Government sterling sukuk issuance:

a response to the consultation

June 2008

HM TREASURY

United Kingdom
Debt Management Office

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Foreword by the Economic Secretary to the Treasury

I am delighted to present the Government's response to the consultation on the potential for the Government to become an issuer of Islamic financial instruments in the wholesale sterling market, that is, for the Government to issue sukuk, the Islamic alternative to conventional debt capital market instruments.

The Government's objectives for Islamic finance are to:

- entrench London as a leading centre for Islamic finance in the world; and
- to ensure that all British citizens can participate in the financial system regardless of faith.

Since 2003, the Government has made significant progress towards meeting these objectives:

- a number of legislative changes have been introduced to ensure a level tax and regulatory playing field between Islamic and conventional finance - most recently, at Budget 2008, the Government announced further measures to continue to develop a level playing field between sukuk and conventional debt instruments;
- an Islamic Finance Experts Group (IFEG) has been established, which I chair, to advise the Government on how it can best focus its efforts. Working with both IFEG and wider industry experts, the Government is now preparing a long-term strategy paper for developing Islamic finance in the UK, which will be published later in the year; and
- five Islamic banks and one insurance (Takaful) firm have been established with authorisation by the Financial Services Authority (FSA) – the only standalone Islamic financial institutions in the European Union.

However, although significant progress has been made, the Government is committed to continuing to support the long-term development of Islamic finance in the UK; in April 2007, it was announced that HM Treasury and the Debt Management Office (DMO) would assess the feasibility of the Government becoming an issuer of Islamic financial instruments in the wholesale sterling market. The Government launched a formal consultation on this issue in November 2007.

As this response to the consultation makes clear, a tremendous amount of work has been completed, all of it greatly assisted by the enthusiastic support of a wide range of external stakeholders, for which I am grateful. It is clear to me that constructive collaboration between Government and industry is critical if our shared objectives are to be met.

I am strongly encouraged by the level of support shown in the Government's feasibility study. Formal responses were received from many interested parties. The majority of respondents were supportive of the Government's achievements so far and for the potential for the Government to issue sukuk. These responses to the consultation have played a valuable role in informing the Government's consideration of the potential issuance of sukuk.

This response to the consultation sets out a number of decisions that the Government has taken on sukuk issuance. However, a number of outstanding issues remain that would need to be resolved before the Government would be in a position to announce a decision on whether or not it would issue sukuk. The Government will continue to work to resolve these outstanding issues. We will provide an update of our progress in the 2008 Pre-Budget Report.

I thank all the respondents to the consultation for their interest and support and look forward to continuing to work with them as we move this important agenda forward.

KITTY USSHER

Economic Secretary to the Treasury

EXECUTIVE SUMMARY

In the 2007 Pre-Budget Report, the Government announced that it would hold a detailed consultation on its feasibility study on the potential issuance of sterling sukuk. On 14 November 2007, the Government published a consultation paper *Government sterling sukuk issuance: a consultation*.

The purpose of the consultation was to seek views on the advantages, disadvantages and risks of the Government becoming an issuer of Islamic financial instruments. The consultation also raised some technical questions, including the merits of 'bill-like' and 'bond-like' sukuk and the characteristics that sukuk would need if they were to be treated in the same way as their conventional equivalents, while ensuring their Sharia'a compliance.

The vast majority of responses to the consultation were supportive of the Government's feasibility study into potential sukuk issuance. Respondents to the consultation believed that there were many advantages to government sukuk issuance and expressed support for both 'bill-like' and 'bond-like' sukuk while noting the associated advantages, disadvantages and risks.

Respondents also identified a number of prerequisites that needed to be met for sukuk to be treated in the same way as their conventional equivalents while ensuring their Sharia'a compliance.

The Government has considered the responses to the consultation closely. The responses to the consultation have played a valuable role in informing the Government's thinking on the nature of potential sukuk issuance. In particular, the Government:

- believes that the balance of advantages and risks lies with 'bill-like' sukuk rather than 'bond-like' sukuk, although it does not rule out potential issuance of 'bond-like' sukuk;
- believes that a rolling programme of up to £2 billion of 'bill-like' sukuk issuance would be achievable over time;
- believes that a 'bill-like' sukuk programme would be fully integrated with the conventional Treasury bill programme, which currently has issuance at one, three and six month maturities; and
- would use a 'plain vanilla' Ijara contract to facilitate sukuk issuance.

The Government notes the features that the sukuk should have in order to be priced at, or close to, their conventional equivalents and will seek to ensure that sukuk have those features.

In addition, as announced in Budget 2008, the Government is currently taking legal powers (in the Finance Bill) to facilitate sukuk issuance.

A number of issues were raised in the responses to the consultation relating to the structuring, regulation and taxation of sukuk. The Government is currently working on a number of structuring, regulatory and taxation issues that need to be resolved before sukuk issuance can proceed. These issues are:

- the transfer of an asset to a special purpose vehicle;
- the application of Stamp Duty Land Tax;
- the application of Value Added Tax;
- the regulatory regime for sukuk;
- the eligibility of the Government's sukuk as acceptable collateral for the Bank of England's open market operations; and
- the settlement of the sukuk within the CREST system.

The Government will continue to engage with its stakeholders as it pursues resolution of the outstanding issues. It will provide an update of its work on these issues in the 2008 Pre-Budget Report.

1 INTRODUCTION

1.1 In April 2007, the then Economic Secretary to the Treasury announced[1] that the Debt Management Office (DMO) and HM Treasury would carry out a feasibility study into the potential for the Government to become an issuer of Islamic financial instruments in the wholesale sterling market, consulting with the Islamic Finance Experts Group (IFEG)[2] that the Economic Secretary established in April 2007 and reporting on progress at the time of the 2007 Pre-Budget Report.

1.2 The objectives of potential issuance of Islamic wholesale financial instruments were set out by the then Economic Secretary, when he said that: "We are determined to do everything we can to deliver greater opportunities for British Muslims – and also to entrench London as a leading centre for Islamic finance in the world"; in line with existing policy on Islamic finance.

1.3 The terms of reference for the study, which were also published in April 2007[3] stated that it would examine the benefits and costs of the case for the Government to become an issuer of wholesale sterling Islamic financial instruments and the practical and legal implications of doing so, taking account of: (i) the Government's debt management policy objective; (ii) the size and nature of demand; (iii) the potential risks; (iv) any implications for the Government's financing strategy; (v) the experience of other sovereign issuers of Islamic financial instruments; and (vi) the impact on markets, including the impact on the City of London as an Islamic financial centre.

1.4 It was also announced by the then Economic Secretary in April 2007 that National Savings & Investments (NS&I)[4] would separately examine the feasibility of the Government becoming an issuer of retail Islamic financial products. The conclusions of NS&I's feasibility study are available on its website[5].

1.5 An update of progress was provided in the 2007 Pre-Budget Report.

1.6 Following the 2007 Pre-Budget Report, the Government published a consultation document, on 14 November 2007[6], the purpose of which was to seek views on the potential for the Government to become an issuer of sterling Islamic financial instruments, specifically, Islamic bonds or sukuk. In particular, the consultation sought views on the advantages, disadvantages and risks of the Government becoming an issuer of Islamic financial instruments and also sought views on technical issues concerning the structuring of sukuk issuance.

[1] The feasibility study was announced in a speech by Ed Balls MP to the Financial Services Authority's (FSA's) 'Principles-based Regulation' Conference, 23 April 2007.

[2] The letter from the Economic Secretary to the Treasury establishing the IFEG is on HM Treasury's website at: http://www.hm-treasury.gov.uk./consultations_and_legislation/islamic_financial/consult_islamic_financial.cfm

[3] The full Terms of Reference for the feasibility study can also be found under the above link.

[4] National Savings & Investments (NS&I) is a Government department and an executive agency of the Chancellor of the Exchequer. It is one of the largest savings institutions in the UK. It has the primary objective of raising cost-effective financing for Government from the retail sector by offering retail customers secure savings and investment products that are both attractive and competitive.

[5] www.nsandi.com

[6] The consultation document can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk./consultations_and_legislation/sukuk_issuance/consult_sukuk_issuance.cfm

1.7 In Budget 2008, the Government made a number of announcements regarding Islamic finance and also made a commitment to publish a full response to the consultation in the summer of 2008. This paper sets out the Government's response to the consultation and explains how the responses have informed the Government's ongoing consideration of the feasibility of issuing Islamic financial instruments. It also provides a more detailed update on progress made since the consultation was launched in November 2007.

2 Level of response

2.1 The Government received a total of 41 responses to the consultation, from a range of respondents, including investment banks and their Islamic 'windows', Islamic banks, law firms, consultancies, ratings agencies, individuals and academics. A full list of respondents is set out in Annex A. Respondents presented a wide range of views and opinions on the questions raised in the consultation document. These views are summarised along with the Government's responses in Chapters 3 and 4.

3 Issues raised by respondents to the consultation

A. Nature of support for Government sukuk issuance

3.1 Nearly all respondents to the consultation were supportive of Government sukuk issuance in either 'bond-like' or 'bill-like' form or in both forms. A small number of respondents believed that it was inappropriate for the Government to issue sukuk or to take any action that could result in the incorporation of Sharia'a law into English law.

3.2 Respondents put forward a number of arguments in favour of Government sterling sukuk issuance, in particular, that it would:

- help to entrench London as a major international centre for Islamic finance and promote the City as a gateway for Islamic finance;
- support the development and delivery of retail Islamic finance products;
- potentially encourage other western sovereign and corporate issuers to access Islamic finance markets by:
  - establishing an effective framework to enable corporate issuers in the UK to issue sukuk; and
  - acting as a risk-free benchmark to facilitate pricing of other issues in the Islamic finance market;
- contribute to the wider acceptability of sukuk as an asset class;
- increase secondary market liquidity in the sukuk market;
- fulfil the needs of all investors regardless of religion;
- create goodwill towards the UK from the Middle East and further encourage economic and political ties;
- potentially strengthen the balance sheets of Islamic financial institutions in the UK by providing a AAA-rated sterling denominated asset for Islamic banks, which would qualify under Basel II[7] as a claim on central government; and
- potentially allow for innovation in the sukuk market, for example, in developing sukuk with returns based on inflation.

3.3 Some respondents also suggested that issuance of sukuk could help further to diversify the Government's investor base, in particular, by offering a product of interest to Middle Eastern investors. However, other respondents argued that there would be relatively low take-up from investors outside the Government's usual investor base given the cost for sukuk investors of purchasing AAA-rated sterling sukuk, relative to the higher-yielding investments that they typically purchase.

[7] Basel II sets out the minimum capital requirements firms have to meet to cover their credit, market and operational risk.

3.4 Respondents also highlighted potential risks associated with sukuk issuance, in particular, recognising that:

- the process of issuing sukuk is not straightforward and can be time consuming, resource intensive and less flexible than the Government's current method of financing via gilt and Treasury bill ('bill') issuance;
- issuance could be more costly than conventional issuance, either as a result of up-front structuring costs or because investors would charge a premium to invest in sukuk;
- demand for AAA-rated sterling denominated sukuk issuance is untested and may be limited, due to either the currency and/or the relatively low yield it could offer;
- there are potentially sensitive issues regarding the transfer of government assets to a special purpose vehicle (SPV);
- there is Sharia'a risk associated with structuring sukuk issuance that could affect the extent to which any sukuk issuance is acceptable to a wide range of Islamic investors given the lack of standardisation in the market; and
- there is a risk that, due to the evolving nature of Islamic jurisprudence, a sukuk issuance that was initially deemed Sharia'a compliant could subsequently be deemed not to be Sharia'a compliant some time after issuance.

3.5 Additionally, a few respondents raised concerns about the interaction between Government sukuk issuance and wider Government financing through gilts and bills. Respondents questioned whether sukuk issuance could reduce gilt issuance.

3.6 Some respondents suggested that the Government may want to delay any issuance of sukuk given the ongoing disruption in world financial markets and the level of uncertainty in the Gulf Cooperation Council (GCC) countries with regard to the possible de-pegging of local currencies from the US dollar.

B. Nature of support for 'bill-like' sukuk issuance

3.7 A number of respondents to the consultation argued that there were clear advantages to the Government proceeding with 'bill-like' sukuk issuance. Respondents put forward a wide range of reasons to support the argument that 'bill-like' sukuk would be the most appropriate instruments to issue:

Filling a gap in the Islamic finance market

3.8 Respondents noted that there are very few existing Islamic liquidity management instruments. Given the absence of tradable short-term liquidity management instruments, respondents argued that 'bill-like' sukuk could provide a vehicle for Islamic financial institutions to manage their liquidity. UK based Islamic banks are subject to the same regulations for liquidity management as conventional banks but lack tradable instruments which would allow for active liquidity management.

3.9 Respondents also noted that 'bill-like' sukuk should appeal to conventional bill investors if designed so that they have key features in common with conventional bills.

A more flexible alternative to Commodity Murabaha

3.10 Respondents noted that the fixed costs associated with transacting in Commodity Murabaha, made investment at short maturities particularly expensive. In addition, some Islamic investors are not permitted, for Sharia'a reasons, to transact in Murabaha instruments, reducing their flexibility as a generally accepted liquidity management tool. A number of respondents also commented that Sharia'a scholars have, for some time, been encouraging the Islamic finance community to seek alternatives to Commodity Murabaha. Given that 'bill-like' sukuk would have lower transaction costs, they could potentially provide a more cost effective and efficient method for the management of Islamic banks' liquidity and reserve requirements.

3.11 A few respondents questioned whether 'bill-like' sukuk would act as a natural substitute for Commodity Murabaha given that 'bill-like' sukuk, if priced in line with conventional bills, would offer a lower rate of return than Commodity Murabaha as a consequence of the difference in credit risk. However, one or two respondents commented that the requirements for Basel II could make 'bill-like' sukuk more attractive to Islamic institutions in the future. One of the effects of the Basel II requirements cited was that they would mean that banks are more inclined to use instruments with a nil or low regulatory capital charge as part of an asset and liability management approach in which a portion of funds is invested in highly rated liquid assets.

Pricing of 'bill-like' sukuk relative to conventional issuance

3.12 Some respondents argued that 'bill-like' sukuk issuance would be more likely to price at, or close to, conventional bills relative to the that with which 'bond-like' sukuk would price to gilts. This arises from the potential for a large difference in liquidity between 'bond-like' sukuk and gilts (relative to the equivalent difference between 'bill-like' sukuk and bills) resulting in a liquidity premium between 'bond-like' sukuk and gilts.

Smaller impact on gilt supply

3.13 Some respondents argued that, within a given quantum of Government financing in which sukuk issuance replaced conventional issuance, there would potentially be a reduction in secondary gilt market liquidity with a consequent negative impact on the gilt market and on gilt investors, in particular pension funds, which are seeking to invest in long-dated gilts. A few respondents argued that the best method to mitigate any tension between a potential sukuk programme and gilt issuance would be through issuance of 'bill-like' rather than 'bond-like' sukuk. Given the shorter maturity of 'bill-like' sukuk, the maintenance of a programme of issuance would require a lower absolute level of funding than for 'bond-like' sukuk and would, therefore, have a smaller impact on conventional issuance.

Development of retail Islamic financial products

3.14 Respondents' views on the impact of 'bill-like' sukuk issuance focused on the benefits to liquidity management that issuance would bring. In particular, Government sukuk would enable UK Islamic banks to invest their reserve requirements which would provide a much needed liquidity instrument and would reduce capital costs. By supporting Islamic institutions, Government sukuk would enable them to develop a range of competitive Islamic retail financial products and assist with the pricing of short-term saving and deposit products for retail customers. However, other respondents noted that 'bond-like' sukuk issuance may be necessary in order to spur the Islamic finance market to develop other retail products such as Islamic insurance (Takaful) or pensions. Comments were also made that the provision of sukuk could facilitate the development of capital-protected investment products.

3.15 Some respondents raised potential risks arising from 'bill-like' sukuk issuance:

Currency of issuance

3.16 Some respondents questioned whether 'bill-like' sukuk issuance should be denominated in US dollars rather than in sterling, with a few respondents arguing that demand from UK Islamic banks is likely to be small, at least initially. Middle Eastern investors typically demand US dollar denominated assets and a significant proportion of international sukuk issuance to date has been in US dollars. In addition, some respondents suggested that the size of demand from Islamic investors would be negatively affected if the sukuk were denominated in sterling given their preference for US dollar denominated sukuk. However, other respondents noted that sterling rather than US dollar issuance was more likely to be of benefit to the development of Islamic finance and retail Islamic financial products in the UK.

Structural complexity

3.17 A number of respondents noted that it could be more difficult to develop an acceptable Sharia'a compliant solution to facilitate the issuance of 'bill-like' sukuk using an Ijara contract, given that it is more commonly used for longer maturity issuance. With the exception of sovereign issuance in Brunei, an Ijara contract has not been used, hitherto, to facilitate short-term sukuk issuance. Issues were raised regarding the flexibility of Ijara-based sukuk, in particular, involving the potential need for frequent transfer of assets. Ensuring that the structure is both Sharia'a compliant and tradable was felt to be the key complexity to issuance of 'bill-like' sukuk.

C. MATURITY OF 'BILL-LIKE' SUKUK ISSUANCE

3.18 The majority of respondents that advocated 'bill-like' sukuk suggested issuance at maturities of six months or less, with one month and three month maturities having the widest support among respondents.

D. SIZE OF 'BILL-LIKE' SUKUK ISSUANCE

3.19 Respondents expressed a range of views about the possible size of 'bill-like' sukuk issuance. Some respondents suggested that ongoing demand for 'bill-like' sukuk could be up to £1 billion with a general consensus that an initial issue should be relatively small. A number of respondents suggested that the size of demand would grow over time citing reasons including:

- rising investor confidence in the asset;
- increasing liquidity;
- rising demand for liquidity by Islamic financial institutions;
- the general growth of Islamic finance and consequent widening of the investor base for Islamic products; and
- the growing acceptability of Sharia'a compliant financial products amongst investors.

3.20 Issuance of sterling denominated Government 'bill-like' sukuk would introduce an entirely new class of financial instrument into the sterling money markets. The initial size of demand for this instrument would, therefore, necessarily be uncertain.

3.21 A key requirement for 'bill-like' sukuk issuance noted by many respondents was the necessity to ensure an appropriate level of liquidity in the instruments. Respondents suggested that it would be appropriate to ensure supply of 'bill-like' sukuk on an ongoing basis in order to generate, and then maintain, liquidity and also to sustain interest in the programme.

E. Nature of support for 'bond-like' sukuk issuance

3.22 A number of respondents were supportive of the Government issuing 'bond-like' sukuk, arguing that issuance would have a significant market impact and would act as the most effective means to develop the Islamic finance sector in London. A few respondents felt that the Government should issue 'bond-like' sukuk prior to the launch of any 'bill-like' sukuk, enabling the 'bond-like' issue to test the extent of demand for sterling sukuk. Respondents put forward a number of reasons supporting 'bond-like' sukuk issuance:

Stimulating the sukuk market in London

3.23 In general, those in favour of 'bond-like' sukuk felt that the issuance of sukuk would stimulate the market for Sharia'a-compliant securities in London. A few respondents felt that a 'bond-like' issue would be more likely than a 'bill-like' issue to establish a benchmark and, therefore, stimulate the primary market for Islamic finance in London. Some respondents suggested that issuance of Government sukuk would help to integrate sukuk as an asset class within the London markets, including in circumstances in which the Government developed a 'sukuk yield curve'.

Establishment of a pricing reference

3.24 A benefit of 'bond-like' sukuk issuance cited was that it would lead to the development of a liquid benchmark reference point for the Islamic finance market. It was argued that it would provide a pricing reference for other issuance, thereby avoiding the need for benchmarking against an interest-based alternative, such as the London Inter-bank Offered Rate (LIBOR).

Development of retail products

3.25 Respondents noted that issuance of 'bond-like' sukuk could facilitate the provision of a wide range of retail Islamic financial products, such as Islamic Individual Savings Accounts (ISAs), savings accounts and capital guaranteed investment products.

In addition, respondents argued that 'bond-like' sukuk would provide the catalyst for the development of new Islamic retail finance product classes in the UK, including Islamic pensions and insurance (Takaful) because, for example, sovereign sukuk issuance would provide a degree of certainty over cash flows.

3.26 It was also suggested that sukuk issuance by the Government could promote confidence within the Muslim population in Islamic finance and increase the uptake of Islamic retail financial products.

Development of Islamic derivatives

3.27 A few respondents argued that the issuance of Government sukuk could spur the development of Islamic derivatives, facilitating the development of Islamic equivalents of swaps and repos.

3.28 However, some respondents were more cautious about the issuance of 'bond-like' sukuk for the reasons cited below:

Pricing and liquidity

3.29 Some respondents cited concerns over the potential for differential pricing between 'bond-like' sukuk and gilts due to the likely lower liquidity in 'bond-like' sukuk. In particular, a few respondents noted that 'pricing risk' was higher for 'bond-like' sukuk than 'bill-like' sukuk because of the greater importance placed on liquidity of longer-dated instruments. It was also argued that increasing the issuance size of the 'bond-like' sukuk would not necessarily be sufficient to ensure liquidity.

Fragmentation of issuance

3.30 A number of respondents raised concerns that 'bond-like' sukuk could fragment government issuance to the detriment of the gilt market, arguing that any fragmentation of issuance would lead to a cost to the Government's financing programme.

Demand from Islamic investors

3.31 A significant proportion of respondents noted that 'bond-like' sukuk would not appeal to investors from the Middle East because Islamic banks in the region tend to have a relatively high cost of funding that would mean that investment in Government sukuk priced at, or close to, gilts would be unattractive. However, respondents argued that existing gilt investors, as well as UK based Islamic banks and overseas central banks, would be likely to support issuance of 'bond-like' sukuk.

Attractiveness to investors

3.32 Nearly all respondents argued that any 'bond-like' sukuk should be designed to be attractive to conventional, as well as Islamic, investors and a number of respondents noted that conventional investors may account for a significant proportion of take-up in any sukuk issue that was so designed. A few respondents argued, however, that some Islamic investors would be actively seeking a product that embodied ethical characteristics that reflected Sharia'a philosophy and, as such, the Government should avoid issuing instruments that simply replicate conventional products.

3.33 The characteristics necessary to ensure that conventional investors would be willing to invest in 'bond-like' sukuk are considered in section H below. Some respondents argued that, in order to appeal to Islamic institutions, any rental payments made on 'bond-like' sukuk should be at a floating, rather than fixed, rate.

F. MATURITY OF 'BOND-LIKE' SUKUK ISSUANCE

3.34 The majority of respondents that advocated 'bond-like' sukuk issuance suggested issuance at maturities from two to ten years, with the majority of responses suggesting issuance at either three or five year maturities.

G. SIZE OF 'BOND-LIKE' SUKUK ISSUANCE

3.35 Respondents expressed a range of views about the potential size of 'bond-like' sukuk issuance. Minimum issue sizes suggested were in the range of £100-500 million. However, in order for Government sukuk issuance to have at least some degree of liquidity, it was noted by a number of respondents that issuance would have to be at least £1 billion and that this issuance size would be large for the sukuk market. A few respondents suggested that issuance should take place in tranches of equivalent size to gilt issuance, in order to ensure the same degree of liquidity in the two products. In this context, some respondents suggested that the Government should initiate a regular programme of 'bond-like' sukuk issuance, in order to increase liquidity and potentially build up a yield curve for Government sukuk.

3.36 Respondents noted that secondary market trading of sukuk remains very limited with insufficient supply to allow for secondary market liquidity to develop. In addition, respondents highlighted that Islamic investors tend to be 'buy-and-hold' purchasers of sukuk because of the lack of alternative financial products. It is likely that low levels of liquidity in the secondary market for sukuk will continue until there is sufficient critical mass of sukuk issuance to allow for the development of a working secondary market. In addition, a few respondents also highlighted the need for the Islamic finance market to provide a suitable alternative to conventional repo to allow for liquidity in sukuk to develop.

H. CHARACTERISTICS OF 'BOND-LIKE' SUKUK REQUIRED TO ENSURE THE SAME TREATMENT AND PRICING AS CONVENTIONAL BONDS

3.37 A number of respondents highlighted liquidity as the key characteristic needed to ensure that the price of the sukuk is the same as, or close to, their conventional equivalents. However, some respondents noted that, given the general lack of liquidity in the sukuk market, the 'buy and hold' nature of the investor base and the need for large repeated issuance of sukuk to achieve any liquidity, it could be more difficult for 'bond-like' sukuk issuance to achieve a price that is the same, or close to, their conventional equivalents.

3.38 Respondents also highlighted the need, as far as possible, to replicate the other characteristics of gilts in order to ensure the same treatment and pricing between gilts and 'bond–like' sukuk. In particular, the sukuk would need to:

- be perceived as having an equivalent credit risk to that of gilts;
- have a zero capital risk weighting;

- be eligible for use as collateral for the Bank of England's open market operations;
- be included in the same Government bond indices as gilts;
- have the same market-making support as for gilts;
- be strippable;
- have the same tax, listing, settlement and clearing treatment as gilts; and
- be eligible for the DMO's standing and special repo facilities.

3.39 Respondents noted that, in the absence of some, or all, of these features, Government sukuk would be likely to trade at a discount to gilts.

3.40 As noted above, respondents expected limited demand from Islamic investors in circumstances in which sukuk priced at, or close to, gilts, due to the high likelihood of a relatively low return and preference for US dollar denominated assets.

3.41 However, some respondents noted that the negative impact on demand due to the likely pricing of Government sukuk could potentially be mitigated by demand for a risk-free benchmark, as well as increased awareness among Islamic financial market participants of the implications for their balance sheet of complying with the requirements of Basel II.

J. CHARACTERISTICS OF 'BILL-LIKE' SUKUK REQUIRED TO ENSURE THE SAME TREATMENT AND PRICING AS CONVENTIONAL BILLS

3.42 A significant proportion of respondents identified liquidity as a key characteristic that 'bill-like' sukuk would need to share with conventional bills in order to be treated in the same way as their conventional equivalents. Other characteristics in common with conventional bills highlighted in responses were that sukuk would need to:

- be perceived as having an equivalent credit risk to conventional bills;
- have a zero capital risk weighting; and
- be eligible for use as collateral in the Bank of England's open market operations.

3.43 A number of respondents also suggested that Middle Eastern investors would be unlikely to participate to a significant extent in 'bill-like' sukuk issuance if these instruments offered a yield equivalent to conventional bills or were denominated in sterling rather than US dollars or local Middle Eastern currencies.

K. APPROPRIATE CONTRACT FOR SUKUK ISSUANCE

3.44 The majority of respondents suggested that an Ijara (lease) contract would be most appropriate for structuring Government sukuk. Respondents noted that the Ijara contract had been widely used by other sovereign issuers such as Malaysia, Qatar, Pakistan and Bahrain.

3.45 A number of benefits from the use of an Ijara contract were cited by respondents, including ease of structuring, wider Sharia'a acceptability, tested legal documentation, flexibility in structuring rental payments, tradability and the ability to repurchase the assets underlying the structure at face value at maturity which allows for redemption of the sukuk at par.

3.46 A number of respondents noted that an Ijara-based sukuk would be 'asset-intensive', as it would require 100 per cent tangible assets to back issuance. Therefore, other contracts such as Musharaka and Mudaraba were also proposed. However, some respondents cautioned against the use of these contracts, on the basis of current uncertainty regarding the Sharia'a compliance of sukuk structured with these underlying contracts.

3.47 Some respondents proposed the use of a Salam or Murabaha contract for 'bill-like' sukuk. However, in doing so, they noted that this would render the sukuk non-tradable by some Sharia'a-compliant investors.

L. DETERMINATION AND TRANSFER OF AN ASSET TO BACK SUKUK ISSUANCE

3.48 Many respondents highlighted the fact that any asset underlying sukuk issuance must comply with Sharia'a law (i.e. have no involvement with any forbidden (haram) activities such as alcohol or pork production or conventional finance). Respondents noted that, to comply with Sharia'a law, it would not be necessary to transfer legal title to the assets, instead allowing for the transfer of beneficial interest in the underlying assets provided that both the associated risks and rewards of ownership are transferred.

3.49 A number of respondents raised issues regarding the tax implications of the transfer of an asset from the Government to an SPV as part of sukuk issuance. In particular, respondents raised issues regarding the potential for payment of Stamp Duty Land Tax (SDLT), Stamp Duty Reserve Tax (SDRT), Value Added Tax (VAT) and Capital Gains Tax (CGT) to act as a deterrent to potential sukuk investors.

3.50 The broader implications of the transfer of Government assets to an SPV were also raised by respondents. However, most respondents noted that as part of a standard sukuk issuance process, the Government would only be required to transfer beneficial title to the underlying assets to the SPV and that maintenance of the underlying assets can remain with the Government via the use of a service agency agreement. In addition, respondents noted that a Purchase Undertaking issued by the Government would ensure that the assets would revert to the Government in the event of default.

M. RIGHTS OF SUKUK HOLDERS, THE SPECIAL PURPOSE VEHICLE (SPV) AND THE GOVERNMENT

3.51 Respondents set out the various rights of sukuk holders, the SPV and the Government in any sukuk transaction. In particular, respondents highlighted the need for the transaction and documentation to be Sharia'a compliant and to exclude any forbidden ('haram') items or elements of uncertainty ('gharar').

3.52 Respondents typically focused on the relationships underpinning sukuk based on an Ijara contract. They set out the need for any transaction to use a well-defined, tangible and non-consumable asset, with well-defined ownership rights, the beneficial ownership of which is transferred to the SPV as part of the transaction. In addition, respondents noted the need for clarity in the sukuk documentation (or elsewhere) regarding:

- the specification of rental payments;
- the duration of the transaction;
- the maintenance of the underlying assets (in particular the transfer of major maintenance to the lessee by way of a service agency agreement);
- the rights of sukuk holders;
- the valuation of the assets by an independent party;
- the processes in the event of total loss or default;
- the independence and nature of any purchase undertaking to facilitate the redemption of the sukuk; and
- the role of the SPV, including bankruptcy remoteness.

3.53 A range of views were expressed on whether the SPV could be owned by the Government. However, respondents noted that the SPV would have to declare a trust in favour of investors, before acquiring ownership, beneficial or otherwise, of the underlying assets.

3.54 Respondents highlighted the need for the sukuk to be approved by a recognised board of Sharia'a scholars, in the form of a fatwa (or opinion). Respondents suggested that this could be achieved by the use of the Sharia'a supervisory board of an investment bank or Islamic finance institution. It was suggested that the Government should incorporate British scholars onto any board used to approve a sukuk issuance. In addition, it was suggested that the Government could seek Sharia'a oversight for any sukuk issue from a recognised international Islamic finance body, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), or the Islamic Financial Services Board (IFSB).

3.55 A number of respondents commented that ensuring the Sharia'a compliance of the structural arrangements can only come after any structure is set out in greater detail.

N. Other issues raised in response to the consultation

3.56 Respondents proposed various methods for the sale of sukuk depending on whether 'bond-like' or 'bill-like' sukuk would be issued. A number of respondents proposed that 'bond-like' sukuk should be issued via syndication, in order to facilitate the price discovery process, ensure efficient targeting of buy-and-hold investors and ensure a sufficiently high-profile launch for any issuance.

3.57 A range of issuance methods were proposed for 'bill-like' sukuk. Some respondents argued that a syndication model could be adapted, while others felt that such adaptation would not be appropriate. A few respondents proposed the use of bilateral sales for 'bill-like' sukuk, or that issuance could take place in a manner similar to a Commercial Paper programme, with maturities and sizes tailored to the needs of investors. A number suggested that a similar tender method to that used for conventional bills should be adopted, albeit on a single-price basis. Some respondents also noted that it would be important to involve the UK Islamic banks in any primary issuance process.

3.58 A number of respondents identified that, in order for 'bill-like' sukuk to be structured in a Sharia'a-compliant manner, they cannot be structured as a discount instrument because this would involve the payment of interest ('riba') for the passage of time.

4 The Government's response to issues raised in the consultation

4.1 The Government has considered all the issues raised in response to the consultation very carefully. The responses to the consultation have played a valuable role in informing the Government's ongoing consideration of the feasibility of sukuk issuance. Chapter 4 sets out the Government's response to the issues raised in the consultation. It is split into two parts:

- Part I sets out the Government's response on the type of sukuk that would be issued, the form (that is, size and maturity) of that issuance and the structure and method used to facilitate that issuance; and
- Part II sets out the Government's response on issues relating to the structure of the SPV and the legal, taxation, regulatory, listing, settlement, compliance and any other issues pertaining to the issuance.

I. The type and form of the sukuk and the contract used to facilitate issuance

A. The Government's approach to sukuk issuance

4.2 As set out in its consultation paper, the Government places importance on ensuring that sukuk are treated by investors as the same as equivalent conventional instruments, while not compromising the Sharia'a compliance of any issuance.

4.3 The Government's approach was strongly supported by respondents to the consultation who noted that the current investor base for government securities could form a significant part of the investor base for sukuk.

4.4 Moreover, such equivalence was noted as being important in ensuring that the Government receives a price for any sukuk that is at, or close to, their conventional equivalents. While there may be some initial premium reflecting the novelty of the sukuk (at least amongst domestic investors), and an illiquidity premium reflecting the potentially lower level of liquidity than conventional equivalents, the Government should aim to ensure that the sukuk were competitively priced over a longer period of time.

> The Government agrees with these views from respondents to the consultation. Its aim remains to ensure that sukuk would be treated by investors as the same as equivalent conventional issuance while not compromising the Sharia'a compliance of any issuance. Achieving equal treatment would require sukuk to replicate key characteristics of equivalent conventional instruments and, therefore, the Government would seek to ensure that these key characteristics were replicated in any issuance. In so doing, the Government expects that, after an initial period, the price of the sukuk would, on average, be the same as, or close to, their conventional equivalents, once the sukuk had achieved the same level of liquidity.

B. The type of sukuk – 'bill-like' or 'bond-like' sukuk

4.5 As outlined in Chapter 3, the responses to the consultation showed considerable support for both 'bill-like' and 'bond-like' sukuk.

4.6 The Government agrees that the advantages of 'bill-like' sukuk include that they could:

- fill a gap in the Islamic finance market, due to the general absence of short-term Sharia'a-compliant money market instruments;
- facilitate liquidity management by Islamic financial institutions;
- be more likely to price at, or close to, conventional equivalents than 'bond-like' sukuk;
- have a smaller impact on gilt supply than 'bond-like' sukuk; and
- facilitate the development of new Islamic retail financial products.

4.7 The Government agrees that the risks associated with 'bill-like' sukuk issuance include:

- the market for 'bill-like' sukuk using an Ijara contract is less tested in practice than for 'bond-like' sukuk – that is, there are relatively few international 'bill-like' sukuk issues (the current sovereign issuers of these sukuk are Bahrain, Brunei and Malaysia) and only one of these has used an Ijara contract to structure its sukuk issuance; and
- adapting an Ijara-based structure to a programme of issuance of 'bill-like' sukuk is more complicated than for 'bond-like' sukuk.

4.8 The Government agrees that the advantages of 'bond-like' sukuk include that they could:

- act as an effective means to develop the Islamic finance sector in London;
- stimulate the market for Sharia'a-compliant securities in London;
- provide a benchmark Sharia'a-compliant risk-free rate; and
- provide the catalyst for the development of new Islamic retail financial products, including Islamic pensions and insurance (Takaful).

4.9 The Government agrees that the risks associated with 'bond-like' sukuk include:

- a larger volume of issuance is required to achieve desirable levels of liquidity;
- a larger volume of issuance would require a larger size and/or number of assets to be transferred to the SPV. Issuance of this size raises practical and other issues; and
- given the size of issuance involved, it is more difficult to achieve a regular programme for 'bond-like' sukuk.

The Government believes that there are merits in the issuance of 'bond-like' and 'bill-like' sukuk, but notes that there are risks attached to issuance of both types of sukuk. However, in the early stages of any issuance, the Government believes it should concentrate issuance in one particular form of sukuk only, in order to build liquidity in that sukuk.

The Government places greater weight on the arguments in favour of 'bill-like' sukuk than it does on the arguments in favour of 'bond-like' sukuk and believes that the risks associated with 'bill-like' sukuk can be better managed than those associated with 'bond-like' sukuk. The Government believes, therefore, that the balance of advantage rests with issuance of 'bill-like' sukuk, although it does not, at this stage, rule out the potential issuance of 'bond-like' sukuk.

C. Programme of issuance

4.10 A number of responses indicated that issuance of sukuk should not be on an isolated basis; rather, a programme of issuance was necessary, in order to build momentum and achieve necessary levels of liquidity. Indeed, a number of responses suggested that the Government should undertake issuance of both instruments and, moreover, issue across the maturity spectrum, in order to create a 'UK sovereign sukuk yield curve'.

The Government sees merit in programmatic issuance of sukuk. Any sukuk issuance would take place on a regular basis. A programme of issuance would help ensure that sukuk are seen as the same as their conventional equivalents.

However, while the Government can see potential benefits in a 'UK sovereign sukuk yield curve', it believes that the development of liquidity through a programme of 'bill-like' sukuk issuance is of greater benefit. However, the Government will assess the success of any initial programme and revisit this issue as part of that assessment.

D. Maturity and size of issuance

4.11 As set out in Chapter 3, responses to the consultation varied on the issue of the preferred maturity of sukuk:

- for 'bill-like' sukuk, the preferred maturities ranged from one month to six months; and
- for 'bond-like' sukuk, the preferred maturities ranged from two to ten years, with the majority of responses suggesting issuance at either three or five year maturities.

The Government sees merit in issuance at the maturities suggested by the majority of respondents to the consultation. Any issuance of 'bill-like' sukuk would be at a similar maturity to conventional bill issuance (currently issued at one, three and six month maturities); issuance at a similar maturity to conventional bill issuance would also be consistent with the maturities of short-term instruments issued by other sovereigns. Issuance of 'bill-like' sukuk would be fully integrated with the conventional bill programme.

4.12 Similarly, responses to the consultation varied on the issue of the preferred size of sukuk issuance:

- for 'bill-like' sukuk, the preferred size of issuance ranged from £100 million to £1 billion, with a smaller size of issuance recommended initially but subsequently built up to a larger volume to develop liquidity; and
- for 'bond-like' sukuk, the preferred size of issuance ranged from £100 million to £1 billion, with a smaller size of issuance recommended initially but subsequently built up to a larger volume, with the balance of responses preferring a size of issuance at an interim point between these extremes.

The Government agrees with respondents to the consultation that a small issuance of sukuk is desirable initially and that sukuk issuance should be gradually increased thereafter. It also agrees that any issuance should be programmatic. Any issuance of 'bill-like' sukuk would initially be relatively small, with a total programme limit of £2 billion. Issuance of this size would be sufficient to build liquidity and to replicate the characteristics of conventional equivalents.

E. The contract used to facilitate sukuk issuance

4.13 As set out above, a number of alternative contracts were proposed by respondents to the consultation as appropriate vehicles to facilitate sukuk issuance. These contracts include: Murabaha, Mudaraba, Musharaka and Istisna'a and/or some combination with an Ijara contract. However, the majority of respondents drew attention to the advantages of sukuk issuance structured with a 'plain vanilla' Ijara contract. The Government agrees that the advantages associated with this underlying contract, as set out in Chapter 3, include:

- ease of structuring;
- wider Sharia'a acceptability;
- tested legal documentation;
- flexibility in structuring rental payments;
- tradability of sukuk using this underlying contract; and
- the ability to repurchase the assets underlying an Ijara sukuk at face value at maturity, which allows for the redemption of the sukuk at par.

The Government shares the view of the majority of respondents to the consultation. It believes that the merits of an Ijara contract outweigh those of alternative contracts. The Government notes, in particular, the wide acceptability of Ijara sukuk amongst scholars and its widespread use in practice, especially by other sovereigns. Any sukuk issuance would be facilitated using an Ijara contract. The Government notes that some respondents to the consultation suggested that an Ijara contract may be inflexible in the context of the issuance of short-term sukuk but believes that the contract can be adapted appropriately. The Government continues to work with its Islamic Finance Experts Group to develop and deliver a Sharia'a-compliant structure for issuance.

F. Method of issuance

4.14 As set out in Chapter 3, respondents to the consultation suggested a number of methods of sukuk issuance including conventional auction, tapping and syndication with the balance of respondents preferring a syndicated issuance.

For 'bond-like' sukuk the Government notes that the cost of issuance via a conventional auction is lower than that for other alternatives and, moreover, is consistent with its approach of minimising the differences between sukuk and their conventional equivalents. However, the Government also notes that investors may need a period of time to become familiar with sukuk issuance so that, at least initially, a more tailored method of issuance may be appropriate. As such, the Government would expect to issue any 'bond-like' sukuk via a syndicated offering.

Any 'bill-like' sukuk issuance would be facilitated by a similar tender method to that used currently for Treasury bills but on a single-price basis.

G. The currency denomination of sukuk issuance

4.15 As set out in Chapter 3, a number of respondents to the consultation stated that sukuk should be denominated in US dollars rather than sterling, noting that a large proportion of international sukuk issuance is denominated in US dollars.

Any sukuk issuance will be denominated in sterling. While the Government can see benefits to issuance of sukuk denominated in US dollars, it believes that sterling issuance would better meet its objectives, in particular, to facilitate the provision of Sharia'a-compliant retail products in the UK, secure the potential benefits to domestic Islamic banks and facilitate ease of structuring.

H. Impact on conventional debt issuance programme

4.16 As noted in Chapter 3, some respondents raised concerns about the interaction between Government sukuk issuance and wider Government financing through gilts and Treasury bills. Respondents questioned whether sukuk issuance could potentially divert supply away from gilts.

The Government would ensure that a sukuk issuance programme would mirror that of its conventional equivalents which it believes would obviate any impact on its conventional issuance programme.

II. THE TYPE AND FORM OF THE SUKUK AND THE STRUCTURE USED TO FACILITATE ISSUANCE

A. Asset to be transferred to the SPV

4.17 Respondents to the consultation did not typically identify specific assets that the Government could transfer to the SPV although a few responses noted the advantages of the transfer of unimproved land to the SPV.

4.18 As set out in Chapter 3, respondents to the consultation indicated that any asset under consideration needed to be:

- Sharia'a compliant (that is, have no involvement with any forbidden (haram) activities such as alcohol or pork production or conventional finance);
- unencumbered by existing leases or pledges; and
- tangible and non-consumable.

The Government is not yet in a position to announce details of any asset that could be transferred to the SPV in order to facilitate sukuk issuance. A number of assets are currently under consideration. The Government notes carefully the assets that have been used to facilitate sukuk issuance by other sovereigns. Any asset that is transferred to the SPV would meet the requirements as set out above.

B. Equity ownership of the SPV

4.19 There was a range of opinions among respondents on the issue of possible structures for the equity ownership of the SPV and the potential position of the Government as the sole, or majority, owner of the SPV. Respondents considered the Sharia'a compliance of possible structures.

The Government is currently considering how to design a structure that is Sharia'a compliant, while ensuring that the issuance of sukuk is treated as being as close as possible to its conventional equivalent by investors.

C. Legal issues - powers to be taken in the Finance Bill to facilitate sukuk issuance

The Government intends to take powers in the Finance Bill to facilitate sukuk issuance. Those powers are set out in Clause 151 and Schedule 46 of the Bill both of which are set out in Annex B.

4.20 The Government's approach is to take powers to make regulations to provide for raising money through alternative finance arrangements. These regulations must specify the purpose(s) for which the money may be raised through each kind of alternative finance arrangement. Alternative finance arrangements are arrangements which, in the Government's opinion:

- equate in substance to a loan, deposit or other transaction of a kind that generally involves the payment of interest (including the issuance of government securities); but
- achieve a similar effect to such a transaction without including provision for the payment of interest.

4.21 The detailed regulations will be prepared at a later date when the precise structure of the sukuk is known. Those regulations will be subject to Parliamentary scrutiny in the usual way. To the extent that the regulations amend primary legislation, an affirmative resolution of the House of Commons will be required before the regulations come into effect.

D. Issues pertaining to regulation and risk weighting

Regulatory Treatment

4.22 As noted by a number of respondents to the consultation, sukuk are typically structured in a way so as to have the same economic characteristics as conventional instruments but in a Sharia'a-compliant manner. The structures used to facilitate the issuance of Islamic financial instruments, including sukuk, have posed challenges with respect to their regulatory treatment in the UK and other jurisdictions.

4.23 Sukuk typically fall within the definition of a Collective Investment Scheme (as set out in section 235 of the *Financial Services and Markets Act* 2000 (FSMA)). As raised by a number of respondents to the consultation, treating sukuk as Collective Investment Schemes would mean regulating sukuk issuers differently to issuers of conventional equivalents. As a result, issuers may need to seek authorisation from the Financial Services Authority (FSA) and there may be restrictions on the marketing and promotion of these instruments which, in turn, potentially places issuers of those instruments at a competitive disadvantage.

4.24 Some respondents to the consultation proposed that it may be more appropriate and create greater certainty if sukuk issued using an Ijara contract were explicitly treated as one of the broad categories of debt instruments, as specified under the Regulated Activities Order (RAO). Such an approach to the regulatory treatment would be consistent with focusing on the economic substance rather than the legal form of these instruments but would require the amendment of existing legislation.

4.25 The variety of contractual structures of the different types of sukuk presents a challenge to regulators. Fully acknowledging the need to provide as much regulatory clarity as possible, the FSA has continued to work closely with HM Treasury and industry on this issue. A series of roundtable discussions have been held by the FSA with city practitioners, lawyers and academics and the FSA has also discussed this issue with other national regulators, who are facing a similar challenge. HM Treasury and the FSA will continue to work closely on the regulatory treatment of sukuk within the UK.

HM Treasury and the FSA agree, in principle, that the Government's sukuk - and any other sukuk issued using the same contract used for the issuance of the Government's sukuk - should be regulated in the same way as a conventional equivalent. HM Treasury and the FSA are developing proposals to achieve this and may consult publicly later in the year. An update of progress will be provided in the 2008 Pre-Budget Report.

Risk weighting

4.26 The appropriate risk-weighting treatment for capital adequacy purposes under the Banking Consolidation Directive (BCD) and Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) of sukuk issued by the Government is currently under consideration by the FSA. Sukuk that were assessed as identical to their conventional equivalent would attract the same risk-weighting treatment as that equivalent which would mean, for example, that under the Standardised Approach, the sukuk would have a risk-weighting of 0 per cent.

4.27 A key issue is the economic exposure of the sukuk investor to the covenant of the Government. There are a number of exposure classes into which such an exposure could potentially fall. The classification of the sukuk for the purposes of European law – that is, under the BCD – is also relevant.

The FSA is currently considering the treatment of the sukuk for risk-weighting for capital adequacy purposes.

E. Listing issues

4.28 As set out in Chapter 3, respondents to the consultation stated that 'bond-like' sukuk would need to be listed in the same way as conventional equivalents, while some suggested that it would not be necessary to list 'bill-like' sukuk. While gilts are listed on the London Stock Exchange (LSE), Treasury bills are not. Amongst other features, listing requires the publication of a prospectus.

The Government intends to list sukuk in the same way that it would list their conventional equivalents.

F. Eligibility of the sukuk as collateral for the Bank of England's open market operations

4.29 Respondents to the consultation stated that both 'bill-like' and 'bond-like' sukuk would need to be classed as eligible collateral for the Bank of England's open market operations in the same way as their conventional equivalents if the sukuk were to be treated as identical to those conventional equivalents.

Eligibility of the sukuk as collateral for the Bank of England's open market operations is a matter for the Bank of England. The Government intends to take forward with the Bank of England the question of the eligibility of the sukuk as collateral for its open market operations.

G. Settlement and registration issues

4.30 Respondents to the consultation stated that both 'bill-like' and 'bond-like' sukuk would need to be registered and settled in the same way as gilts or Treasury bills if the sukuk were to be treated as being equivalent to existing conventional equivalents.

> The Government intends to work with Euroclear to ensure an appropriate settlement solution for sukuk, which would allow them to be settled in the CREST system. However, the Government recognises that any required systems changes could take a significant period of time, and will work closely with Euroclear to resolve this issue at the earliest opportunity.

H. Inclusion in the relevant indices ('bond-like' sukuk)

4.31 Respondents to the consultation stated that, in order to ensure the same treatment as conventional equivalents, sukuk would need to be included in the relevant bond indices.

> In the event that the Government did issue 'bond-like' sukuk, the Government would approach the relevant bodies to ask them to examine the case for inclusion of the sukuk in the relevant government bond indices.

J. Taxation issues - overview

4.32 A number of responses to the consultation noted the Government's reforms to the taxation of sukuk and the importance of those reforms in encouraging Islamic finance.

4.33 Prior to 2007, the taxation arrangements relating to sukuk differed from those relating to conventional debt securities. For taxation purposes, sukuk could be treated in a number of different ways according to the legal form of the transaction and this would have needed to be assessed on a case by case basis. The taxation arrangements, therefore, placed the issuers of – and investors in – sukuk at a competitive disadvantage to conventional equivalents and hampered the development of London as a world centre for Islamic finance.

4.34 As a result, in Budget 2007, the Government announced the introduction of a specific tax regime for sukuk. The *Finance Act* (FA) 2007 introduced two new sections in FA 2005, namely sections 48(A) and 48(B), dealing with 'debt-like' sukuk, which are referred to as 'alternative finance investment bonds'. The legislation sets out a number of conditions that must be satisfied.

4.35 If sukuk meet the conditions in FA 2005/s48A, conferring on them the status of alternative finance investment bonds, any 'interest-like' payments made or received under the bonds are treated as an alternative finance return.

4.36 For the purposes of corporation tax, alternative finance investment bonds are taxed under the rules on loan relationships (FA 2005/s50). For income tax purposes, alternative finance return received on such bonds is taxed as if it were interest (FA 2005/s51). For the purposes of capital gains tax, alternative finance investment bonds are taxed as qualifying corporate bonds and exempt from tax if they meet conditions equivalent to those for conventional securities to be qualifying corporate bonds.

4.37 As many, if not most, sukuk arrangements involve the creation of a trust, and are treated as collective investment schemes under FSMA 2000, the legislation provides that tax provisions relevant to trusts or to collective investment schemes do not apply.

4.38 Specifically, FA 2005/s48(B)(5) ensures that alternative finance investment bonds are not treated as a unit trust scheme either for the purposes of the *Income and Corporation Tax Act* 1988/s469 or the *Income Tax Act* 2007/s1007 or the *Taxation of Chargeable Gains Act* 1992; not treated as an offshore fund; and, for a company, are not a "relevant holding" in a unit trust or offshore fund for loan relationships purposes.

4.39 Furthermore, since the alternative finance investment bond must be listed on a recognised stock exchange, income payments can be made without withholding income tax in the same way that no income tax is withheld on interest paid on listed Eurobonds.

4.40 This legislation gives certainty about how sukuk holders or issuers are treated for income and corporation taxes, capital gains, capital allowances and withholding tax. However, these provisions did not cover stamp duty, SDRT or SDLT which are duties rather than taxes.

> The Government reaffirms its aim to ensure, as far as possible, neutral taxation treatment between sukuk and their conventional equivalents.

K. Stamp Duty Land Tax

4.41 Respondents to the consultation identified the implications for potential sukuk issuance under the current requirements to pay SDLT on the transaction. Specifically, sukuk may often be 'backed' by interests in land or property as the underlying asset. In comparable securitisations, the investor does not have a direct ownership share in the underlying asset, but merely an interest-bearing certificate, whereas, for the issuance of sukuk, investors own part of the underlying asset.

4.42 SDLT is a charge on the acquisition of a chargeable interest whether or not evidenced in writing. The issuance of a conventional bond secured on a building does not cause any SDLT payment to arise. However, in a sukuk structure, the originator, in order to ensure Sharia'a compliance, must transfer an asset to an SPV, so that the investors can own part of the underlying asset. SDLT would, therefore, be charged if a chargeable interest, such as a building, is transferred to an SPV that issues sukuk, and is charged again when the originator buys back the building or land. (SDLT is generally not chargeable on the rent payable by the sponsor to the SPV, as "sale and leaseback relief" should usually be available.)

4.43 Sukuk issuance using a 'plain vanilla' Ijara contract would currently be subject to SDLT charges at the following points with the following charges:

- SDLT charge 1 – SPV purchasing asset from originator. At this point, the purchaser (the SPV) will be liable for a chargeable consideration for the transaction at a rate of four per cent (assuming that the asset is valued at more than £500,000); and

- SDLT charge 2 – Originator purchasing asset from SPV. On the winding up of the sukuk, the originator would purchase the asset back from the SPV, at the point the purchaser (this time the originator) will be liable for a chargeable consideration for the transaction at a rate of four per cent (assuming that the asset is valued at more than £500,000).

4.44 This additional charge puts this structure at a disadvantage relative to its conventional equivalents.

> The Government is currently considering how best to address the differential treatment of sukuk under the SDLT regime through legislative changes. At Budget 2008, the Government reiterated its aim to legislate, following consultation, to provide relief from SDLT for alternative finance investment bonds in the Finance Bill 2009. A working group, comprising representatives of HMRC, HMT and experts in the finance and business sectors, is currently examining the issues, and a formal consultation paper will be published on 26 June 2008. The Government will announce the results of its consultation in the 2008 Pre-Budget Report.

L. Stamp duty and Stamp Duty Reserve Tax (SDRT)

4.45 Stamp duty is a tax payable on the transfer of certain types of documents/instruments, which transfer certain kinds of property. 'Property' mainly consists of stock or marketable securities, but also includes transfers of interests in partnerships. Stamp duty or SDRT may be charged at the rate of 0.5 per cent on the transfer of an instrument. A higher rate of 1.5 per cent is applicable when the documents/instruments are transferred into a 'depositary receipt scheme' or a 'clearance service'. These are special arrangements in which the documents are held by a third party.

4.46 Respondents to the consultation stated that stamp duty and SDRT may also act as a barrier to issuance and secondary market transfers. Under current tax legislation, the issue and/or transfer of the sukuk is likely to give rise to an SDRT payment on the basis that the sukuk would probably constitute chargeable securities as non-exempt loan capital or possibly "units in a unit trust scheme", which would cause them to fall within the definition of "chargeable securities" and thus within the scope of SDRT.

4.47 In addition, if the sukuk were held outside a clearance service and a written document was required in order to establish a transfer, then stamp duty may be payable. By contrast, the transfer of a 'plain vanilla' bond would be generally exempt from stamp duty and SDRT. This differential taxation treatment places the sukuk at a competitive disadvantage vis-à-vis conventional debt instruments.

> The Government is addressing this issue in the Finance Bill to help facilitate sukuk issuance and transfer. This legislation is set out in Clause 148 of the Finance Bill. It aims to extend the scope of the loan capital exemption from stamp duty in section 79(4) of the *Finance Act* 1986.

M. Value Added Tax (VAT)

4.48 Respondents to the consultation identified a number of VAT issues arising at various points in the process of sukuk issuance, depending on what the sukuk holder was considered to have obtained at the point of transfer and issuance.

4.49 As the investors in sukuk are described as having an 'undivided beneficial ownership interest' in the underlying asset, the investors may be subject to a VAT charge of 17.5 per cent on any rental payments received from the SPV and on their purchase of the sukuk. VAT payments may not be recoverable.

4.50 The taxation arrangements, therefore, place the issuers of – and investors in – sukuk at a competitive disadvantage vis-à-vis a conventional equivalent as they would not need to pay VAT.

> The Government recognises that there may be differences between the VAT liability associated with sukuk and conventional products. It will work with businesses to consider ways in which the difference in liability might be eliminated.

N. Roles and responsibilities of the SPV

4.51 Respondents to the consultation raised a number of issues pertaining to the operational arrangements of the SPV. These issues include:

- that the Government (as lessee of the asset from the SPV) would be expected to retain responsibility for the day-to-day operation and maintenance of the asset that it transferred to the SPV, which would be set out in a service agency agreement between the SPV and the Government;
- that, in the event of destruction or significant impairment of the asset that is transferred to the SPV, the Government could retain the right either to substitute that asset with an asset of equivalent value or terminate the sukuk by making remaining payments to sukuk holders in full;
- that insurance arrangements would need to be consistent with the Government's policy towards insurance of its assets and the responsibility for insurance within the arrangements for the SPV; and
- that it is possible to substitute assets held in the SPV for other assets during the life of the SPV providing that those assets were of the same value and Sharia'a compliant.

> The Government intends that the roles and responsibilities of the SPV, as regards the asset that is transferred into it, are consistent with the current arrangements for management of that asset and the requirements of Sharia'a law.

P. Ensuring Sharia'a compliance of the sukuk

4.52 The Government notes, as set out in Chapter 3, that respondents to the consultation indicated that the Sharia'a compliance of the sukuk could be achieved in a number of ways, including:

- the use of a board of internationally recognised scholars appointed by the institutions advising the Government on its issuance;
- the use of a board of internationally recognised scholars appointed by the Government; and/or
- the use of an internationally recognised Islamic standard-setting institution (such as AAOFI or the IFSB).

4.53 Some respondents to the consultation drew attention to the risk that the Sharia'a compliance of the issuance could be challenged following the issuance and the need for the appropriate disclaimer clauses to be included in the contractual documentation. A small number of respondents believed that it was inappropriate for the Government to issue sukuk or to take any action that could result in the incorporation of Sharia'a law into English law.

The Government has not yet decided its preferred way to ensure the Sharia'a compliance of sukuk issuance. The Government will pay careful attention to the views of respondents to its consultation, and the experience of other sovereigns, in reaching its decision.

The issuance of a sukuk does not require the incorporation of Sharia'a law into English law.

5 CONCLUSIONS

5.1 The responses to the consultation have been valuable in forming the Government's thinking on sukuk issuance. As set out in this paper, the Government has reached a number of decisions relating to potential sukuk issuance, including:

- that the balance of advantages and risks lies with 'bill-like' sukuk, although it does not rule out potential issuance of 'bond-like' sukuk;
- that a rolling programme of up to £2 billion of 'bill-like' sukuk would be achievable over time;
- that a 'bill-like' sukuk programme would be fully integrated with the conventional Treasury bill programme which currently has issuance at one, three and six month maturities; and
- that a 'plain vanilla' Ijara contract would be used to facilitate sukuk issuance.

5.2 In the Finance Bill currently before Parliament, the Government is taking powers to facilitate sukuk issuance.

5.3 The outstanding questions discussed elsewhere in this consultation response will need to be resolved before any announcement could be made that the Government will issue sukuk. It is also important to note that issuance would not automatically follow resolution of the outstanding questions but would be based on the Government's assessment of the costs, benefits and risks of so doing. The Government will continue to work on the structuring, value-for-money, regulatory, taxation and other issues identified in this paper. It will provide an update on the progress of this work in the 2008 Pre-Budget Report.

A Respondents to the consultation

ABN AMRO

Allen & Overy LLP

Association of International Accountants (AIA)

Bank of London and the Middle East

Barclays

British Bankers' Association (BBA)

BNP Paribas

CIMB Bank Berhad

Citi Markets and Banking

Credit Suisse

Cruickshank, Mrs Geraldine

DDCAP

Deloitte

Deutsche Bank

Dott, Mrs Jennie

European Islamic Investment Bank (EIIB)

Ernst & Young LLP

Euroclear

European Finance House

Gassner, Mr Michael Saleh

Gatehouse Capital

Goldman Sachs

HSBC

International Islamic Financial Market (IIFM)

Investment Management Association

Iqbal, Mr Imran

Islamic Finance Council

Lehman Brothers

London Stock Exchange

Moody's Middle East Limited

Morgan Stanley

Muslim Council of Britain

Norton Rose

PricewaterhouseCoopers LLP

Royal Bank of Scotland (RBS)

Royal & Sun Alliance Insurance Group (RSAIG)

Standard Life Investments

Scottish Widows Investment Partnership (SWIP)

UBS

West LB

Wilson, Professor Rodney

B LEGISLATIVE CHANGES IN THE FINANCE BILL

The Government is introducing legislative changes in the Finance Bill (in clause 151 and schedule 46) to facilitate Government sukuk issuance. These relevant extracts are shown below.

Clause 151

1. The Treasury may by regulations make provision for raising money through alternative finance arrangements.
2. Regulations under subsection (1) must specify the purpose or purposes for which money may be raised through each kind of alternative finance arrangements that, under regulations under subsection (1), is available for raising money.
3. The Treasury may not raise money through a particular kind of alternative finance arrangements unless, in the Treasury's opinion, raising the money would be in accordance with the provision made under subsection (2) in relation to that kind of arrangements.
4. Regulations under subsection (2) may, in particular, specify a purpose or purposes for which money may be raised under the National Loans Act 1968 (c. 13).
5. Money to be raised under regulations made under this section—
   a. may either be raised within or outside the United Kingdom, and
   b. may either be raised in sterling or in any other currency or medium of exchange, whether national or international.
6. Subsection (5) is subject to provision made in or under the regulations.
7. Schedule 46 contains further provision about regulations under this section.
8. In this section and Schedule 46 "alternative finance arrangements" means arrangements which in the Treasury's opinion—
   a. equate in substance to a loan, deposit or other transaction of a kind that generally involves the payment of interest (including the issuance of government securities), but
   b. achieve a similar effect to such a transaction without including provision for the payment of interest.

Schedule 46

Introduction

1. In this Schedule "regulations" means regulations under section 151.
2. Paragraphs 3 to 14 do not limit the generality of the power conferred by section 151.

Alternative finance arrangements that are to be available

3. (1) Regulations may make provision about the kind or kinds of alternative finance arrangements that are to be available for raising money.

(2) That includes provision specifying, or about the specification of, available arrangements (or any aspect of available arrangements).

Terms, conditions and procedures

4. (1) Regulations may make provision about—

(a) the terms on which money is to be raised through alternative finance arrangements,

(b) the conditions subject to which money is to be raised through alternative finance arrangements, and

(c) the procedures for the raising of money through alternative finance arrangements.

(2) That includes provision specifying, or about the specification of, terms, conditions or procedures.

Decisions to raise money through alternative finance arrangements

5. (1) Regulations may make provision about decisions by the Treasury to raise money through alternative finance arrangements.

(2) Regulations under this paragraph may, in particular, make provision about considerations that may be, must be, or must not be, taken into account in—

(a) deciding the terms on which to raise money through alternative finance arrangements,

(b) deciding whether or not to raise money through alternative finance arrangements, or

(c) deciding what amount of money to raise through alternative finance arrangements.

Involvement of persons other than the Treasury

6. (1) Regulations may make provision about the involvement of persons other than the Treasury in the raising of money through alternative finance arrangements.

(2) Regulations under this paragraph may, in particular, make provision for the Treasury to enter into arrangements with other persons.

Ancillary arrangements

7. (1) Regulations may make provision about ancillary arrangements.

(2) Regulations under this paragraph may, in particular, make provision about the terms or conditions of ancillary arrangements (including terms or conditions about payments).

(3) That includes provision specifying, or about the specification of, terms or conditions.

(4) In this paragraph "ancillary arrangements" means arrangements that are connected with the raising of money through alternative finance arrangements (including arrangements to facilitate or enable money to be raised through alternative finance arrangements).

Property

8. (1) Regulations may make provision about property to be employed in raising money through alternative finance arrangements.

(2) That includes provision—

(a) about selection of property,

(b) specifying, or about the specification of, property selected,

(c) about dealings with property, and

(d) about the holding of property.

(3) Regulations under sub-paragraph (2)(c) or (d) may, in particular, make provision about the terms on which property is to be dealt with or held (including terms about payments).

(4) That includes provision specifying, or about the specification of, terms or conditions.

(5) In this paragraph "property" includes land.

(6) In this paragraph a reference to a dealing with property includes—

(a) a transfer of property, and

(b) the creation or termination of a right, interest or estate in property (including a legal or equitable right, interest or estate).

Powers and duties

9. Regulations may confer powers, or impose duties, on any person (including the Treasury, the Secretary of State or another Minister of the Crown).

Liabilities

10. Regulations may make—

(a) provision for expenditure and other liabilities to be incurred in connection with raising money through alternative finance arrangements, and

(b) provision about how expenditure and other liabilities are to be met.

Money raised

11. (1) Regulations may make provision about the treatment of money raised through alternative finance arrangements.

(2) That includes provision specifying, or about the specification of, the account or fund into which money is to be paid.

Other legislation

12. (1) Regulations may make modifications of any enactment.

(2) Regulations may provide that available alternative finance arrangements are to be treated for the purposes of any enactment—

(a) as an investment or security of a particular description, or

(b) as an investment or security listed on a particular stock exchange.

(3) In this paragraph—

“available alternative finance arrangements” means alternative finance arrangements of a kind that, under regulations, are available for raising money;

“enactment” means an enactment contained in an Act or other instrument; “modifications” includes amendments, repeals and revocations.

Things to be done otherwise than in regulations

13. (1) The power under paragraph 3(2), 4(2), 7(3), 8(2)(b) or (4), or 11(2) to make provision about the specification of the matter mentioned there may, in particular, be exercised so as to provide for the Treasury or any other person to specify that matter otherwise than in regulations.

(2) Regulations may provide for the Treasury or any other person to do anything else otherwise than in regulations.

14. (1) This paragraph applies if regulations provide for a person to do something otherwise than in regulations.

(2) Regulations may make provision about considerations that may be, must be, or must not be, taken into account by a person in connection with the doing of that thing.

Regulations to be made by SI

15. Regulations are to be made by statutory instrument.

Parliamentary scrutiny

16. (1) A statutory instrument containing regulations that amend or repeal an

enactment contained in an Act may not be made unless a draft has been laid before, and approved by resolution of, the House of Commons.

(2) Subject to that, a statutory instrument containing regulations is subject to annulment in pursuance of a resolution of the House of Commons

(unless a draft of the statutory instrument has been approved by resolution of the House of Commons).

Interpretation

17. (1) In this Schedule, a reference to a person other than the Treasury includes a reference to—

(a) a body corporate established by or under regulations, and

(b) a company formed under the Companies Acts.

(2) For the purposes of sub-paragraph (1)(b), it does not matter—

(a) whether a company is formed specially in connection with the raising of money through alternative finance arrangements,

(b) whether a company is formed by the Treasury, or

(c) whether a company is independent of the Treasury.

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