



BANK OF ENGLAND

# Speech

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## **Why Islamic finance has an important role to play in supporting the recovery from Covid – and how the Bank of England’s new Alternative Liquidity Facility can help**

Speech given by

Andrew Hauser, Executive Director, Markets

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## Introduction

It's a privilege to be with you today to talk about the Bank of England's work on Islamic finance – and to announce the launch date for our new Shari'ah compliant non-interest based deposit facility, the first such account from a Western central bank.

The facility, in which deposits from Islamic banks will be backed by a return-generating fund of high quality Shari'ah compliant assets, will further strengthen the United Kingdom's role as the leading international financial centre for Islamic finance outside the Muslim world.

But it also goes deeper – because the core principles<sup>1</sup> of Islamic finance are strikingly well suited to responding to some of the biggest challenges we will all face in rebuilding our economy once Covid has passed. Prioritising equity-like risk-sharing over debt. Factoring ethical and environmental considerations into investment decisions. And embracing innovative financial solutions beyond traditional banking.

And that lies four square within the Bank of England's mission to promote the good of the people of the United Kingdom, Muslim and non-Muslim alike.

## Global growth in Islamic Finance

Islamic finance is a global success story, with assets of \$2.4 trillion in 2019 (Table 1). That's 11% higher than a year earlier, and fully a third bigger than in 2015.

**Table 1: Size and composition of Islamic Finance Services Industry (\$bn, 2019)**

Region	Banking Assets	Şukūk Outstanding	Islamic Funds' Assets	Takāful Contributions	Total	Share
GCC*	854.0	204.5	36.4	11.70	1,106.6	45.4%
South-East Asia	240.5	303.3	26.7	3.02	573.5	23.5%
Middle East and South Asia	584.3	19.1	16.5	11.36	631.3	25.9%
Africa	33.9	1.8	1.6	0.55	37.9	1.6%
Others	53.1	14.7	21.1	0.44	89.3	3.7%
<b>Total</b>	<b>1,765.8</b>	<b>543.4</b>	<b>102.3</b>	<b>27.07</b>	<b>2,438.6</b>	<b>100%</b>
<b>Share</b>	<b>72.4%</b>	<b>22.3%</b>	<b>4.2%</b>	<b>1.1%</b>	<b>100.0%</b>	

\*Gulf Co-operation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates).

Source: Islamic Financial Services Industry Stability Report 2020<sup>2</sup>

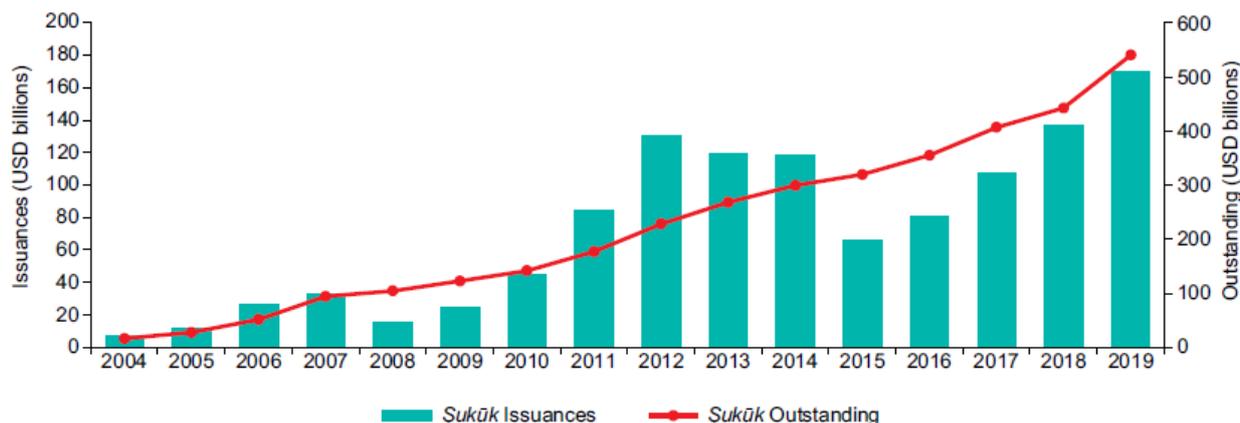
Three quarters of those Islamic finance assets are held by banks – and are large enough to play a

<sup>1</sup> For a summary of these principles, see eg <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/islamic-banks-and-central-banking.pdf?la=en&hash=15D94BD65C2EFA6962989D10E21543B7B7013C1C>.

<sup>2</sup> <https://www.ifsb.org/download.php?id=5724&lang=English&pg=/index.php>.

systemic role in thirteen countries.<sup>3</sup> There's also a nascent Islamic insurance industry (takaful) – and a much larger capital market, anchored around the growing stock of sukuk<sup>4</sup> issued by companies and governments (Chart 1), and over 1,500 Shari'ah compliant investment funds.

**Chart 1: Global sukuk issuance and stock outstanding**



Source: Islamic Financial Services Industry Stability Report 2020<sup>2</sup>

### The role of the UK and the Bank of England in supporting Islamic Finance

So far, so impressive. But what, you might ask, does all this have to do with the UK or the Bank of England, when the centre of gravity for Islamic finance lies in the Middle East, North Africa, South and South East Asia?

Well, the fact is that, outside those regions, the UK is *the* pre-eminent centre for Islamic finance. And that reflects its significant, well-established domestic Muslim population; its strong relationships with the wider Muslim world; and its deep expertise in financial market origination and distribution, embedded in a mature legal and regulatory framework.<sup>5</sup>

Indeed, Islamic finance in the UK goes back many decades (Table 2): from commodity-based short term liquidity management and trade finance in the 1970s, to the first UK Islamic bank, investment funds and takaful in the early 1980s.<sup>6</sup>

<sup>3</sup> Defined by the Islamic Financial Services Board as countries where at least 15% of banking assets are (self-declared as) Shari'ah compliant.

<sup>4</sup> Islamic financial instruments conferring direct partial ownership of underlying assets.

<sup>5</sup> See for instance '[Challenges and Opportunities for Islamic Banking and Finance in the West: the United Kingdom Experience](#)' by Rodney Wilson [1999, 2000] 7(1&2) *Islamic Economic Studies* 35-59; or '[Islamic Finance in the United Kingdom: Factors Behind its Development and Growth](#)' by Ahmed Belouafi and Abdelkader Chachi [2014] 22(1) 37-78.

<sup>6</sup> Al Barakah International Bank, Dar Al Mal Al Islami, and Takaful UK Ltd respectively.

**Table 2: Islamic finance in the UK – selected timeline**

1970's	London market brokers offer wholesale liquidity management using commodities
1982	Swiss-based Dar al Mal al Islami opens London office offering investment management services
1983	Establishment of first Islamic bank, Albaraka Bank (ceased 1993)
	Establishment of first UK Islamic insurance (takaful) company, Takaful UK Ltd
1996	Islamic mortgages offered in the UK by United Bank of Kuwait (now Ahli United Bank)
2003	HSBC Amanah launches Islamic mortgages and bank accounts in the UK
2004	Authorisation of Al Rayan Bank Plc (formerly Islamic Bank of Britain)
	Court case of Beximco vs. Shamil Bank of Bahrain establishes principle that secular authorities cannot opine on Shari'ah compliance
	Bank ABC offers Islamic mortgages under Al Buraq brand
2005	Children's Mutual launches Shari'ah compliant Child Trust Fund
	Lloyds TSB offers Shari'ah compliant current account
2006	Authorisation of European Islamic Investment Bank Plc (ceased in 2018)
	First sukuk listed on the London Stock Exchange (Tabreed, \$200m)
2007	Authorisation of Bank of London and the Middle East Plc
	Authorisation of investment firm Amiri Capital (ceased 2018)
	FSA outlines regulatory approach to Islamic finance in: "Islamic finance in the UK: regulation and challenges"
2008	Authorisation of QIB (UK) Ltd (formerly European Finance House)
	Authorisation of Gatehouse Bank Plc
	Authorisation of British Islamic Insurance Holdings/Principle Insurance (ceased 2013)
	Consultation paper CP08/22 establishes liquid asset buffer requirement for all UK banks
2012	Authorisation of ADIB (UK) Ltd (ceased 2020)
	HSBC Amanah exits UK market
2013	Authorisation of Cobalt Underwriting
	London hosts the World Islamic Economic Forum, the first time outside the Muslim world
2014	UK Government issues its first sovereign sukuk
	Authorisation of Investment firm Arabesque Asset Management
	TAM Asset Management launches Shari'ah compliant investment funds
2015	Islamic Insurance Association of London established
	Bank of England commences Shari'ah compliant facilities (SCF) project
2017	Authorisation of Shari'ah compliant crowd funding firm Yielders
	Columbia Threadneedle Investments launches Shari'ah compliant global equity fund
	Authorisation of Shari'ah compliant home finance firm Strideup Homes
2018	Al Rayan Bank issues first sterling denominated residential mortgage backed sukuk
2019	Registration of PrimaDollar Factoring, Shari'ah compliant trade finance firm
2020	Authorisation of Investment firm Wahed Invest
	Registration of several Shari'ah compliant e-money and payment services firms and agents, including: Niyah, Moneemint, Rizq
2021	<b>Planned launch of the Bank of England's Alternative Liquidity Facility (ALF)</b>

Sources: Bank internal analysis and FCA Register

I am proud to say that the Bank of England has been involved throughout those developments.

A key moment, which some of you will recall first-hand, came in 2003 when our then Governor, the late Sir Edward George, delivered a speech in which he talked about being touched by the plight of Muslim neighbours who had had to use a conventional interest-bearing mortgage to purchase their home, reluctantly and against their principles. He reflected on how sad and unnecessary this seemed, given the UK financial system's capacity for innovation in meeting the needs of different parts of society.<sup>7</sup>

To put that right, the Bank asked a senior working group drawn from the public and the private sectors to identify the changes needed to legal, tax and regulatory arrangements. Those changes formed the foundations of the system we have today. They were subsequently reinforced by a 2007 FSA paper articulating how Islamic finance could be fairly and consistently supervised within a secular regulatory framework.<sup>8</sup> Thirteen years later, one of the co-authors of that paper – Arshadur ('Ash') Rahman, known to many attending Islamic Finance Week – is the driving force behind our new facility.

The regulatory approach set out by Ash and his co-authors still applies today. A preference for principles over excessively rigid rules, able to respond to diverse and evolving markets, and reduce the scope for regulatory arbitrage. Avoiding unnecessary regulatory obstacles to Islamic finance, while giving no special favours. And recognising we are secular, not religious, regulators, who cannot opine on Shari'ah compliance,<sup>9</sup> and equally cannot disapply regulations either.<sup>10</sup> To deepen our international engagement further, the Bank of England joined the Islamic Finance Stability Board as an Associate Member in 2015.<sup>11</sup>

That approach has paid off. Today, the UK is home to four exclusively Islamic banks with assets of over £5bn, more than a dozen conventional banks offering Shari'ah compliant services, a host of investment firms, and a thriving advisory sector.

## **Islamic finance and Covid**

Of course there have been many challenges over the years – but none perhaps quite as serious as the Covid pandemic. The human cost has been enormous – as has the economic impact,

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<sup>7</sup> <https://www.bankofengland.co.uk/-/media/boe/files/speech/2003/edward-george-islamic-home-finance-seminar.pdf?la=en&hash=D2C5BC0A2C057ACCD9A8F40F74A7EBB742FE6C58>.

<sup>8</sup> [https://www.isfin.net/sites/isfin.com/files/islamic\\_finance\\_in\\_the\\_uk.pdf](https://www.isfin.net/sites/isfin.com/files/islamic_finance_in_the_uk.pdf).

<sup>9</sup> This point was made in the judges' commentary to the 2003/2004 court cases of Beximco and others vs Shamil Bank of Bahrain: <http://www.bailii.org/ew/cases/EWCA/Civ/2004/19.html>.

<sup>10</sup> So, for example, the basis of any assertion that a product is Shari'ah compliant must be communicated to the customer, as must all decision-relevant information, in a way that is clear, fair, and not misleading.

<sup>11</sup> [https://www.ifsfb.org/membership\\_org.php?org=1](https://www.ifsfb.org/membership_org.php?org=1).

particularly in parts of the Muslim world. I know that some worry that Covid might slow the pace of growth in Islamic finance, as economic activity declines, and market participants revert to more conventional tools to meet the daunting financing needs of the crisis.

But that needn't be so – because key aspects of Islamic finance make it particularly well suited to financing the post-Covid recovery:

- First, the philosophical focus on equity-like sharing of risk and reward will become increasingly relevant as market participants get to grips with the scale of debt accumulated in response to Covid. The attractions of debt are obvious when interest rates are so low – particularly for those able to lock in long-term fixed rates in local currencies. But those borrowing at floating rates, at short maturities, or in foreign currencies, face sharp negative income shocks when rates rise, debt rolls over, or local currencies depreciate. Risk-sharing contracts, including those promoted by Islamic finance, pose materially lower medium-term risks to stability.<sup>12</sup> The Bank of England has long advocated the risk-sharing merits of GDP-linked instruments, which could be packaged in sukuk form.<sup>13</sup> And, together with HM Treasury and the FCA, we have recently announced a high-level working group to consider ways to foster a longer-term financial markets culture to support productive investment.<sup>14</sup>
- Second, Islamic finance seeks to avoid investing in socially detrimental activities. In fact, it was pro-ESG before the term was ever invented! Issuance of so-called 'green sukuk' has risen sharply in the past three years (Chart 2) – and the Islamic Development Bank issued an innovative \$1.5bn sustainability sukuk in June.<sup>15</sup> But these are still quite modest numbers relative to the vast sums of money now looking to invest in credible ESG assets.<sup>16</sup> So there's plenty of scope for further growth.
- Third, the prohibition on many forms of traditional banking in Islamic finance should naturally spur exploration of more innovative forms of intermediation. There's great interest in exploring the scope for Islamic fintech like Shari'ah compliant e-money platforms and

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<sup>12</sup> On this topic, see "Why Economists (and Economies) Should Love Islamic Finance" by Willem Buiter and Ebrahim Rahbari (2015): <https://willembuiter.com/if.pdf>.

<sup>13</sup> See for instance <https://bankunderground.co.uk/2020/06/24/pricing-gdp-linked-bonds/> and 'The Case for GDP-linked Sukuk' by Arshadur Rahman in 'Sovereign GDP-Linked Bonds: Rationale and Design' [2018], edited by Robert Schiller, Jonathan Ostry and James Benford.

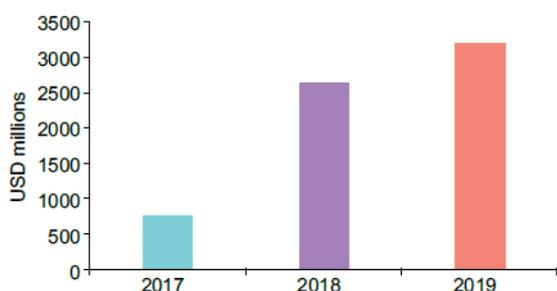
<sup>14</sup> <https://www.bankofengland.co.uk/news/2020/november/hmt-boe-and-fca-convene-working-group-to-facilitate-investment-in-productive-finance>.

<sup>15</sup> <https://www.isdb.org/news/islamic-development-bank-issues-us-15-billion-debut-sustainability-sukuk-in-response-to-covid-19>.

<sup>16</sup> I discussed these themes in a speech in October 2020: <https://www.bankofengland.co.uk/speech/2020/andrew-hauser-the-investment-association-viewpoint>.

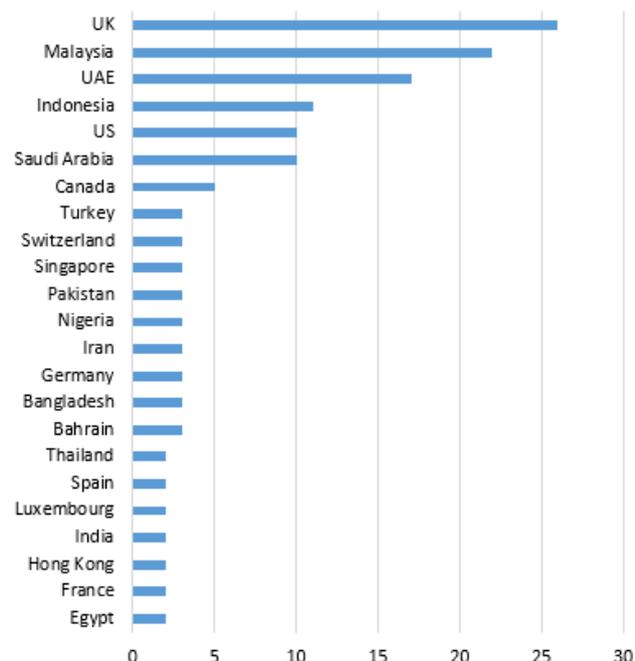
peer-to-peer lenders, to tackle a range of issues, including financial inclusion.<sup>17</sup> The UK is a world leader in this sector (Chart 3).

**Chart 2 Green sukuk issuance**



Source: Islamic Financial Services Industry Stability Report 2020<sup>2</sup>

**Chart 3 Number of Islamic finance fintech firms by country**



Source: data from <https://ifnfintech.com/landscape/>, and Bank calculations.

### The challenges of managing liquidity in Islamic finance banks

As well as supporting the safe development of new types of Islamic finance, we also recognise some of the challenges facing more established parts of the sector.

Islamic banks, for instance, have long faced profound challenges in efficiently managing their liquidity, and it's here that the Bank of England's new non-interest based central bank deposit facility is designed to help level the playing field.

All banks need to manage expected and unexpected outflows, eg as depositors make payments and withdrawals. Conventional banks hold a range of high-quality liquid assets to meet those obligations, including cash and central bank reserves; government and corporate debt; and asset backed securities and commercial paper. They can also borrow in secured and unsecured money markets and, as a backstop, from central banks.

<sup>17</sup> [http://documents1.worldbank.org/mwg-internal/de5fs23hu73ds/progress?id=wYC7RO1Zn\\_OM1VWkvBTqgxD-6WoVnUCIPU3q5WCRi6Y.&dl](http://documents1.worldbank.org/mwg-internal/de5fs23hu73ds/progress?id=wYC7RO1Zn_OM1VWkvBTqgxD-6WoVnUCIPU3q5WCRi6Y.&dl).

But Islamic banks' prohibition on the payment or receipt of interest means they can't access many of these tools. To avoid being caught short, they have historically had to structure their business in inherently narrow or inefficient ways, for example by holding large stocks of non-interest bearing cash, or limiting their offerings of short-term deposits.

Ironically this left them relatively well placed to weather the Global Financial Crisis of 2008-09: in aggregate UK Islamic banks remained liquid, in a market where liquidity was otherwise very scarce. But they found it harder to adjust to the post-crisis 'Basel 3' liquidity rules, which gave centre stage to the very instruments they were prohibited from holding, including government bonds, such as UK gilts and US Treasuries, and remunerated central bank reserves accounts.

To meet this challenge, the Basel liquidity rules give national supervisors discretion to treat sukuk as High Quality Liquid Assets (HQLA), subject to haircuts or other conditions. The consequent increase in demand for sukuk from banks was one factor boosting issuance in recent years. But the proportion of sukuk classed as eligible for regulatory buffers remains relatively modest compared to demand. As a result, while sukuk can provide a reliable medium-term store of value, the relative scarcity of HQLA-eligible stock can give rise to uncertain price movements, especially in stressed markets, reducing the value that is readily realisable, and making it harder for banks to increase their holdings quickly when required.

All of this means that Islamic banks can face a somewhat uneven playing field relative to conventional banks when it comes to liquidity management. Unable to use liquid gilts or interest-bearing reserves accounts at the Bank of England to meet short-term outgoings, they have tended to hold inefficiently high stocks of cash at zero return, or higher-yielding but somewhat less liquid sukuk.

### **The design and launch of the Bank of England's Alternative Liquidity Facility**

That's where our new Alternative Liquidity Facility (or 'ALF') should make a real difference.

Initially we had hoped Islamic banks might be able to use our normal reserves accounts, by agreeing to forgo any interest paid – as many observant Muslim customers do on their retail bank deposits. But on further investigation this proved unworkable: reserves accounts were too intimately bound up with the concept of interest, given their core role in implementing monetary policy. And the disparity in return offered to Islamic and non-Islamic banks at higher levels of Bank Rate would have left a decidedly uneven playing field.

Work therefore commenced in 2015 to assess the feasibility of establishing a standalone non-interest based facility. Recognising the limits of the Bank's knowledge of Islamic finance, we drew

on the expertise of fellow central bankers across the Middle East and Asia, including those from Bahrain, Malaysia and the UAE.

In light of that research, we triaged a number of potential models to gauge which might fit best with the specificities of the UK market, legal and regulatory environment. We consulted publically on those options in 2016, and again in 2017 to fine tune our intended approach.<sup>18</sup>

Today, after a long and comprehensive process, I'm pleased to announce that the Alternative Liquidity Facility will be open for business from the first quarter of 2021. The new facility will provide UK Islamic banks (and indeed any other UK banks with formal restrictions on engaging in interest-based activity) with greater flexibility in meeting HQLA requirements, enabling them to hold a reserves-like asset in a non-interest based environment.

The ALF will be structured as a wakalah or fund-based facility: a commonly used model in Islamic finance (Chart 4). In simple terms, that means that participant deposits will be backed by a fund of assets, the return from which, net of hedging and operational costs, will be passed back to depositors in lieu of interest.

The strengths of this model include its relative simplicity – conceptually and practically – and its flexibility to accommodate future changes in what is a still fast-developing market. The ALF will grow as the UK Islamic bank sector grows. And it will be well placed to exploit the growing diversification of available HQLA-eligible sukuk assets.

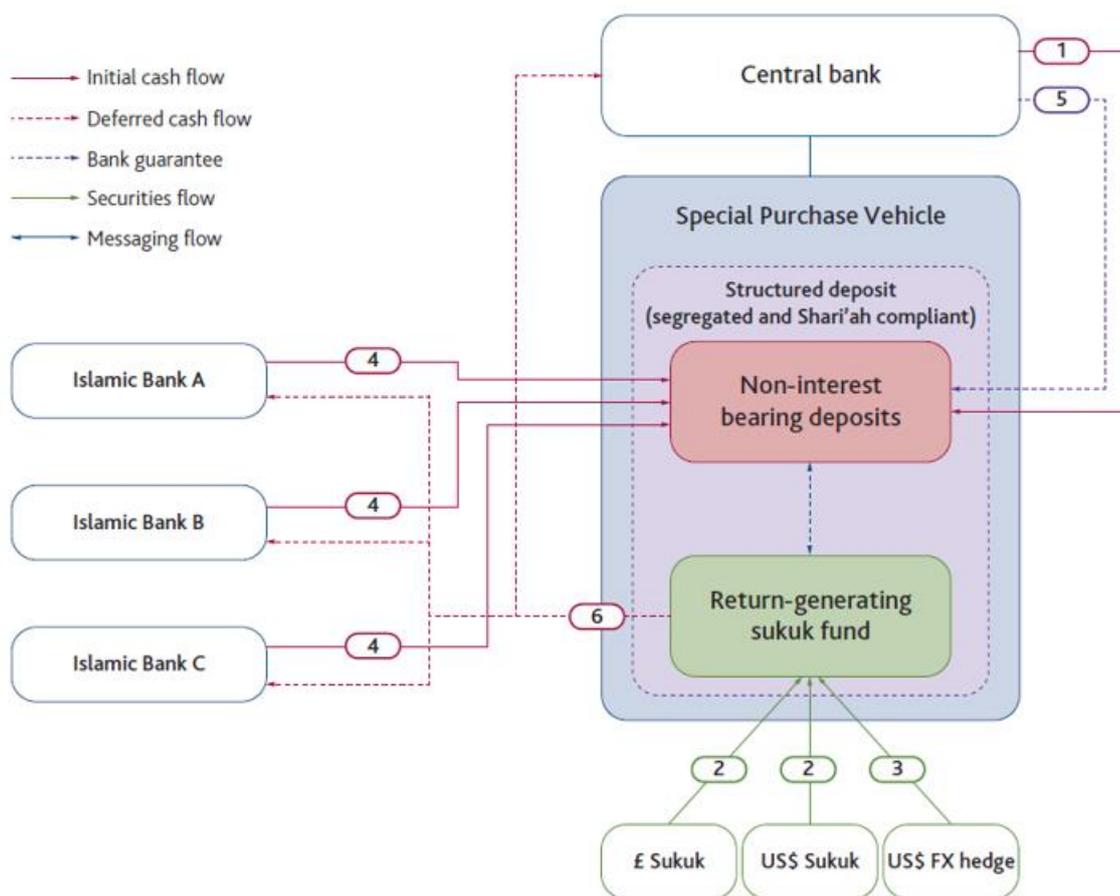
Over the coming months, we will finalise legal documentation, complete our operational testing and begin the onboarding process for eligible applicants. Firms should expect to commence this work from January 2021.

Once operational, the ALF should help put the UK Islamic finance sector on a more level footing with the rest of the market, giving firms here greater flexibility in meeting their liquidity requirements, and helping them to compete with conventional peers while staying true to their founding principles.

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<sup>18</sup> <https://www.bankofengland.co.uk/-/media/boe/files/paper/2016/establishing-shariah-compliant-central-bank-liquidity-facilities-consultation.pdf> and [https://www.bankofengland.co.uk/-/media/boe/files/paper/2017/scf\\_consultationpaper2017.pdf?la=en&hash=E6C1BCEE76AF3812D1985B911E0D29A0DA8A5043](https://www.bankofengland.co.uk/-/media/boe/files/paper/2017/scf_consultationpaper2017.pdf?la=en&hash=E6C1BCEE76AF3812D1985B911E0D29A0DA8A5043).

**Chart 4 How the ALF will work<sup>19</sup>**



We've come a long way since Eddie George's speech almost 20 years ago. But one thing that remains more important to us than ever is working with you. The liquidity facility I've described here today is in no small part a product of close and committed co-operation between the Bank, industry bodies and the private sector. It's a real step forward, but it's only one step. Through continued engagement and focused effort, together we can build a more innovative, diverse and inclusive marketplace: one which really can meet the needs of every part of our society.

Thank you

<sup>19</sup> In the first instance, (1) the Bank pre-funds the ALF with an interest-free loan, which is used (2) to purchase eligible sukuk and (3) any hedges required to insulate the fund from FX risk. Islamic banks then (4) place deposits in the ALF, the principal value of which is (5) guaranteed by the Bank to ensure the facility is HQLA-compliant. In the event the aggregate value of participating bank deposits do not reach the aggregate value of the fund, the Bank will step in as co-depositor for the residual amount. The rate of return on the deposit (6) is based on the rate of return on the portfolio backing it, net of hedging and other operational costs; and on maturity the return from the fund is paid over to participating banks, and the principal amount is returned or rolled over.