sector.

## **CHAPTER XI:**

### **CONCLUSION: FAITH, COMMERCE, & LIBERAL DEMOCRACY**

This paper has been concerned with the very different legal development and institutional inclusion of Islamic financial services in Britain and France. Using a comparative analysis of both institutional aspects of inclusion and key legal reforms in both countries, I have confirmed the central claim that the nature and actions of state financial regulatory bodies determine the development of Islamic financial sectors in Western Europe. While presence of sizable Muslim populations and status as a global financial capital are necessary preconditions for the emergence and success of Islamic finance, I have demonstrated that they are insufficient determinants alone.

Through a comparative analysis of the United Kingdom and France, I have argued that the UK's financial regulatory system's openness and flexibility toward Islamic finance provided the foundation for the unprecedented growth of Islamic financial institutions and services in that country. Secondly, this paper's analysis has demonstrated that the French regulatory system discouraged the growth of an Islamic financial sector in the French Republic.

The British financial regulatory system's openness and flexibility was evident through several factors. First, Her Majesty's Treasury and the Financial Services Authority (FSA) spearheaded a series of tax reforms, which allowed banks to offer Islamic financial products at competitive rates. The most critical aspects of these reforms were that they were timely, frequent, and comprehensive. These aspects established the necessary legal and institutional foundation for Islamic finance and assured investors and bankers that British financial authorities were committed to Islamic finance. Second, these reforms were coupled with strong, public state support for Islamic finance, evident through the FSA's authorization of Islamic banks, HM

Treasury's frequent and enthusiastic speeches on London as a capital of Islamic banking, and numerous consultation initiatives with the banking and Muslim community. Finally, the institutional strength and arguments of the FSA, Treasury and Bank of England shielded their reforms and the emergence of Islamic financial institutions and services from right-wing political discourse of anti-Islamism and strong secularism.

Across the Channel, headed by the Autorité des Marchés Financiers (AMF), the French financial regulatory establishment's inflexibility and caution toward Islamic finance were evident through delays, incomprehensive tax reforms, the state's complete disinterest in retail Islamic banking, and the lack of public endorsement and enforcement of Islamic finance and reforms. The lack of vocal support in the political sphere from any state financial authority beside Christine Lagarde meant that the pervading nationalistic political climate and institutional aspects of *laïcité* dominated the discourse on Islamic finance.

#### I. MODELS FOR WESTERN EUROPE

Comparing reform, enforcement, and the products of these efforts in France and Britain speaks to the larger prospects for the growth of Islamic finance in Western Europe. I have shown three necessary aspects of financial regulatory systems for the development of Islamic finance: legal reforms, state initiative, and political climate. First, in both countries, a series of reforms, primarily in the tax code, was necessary for the actual legal inclusion of Islamic finance. These reforms reconciled the structural differences of Islamic financial products and services in comparison to conventional finance by offering tax exemptions to 'level the playing field' between variant modes of banking.

Even as the pillar of Islamic banking sector development, reforms in tax code for the inclusion of Islamic finance do not ensure the development of Islamic finance in a given Western

## CONCLUSION

European state alone. The case of France demonstrated that when ‘inclusionary’ regulatory policy begins and ends at tax code reforms, the state’s approach is insufficient. Thus, state initiative (demonstrated through implementation and enforcement) is the second aspect of state financial regulatory systems necessary to the development of Islamic finance. States can demonstrate regulatory initiative through several actions: 1) most importantly, authorization of Islamic banks, 2) vocal promotion of Islamic finance in political and banking spheres through speeches and press releases, 3) collaboration and consultation with banks, Islamic investors, and Muslim organizations.

Third, the political climate influences the development of Islamic finance in Western European states. In the French case study, it was evident that the AMF and Ministry of Finance were strongly influenced by the pervading French political climate, which emphasized assimilation over inclusion and toleration of difference. While there are similar conservative discourses in the UK, they are less prevalent institutionally because the government does not formally recognize a separation between religion and the state. Thus, the degree to which prevailing ideas of liberalism and nationalism are influential within financial regulatory institutions affects the ability of those institutions to implement inclusionary policies for Islamic finance.

## II. ISLAMIC FINANCE AT THE CRUX OF LIBERALISM

These interwoven aspects of state financial regulatory systems have informed governmental approaches to the development of Islamic finance in Britain and France. The difference in these two approaches is extraordinary when we consider how similar the two countries are. Their list of common traits is significant: early democratizers, European Union member states, *jus soli* citizenship states, unitary and highly centralized governments, colonial

powers with long relationships with the Islamic World, and countries of global languages and containing international banking capitals. Yet, despite all of these commonalities, the development of Islamic finance in each country could hardly have been more different.

As this thesis has demonstrated, the stark divergence in the development of Islamic finance between France and the United Kingdom is ultimately the result of a variation in liberal democracy and capitalism. The difference in French and British governmental approaches to Islamic finance and banking is consistent with national and institutional traditions of liberalism and nationalism in both economy and society. The French political, economic, and cultural climate is driven by nationalism, *dirigisme*, and nation-based collectivism. Notions of *laïcité* and the national motto (*liberté, égalité, fraternité*) conceive of liberalism only within a limited collectivist framework of the Republic, not in terms of individualism. This is particularly true for the individual right of association and membership. The British political, economic, and cultural climate meanwhile is shaped by liberal, market-oriented capitalism. *Laissez-faire* capitalism translates to a British state that is open and flexible to change with a low gate of entry for both business and culture.

Degrees of liberalism and nationalism affect the prospects of Islamic banking in the United Kingdom and France in two ways. First, liberalism and nationalism inform governmental tolerance of diversity and, consequently, the practice of (or abstention from) policies of multiculturalism. English liberalism promotes an open and inclusive understanding of both economics and citizenship, owing to the respect of difference. Such perspectives make it possible for the state to recognize customs that are not the norm—such as Muslim cultural traditions like Islamic banking and prayers in schools—through multicultural policies.

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French nationalism, meanwhile, dominates over social and cultural liberalism.

Nationalism and national collectivism stifle the recognition of *différence* and prohibits French governmental officials from enacting multicultural policies for the affirmation of any collective unit besides the nation. Consequently, officials have long been hesitant toward liberal inclusion and have more consistently favored the assimilation of cultural minorities into the ‘French way of life.’ These observations could describe politics surrounding the *hijab* as easily as politics surrounding Islamic banking. Thus, the institutional reality of the *République laïque* does not allow for a separation in the country’s banking system based on religious adherence.

Second, degrees of liberalism and nationalism influence the development of Islamic finance and banking in that liberal capitalism in London provides lower gates of entry for business. A higher degree of nationalism and *dirigisme* prohibits liberal, *laissez-faire* capitalism through statist controls. Accordingly, French *dirigisme* presents numerous hurdles for Islamic bankers to clear in France, the least of which not being *laïcité*.

### III. FUTURE PROSPECTS FOR ISLAMIC FINANCE

The tensions between the Republic and Islamic finance remain unresolved in Paris. They will likely continue to dominate discussions of the prudence of establishing an Islamic financial sector in Paris in coming years. If an Islamic sector were to emerge in France in the future, it would be markedly different from the Islamic financial sectors in Dubai, Jeddah, Kuala Lumpur, and Bahrain. It is likely that a French Islamic financial sector would be based on more marketable (and *laïque*) notions of ‘alternative finance’ or ‘ethical banking.’ Yet before *banques éthiques* emerge in France, regulatory officials will have to reevaluate the remaining institutional and legal obstacles examined in this paper. Moreover, the sector will have to find a new champion since its principal proponent, Christine Lagarde, has moved from the Ministry of

Finance to lead the International Monetary Fund.

Islamic finance will continue to develop vibrantly in London on multiple fronts: retail expansion, greater *sukuk* issuance, and increased interest in *shari'ah* compliant mutual funds. Uninhibited by regulations, London's Islamic banking gateway will continue to mirror the industry capitals in the Gulf and South East Asia. This paper has addressed only the most critical reforms and Islamic products in the UK. Numerous other products have been and are being addressed in the FSA and HM Treasury, such as Islamic insurance (*takaful*), pensions, and private equity funds. Finally, the continued development of Islamic finance in the UK corresponds to the continued economic integration of British Muslims. With a wide array of *shari'ah*-compliant products and services to choose from, state financial regulatory officials in the FSA and the Treasury have invited Muslims to play a greater and more integrated role in commerce in a newly multi-financed and multi-cultured Britain.

#### IV. LIBERALISM AND THE HUMAN IMPACT OF ISLAMIC FINANCE

This thesis began as a story about two global banking capitals that had opposite reactions to Islamic finance, but it has ended as a story about the challenge of inclusionary democracy in an era of increasing diversity. The variance of liberal democracy and nationalism between Britain and France has strikingly human ramifications. Her Majesty's Treasury's long consultations with international bankers and Muslim community leaders alike were as much about the UK gaining access to Gulf liquidity as they were about making room at the table for British Muslims. When individuals like Syrian investor Fehmy Saddy sought to open Islamic banks in France and were met only with impossible stipulations from the Banque de France, the weight of nationalism was felt by ordinary French Muslim citizens.

At the core of this thesis has been an inquiry into the role of the state in the reconciliation

## CONCLUSION

between faith and commerce. Degrees of governmental accommodation of Islamic banking have corresponded with national traditions of liberal capitalism and nationalist *dirigisme* in Britain and France. The variation in liberalism and nationalism between these two countries affects ordinary citizens because it leads to either a provision or a restriction of the religiously conscious banking products that could bring positive development to their socially excluded communities. French regulatory officials have not considered the provision of access to Islamic finance to be a duty of the state or even an appropriate governmental pursuit. British officials, meanwhile, have embraced the notion of inclusive financial systems that are able to serve every citizen, regardless of reason for previous exclusion.

The divergence of liberalism and nationalism leads to a difference in multicultural policy, which, in turn, leads to a difference in the tolerance and inclusion of Islamic finance between Britain and France. The end result of inclusion is strikingly ordinary: a counter and a clerk at a bank like HSBC offering products like mortgages, small business financing plans, debit cards, and college loans. A banner near the counter might use the phrase “*shari’ah*-compliant,” loan pamphlets might be available in Urdu, or the clerk might take a break for prayers. But otherwise, the bank looks quite conventional. Once the structural differences of Islamic finance are overcome, commerce is commerce.



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**APPENDIX:**  
**GLOSSARY OF FOREIGN TERMS**

<i>Banlieues</i>	Outskirts of a city. They typically refer to the poor, immigrant and minority suburbs of Paris. (Fr.)
<i>Burqa</i>	Veil that covers the face and entire body. (Ar.)
<i>Dirigisme</i>	Government control over economic and social matters. Adjective: <i>dirigiste</i> . (Fr.)
<i>Gharar</i>	Speculative gain. (Ar.)
<i>Halal</i>	Literally permissible in Islamic law. (Ar.)
<i>Haram</i>	Literally forbidden in Islamic law. (Ar.)
<i>Ijara</i>	Leasing contract. (Ar.)
<i>Istisna</i>	Shared financing contract for construction. (Ar.)
<i>Laïcité</i>	Very roughly secularism. More accurately, <i>laïcité</i> has to do with ‘freedom from religion’ and, more institutionally, the complete absence of religion in the affairs of the state and its reverse. Adjectives: <i>laïque</i> . (Fr.)
<i>Manzil</i>	Dwelling. Also a home purchase plan from Ahli United Bank. (Ar.)
<i>Mudaraba</i>	Passive partnership contract. (Ar.)
<i>Murabaha</i>	Sales contract. (Ar.)
<i>Musharaka</i>	Active partnership contract. (Ar.)
<i>Niqab</i>	Similar to the well-known burqa, the <i>niqab</i> is a veil that covers the face, but the <i>burqa</i> covers the entire body. (Ar.)
<i>Riba</i>	Excessive interest. (Ar.)
<i>Shari’ah</i>	Vast collection of jurisprudence and rules based on the principles of the Qur’an and the Sunnah. The <i>Shari’ah</i> consequently is not a law canon <i>per se</i> , but a methodology of interpreting the scriptures and the words and deeds of the Prophet Mohammed. (Ar.)
<i>Sukuk</i>	Islamic bonds. Singular: <i>sakk</i> . (Ar.)
<i>Sunnah</i>	Words and deeds of the Prophet Mohammed. The Sunnah accompanies the Qur’an as a main source of inspiration for the <i>shari’ah</i> .
<i>Takaful</i>	Islamic insurance. (Ar.)
<i>Wakala</i>	Agentship contract. (Ar.)