



**National Savings and Investments (NS&I)**

**Sharia'a Compliant Savings Review**

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## **Executive Summary**

On 23 April 2007, the Government announced a review of the feasibility of offering Sharia'a compliant products in support of its two objectives for Islamic finance: to establish London as a gateway for international Islamic finance and to promote financial inclusion, irrespective of religious beliefs.

NS&I's review has comprised four workstreams and has sought to identify the most appropriate route to develop a retail Sharia'a compliant offer.

Despite the growing number of players entering the UK Islamic banking market, currently only the Islamic Bank of Britain offers Sharia'a compliant retail savings products.

The adult Muslim population is estimated to be approximately 1.4 million. Research suggests that 4% of adult Muslims have a staunch demand for Sharia'a products, and another 21% might select these products if they were widely available, indicating the potential for a strong demand from 350,000 adult Muslims.

In structuring a Sharia'a savings product the most suitable front-end contracts between NS&I and the customer are likely to be either Mudaraba or Wakala, with a final decision to be reached following consultation with both Sharia'a scholars and the FSA.

In identifying and assessing appropriate underlying assets three structures were considered: investing in the government sukuk, creating a Special Purpose Vehicle through which funds would be invested, and investing in Sharia'a compliant assets through a non-government counterparty. The review concluded that utilising the government sukuk is the most straightforward and cost effective of these options.

Industry opinion suggests the need for a potential return which is competitive with non-Sharia'a products.

The analysis concluded that scale was the most effective way to improve the return to customers, as the fixed costs would be spread across a broad base. To achieve a return of 4.6% to 4.9% would require annual inflows of £350m. Below this level, fixed costs have a greater effect on potential returns and consequently the amount invested by customers. Analysis indicated flows of £20m p.a. with a return to customers of 2.9 – 3.2%.

Whilst the aim would be to stimulate the market, the flows required to maximise the return offered to customers may have a negative impact by crowding out competitors or potential new entrants.

A Direct Savings Account was considered the most appropriate offer in order to help minimise costs and improve the potential return for customers hence attract as broad a customer base as possible.

To meet customer demand for withdrawals, not all of the funds would be invested (liquidity reserve). The impact of holding this reserve is to reduce the returns offered to customers by 30 – 60 bps. The development of a secondary market for the government sukuk would reduce the size of the reserve fund required and improve the return for customers.

NS&I attempted to achieve scale by broadening the appeal to include the ethical market, which has a strong overlap with Islamic principles and is an established and sizeable retail market. To offer a compelling ethical proposition the asset must have a clear and strong ethical link, such as a wind farm or solar power technology. The

review concluded there were insufficient strongly ethical government assets available, and therefore the dual-positioned proposition does not appear feasible.

The feasibility study identified a number of risks and issues that would need to be addressed in order to progress a retail Sharia'a offer:

- New primary legislation would be required to allow hypothecation, NS&I to purchase and own assets and retain investment earnings.
- One of NS&I's key brand values is security, which is embodied by the 100% guarantee on all products. NS&I could not offer this guarantee on a Sharia'a retail product. This would need to be managed carefully to prevent brand erosion.

The review therefore concluded that the decision be revisited in 18 months to allow for the launch of the UK government sukuk, the development of a secondary market for the sukuk, and to gauge its impact on the development of the Islamic retail savings market.

## Background

1. On 23 April 2007, the Government announced a review of the feasibility of offering Sharia'a compliant products to the wholesale and retail markets conducted by DMO and NS&I respectively.
2. The government has two objectives for Islamic finance.
  - On the wholesale side the objective is to establish London as a gateway for international Islamic finance, which was identified by the Chancellor's High-Level Group as a key potential growth area for the City.
  - On the retail side, the objective is to promote financial inclusion, irrespective of religious beliefs.
3. Sukuk issuance (Islamic bonds) can help achieve both of these objectives.
4. NS&I's Sharia'a review has comprised four elements:
  - Understanding the Sharia'a rules and how these may be used to develop offers
  - Sizing the target market
  - Assessing the costs of making these offers
  - Identifying risks to both NS&I and the government
5. The findings of this review are as follows.

## **Islamic Savings in the UK**

### **Supply**

6. Prior to 2003, the only Islamic banking products available in the UK were offered either by UK-based branches of Middle Eastern banks such as the National Bank of Kuwait or by relatively small institutions such as the West Bromwich Building Society acting as an introducer to an existing provider.
7. In 2003, HSBC launched its Amanah current account and home finance products, becoming the first UK high street bank to offer Sharia'a compliant products. Since then, Lloyds TSB has also launched a range of Islamic retail banking products including primarily current accounts and home finance.
8. The Islamic Bank of Britain (IBB) was authorised by the FSA in 2004, and is the first wholly Sharia'a compliant<sup>1</sup> retail bank in the UK. The European Islamic Investment Bank, the first such investment bank also operates within the UK and is authorised by the FSA.
9. Despite this growing number of players entering the UK Islamic banking market, they have predominantly focussed on wholesale business, with retail offerings largely limited to home finance and current accounts.
10. IBB is to date the only player to have launched a retail savings product in the UK.

### **Demand**

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<sup>1</sup> As opposed to banks such as HSBC that operate an Islamic window i.e. an Islamic banking business that is partially ring-fenced from, but run alongside conventional, non-Islamic banking activities

11. The current Muslim population of the UK is estimated to be approximately 2 million<sup>2</sup>.  
Of these, approximately 1.4 million are above 16 years of age.
12. Socio-economic data shows that a high proportion of Muslims are less economically active compared with the general population trends. This suggests that the Muslim saving population is likely to be lower than the 1.4 million aged over 16.
13. Research<sup>3</sup> suggests the market might be divided into three segments:
- Those for whom Sharia'a compliant products are the only option ("staunch demand"). Some 4% of Muslim adults demonstrate staunch demand.
  - Those who might choose Sharia'a products if they were widely available. A further 21% show this preference. Discussions with other banks during the feasibility study suggested that attracting this additional 21% requires a rate competitive with conventional products.
  - Those who continue to use conventional products
14. Assuming a saving population of 1.4 million; the strongest demand for Sharia'a compliant savings products is likely to be seen from approximately 350,000 people. Assessment of the potential for a retail Sharia'a offering has not been restricted to the strongest demand group alone.

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<sup>2</sup> Estimates are based on 2001 Census data and analysis of organic population growth and immigration trends

<sup>3</sup> Demand for Islamic financial services in the UK: Chasing a Mirage? Loughborough University - 2004

## **Structuring an Islamic Savings Product**

15. The structure of an Islamic savings product comprises two key elements, the front-end contract between the customer and the financial institution and the back-end investment strategy.

### **Front-end Considerations**

16. There are three contracts that NS&I could potentially use at the front-end: Mudaraba, Musharaka, or Wakala.

- Mudaraba is a contract between a 'fund manager' and investors, and is based on principles of profit and risk sharing.
- Musharaka is a partnership contract based on principles of profit and loss sharing and therefore requires a capital contribution from each partner.
- Wakala is an agency contract, under which one party acts as an agent for another and takes an agency fee (as opposed to a share of profits).

17. The most suitable contract for NS&I is likely to be either a Mudaraba or a Wakala, because neither contract requires capital investment from NS&I (unlike Musharaka). Although there are technical differences between the two for example the treatment of returns for taxation purposes, and the timing and form of returns to NS&I - from the customer perspective, there is little difference between them. The main difference is how the rate of return and NS&I's share of that return are communicated.

18. A final decision as to which contract to use would only be made after consultation with Sharia'a scholars and the FSA.

### **Back-end Considerations**

19. Irrespective of whether a Wakala or Mudaraba structure is chosen the key requirement is for funds to be invested in a physical asset that is Sharia'a compliant. This means the investor must not earn interest from the asset, but must earn a return derived directly from the productive use of the asset, such as profit from activities, or rental income.

20. In addition, the asset must not be associated with activities considered immoral or socially detrimental, such as alcohol and tobacco or gambling.

21. This would necessitate a number of changes to legislation to allow funds to be hypothecated and invested into a specific asset, instead of being pooled with other funds into the National Loans Fund as currently happens with monies raised by NS&I.

22. There are three ways the return could be generated:

**a. Invest in UK Government Sukuk (Sharia'a compliant T-bills)**

- This involves NS&I acting as an investment manager, pooling customer funds and investing them in the wholesale sukuk. The return to customers would be generated from maturity payments from the sukuk.
- This option supports the government objective of using the sukuk to stimulate the retail Sharia'a market. However, the feasibility of this option clearly depends on a regular issuance of a short term bill-like sukuk.

**b. Invest through a Special Purpose Vehicle (SPV) into a physical government (or non-government) asset**

- Again acting as an investment manager NS&I pools customer deposits and invests them into an SPV (the SPV issues one share to the fund of customer money).

- The SPV uses the funds to purchase beneficial title to an asset. The beneficial title is then leased back to the relevant government department (or non-government owner), with the lease payments providing a return to customers. [Note that this process would need to be repeated on a regular basis, to allow for investment of new funds as customers add to their investments].
- Each contract would require an option to be dissolved upon NS&I request in order to meet withdrawal requirements. The owner of the asset, whether a government department or non-government entity, would need to commit to re-purchasing the beneficial title sold, upon dissolution of the contract - to provide a return of capital to investors.
- In addition, agreement would need to be reached on an exemption from the various forms of stamp duty and VAT taxation which would otherwise make the option unfeasible. The additional costs of these taxes would reduce the potential returns for customers.

### **c. Invest in non-government Sharia'a compliant instruments**

- Acting as investment manager NS&I uses pooled customer funds to invest in Sharia'a compliant assets (e.g. Guaranteed Equity Bonds, stocks, commodities) through a non-government counterparty.
- This option introduces a risk to the NS&I brand - counterparty risk.
- Commodity trades have become a common form of Sharia'a compliant investment. However, liquidity issues persist as a market for overnight trades has yet to develop in the UK.
- This practice has also been criticised by Sharia'a scholars who view commodity trades as a means of synthesising interest payments

(particularly where dual contracts of purchase and forward sale are between the same party)

23. The Sharia'a compliant T-bill option is the most straightforward approach and appears to be the most suitable for a potential NS&I retail offer.

Whilst this creates a dependency on the development of the UK government sukuk, it is unlikely NS&I would be able to develop the SPV structure any quicker than the DMO, as the same issues such as stamp duty, VAT, and the asset transfer process have to be addressed.

## Potential Returns

24. Two potential options for delivery have been evaluated:

- using the government sukuk as the underlying asset
- using an SPV to deliver returns

25. Analysis was conducted based on:

- An instant access savings account (in order to attract as broad a customer base as possible)
- A direct offer: while we included analysis of a branch-based offer, the focus turned to an account that could only be purchased and managed via telephone and internet to help minimise costs and thereby increase the potential return for customers.

26. Using the government sukuk as the underlying asset we assumed a return of 5.74% in the following analysis.

27. Unless and until a liquid secondary market is established for the government sukuk, NS&I would need to maintain a liquidity pool as a reserve from which to draw funds to meet customer withdrawals during the term of each T-bill issue.

28. The size of the reserve requirement, as a percentage of total stock, will depend largely on the frequency and term length of the sukuk, but forecast estimates show that for a 1-3 month rolling issuance the reserve fund is likely to cost between 30 and 60 basis points.

29. Waiting until a secondary market has established in the government sukuk would improve the potential return. This would reduce the size of the reserve fund required and therefore improve the return to customers by 30 – 60bps,

30. Industry opinion suggests that, to attract the broadest range of customers, a rate of return comparable to non-Sharia's savings accounts is required.
31. We therefore analysed the level of business we would need in order to achieve sufficient scale to absorb the fixed costs and thereby offer a more attractive potential return.
32. With £350m in annual inflows resulting in stock of £1.8bn by year 5, a potential return of 4.6% to 4.9% could be achieved with 3mth and 1mth liquidity costs respectively, or 5.2% if a secondary market is established.
33. For a branch-based savings account with an average balance of £2,000, this would require 175,000 new customers per year, reaching a total 875,000 by year 5.
34. For a direct account average balances tend to be higher and assuming an average balance of £9,900, this would require approximately 35,000 new customers per year, reaching a total of 180,000 by year 5.
35. These flows appear challenging as the rates offered would remain some way behind the current market-leading non-Sharia savings accounts.
36. Flows below this required level reduce the rate that can be offered and are likely to have the effect of depressing flows further. Analysis indicates a relatively modest flow of around £20m p.a. with a potential rate of return to customers<sup>4</sup> of between 2.9 and 3.2%.
37. The second option was to develop an offer based on an SPV.
38. There would be additional set-up costs for the SPV route resulting in a lower potential return to customers.

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<sup>4</sup> Note: this is a steady state return (return during start-up period would be considerably lower without the use of seed capital; based on the assumption of a 1 to 3 month rolling sukuk issuance

39. The SPV route would also incur the 30 to 60bps cost of holding a reserve to manage liquidity. However, unlike the sukuk route there is no potential for a secondary market to develop, and therefore mitigate this cost

40. It is likely the ongoing costs would also be higher utilising an SPV, due to the need to repeat the more complex purchase and lease arrangement to enable the investment of new funds. This would reduce potential returns further.

## Broader Investigations

41. NS&I's sole remit is to deliver cost effective financing for Government. In 2006/7 over £5.6bn of Net Financing was raised including sales of over £8.4bn for Premium Bonds, £2.1bn of Saving Certificates and £0.6bn of Income Bonds respectively, and value added (the measure of cost effectiveness) of £337m was achieved.
42. To fit with the remit any new product must be able to deliver cost-effective financing for Government. The analysis undertaken highlights the challenge in developing a retail Sharia'a offer with the potential to raise significant financing.
43. In an attempt to resolve the strategic and economic challenges discussed above, investigations were broadened to try to identify other ways in which compliant offers may be made.
44. Options have been explored to gain scale by designing a Sharia'a compliant product that would have broader appeal. By increasing scale fixed costs would be shared across a broader base thereby increasing potential returns for customers.
45. A logical choice is the "ethical" investment market, which is growing rapidly and has strong overlap with Islamic principles of fairness, and moral investment.
46. High level analysis indicated that if a strong ethical proposition could be developed, stock of up to £2 billion could potentially be achievable by year 5.
47. It is unlikely that the government sukuk would be a suitable investment option for this proposition given that none of the available government assets large enough to back the sukuk represents an "ethical" investment proposition.
48. In order to offer a compelling "ethical" proposition, the SPV approach would be required to enable customer funds to be invested into physical ethical assets such

as wind farms, solar power technology etc. (whether a government or privately owned).

49. Using an SPV would require the issues referred to in paragraph 22 to be resolved before it could be progressed.

50. Three routes have been explored to do this:

- Government assets
- PFI
- Private Sector

51. Government Assets

There appears to be a very limited number of strongly ethical assets on the government books that would be suitable for the offer. Assets such as land, schools and hospitals may appeal to investors on the basis of “public good” but would not represent the “strongly ethical” proposition required to achieve sufficient scale benefits.

52. PFI

PFI projects were ruled out on the basis that a Sharia’a compliant structure will introduce an additional layer of complexity to an already complex public procurement route. This would introduce additional costs.

In addition, a Sharia’a compliant structure would likely increase procurement times and undermine the risk management objectives on which PFI is based.

53. Private Sector

While it may be possible to achieve a wider appeal using a non-government asset, (e.g. private sector wind farm) this introduces additional risks, including counterparty risk and government investment in private sector projects.

Furthermore, investigation revealed that it would be difficult to structure a contract for project finance that fits the requirements of an instant access proposition in terms of money flow.

For these reasons this option was not explored in detail

54. A dual positioned “Ethical” and Islamic savings proposition does not appear feasible.

## **Additional Issues and Risks**

55. In addition to the economic challenges a Sharia'a compliant product presents, a number of other issues and risks have been considered.

### **Legislation**

56. New primary legislation would be required

- To allow hypothecation: to allow the funds to be invested in a specific asset rather than being transferred to the National Loans Fund to be used generally for government investment expenditure.
- To allow NS&I to purchase and own assets
- To allow NS&I to retain investment earnings

### **Brand Risk**

57. Under Sharia'a law, NS&I would not be permitted to provide a capital guarantee to customers. This has the potential to damage the NS&I brand, which is founded on the 100% guarantee it offers customers.

58. The risk can be mitigated to some extent by allowing customers the option of declining the guarantee.<sup>5</sup>

### **Impact on Competitors**

59. There is a risk relating to the potential impact that NS&I entering the market may have upon current players. If NS&I was successful it could potentially result in crowding out of the fledgling Sharia'a compliant retail savings market. Whilst there is

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<sup>5</sup> In the same way that that IBB offers its customers the option of declining to use the Financial Services Compensation Scheme

no direct evidence to suggest that NS&I's entry would lead to churn within the market, there is no strong evidence to suggest it would stimulate the market.

### **Requirement for Seed Capital**

60. After the initial launch, as stock is accumulating, there would be periods of time during which only a small proportion of customer funds are invested because of the sukuk issuance schedule.

61. To mitigate the impact of this on the return to customers NS&I would require seed capital to invest in the sukuk

62. The requirement for seed capital, based on forecasts of ~£20 million net inflows per year are:

- For a 1 month rolling sukuk issuance: ~£2 million (equivalent to 1 month's worth of expected inflows) for a period of 15 months
- For a 3 month rolling issuance: ~£6 million (3 months' worth of expected inflows) for a period of approximately 60 months

63. For the annual inflows of £350m required to achieve sufficient scale, seed capital of £87.5m for the 3 month issuance and £29.2m for the 1 month, would be required for equivalent periods.

### **Requirement for a Call of Last Resort on NLF Funds**

64. Even using the above liquidity management process, NS&I would need the option of a Call of Last Resort on NLF funds for extreme situations (for example, if all customers withdrew funds at the same time). This would need to take the form of an interest-free loan from the NLF, to ensure Sharia'a compliance.

## Summary

65. In order to balance the need to minimise costs and attract as broad a customer base as possible the most suitable option for an NS&I Islamic savings product is likely to be an instant access savings account based on investment in the government sukuk.
66. Whilst this creates a dependency on the development and launch of a government sukuk, it will lead to lower costs as it removes the need to create and manage the SPV. However, the taxation issues regarding the creation of an SPV will need to be resolved to enable the development of the government sukuk.
67. The development of a secondary market for the sukuk will reduce liquidity management issues, thereby improving the potential return for customers by 30-60bps, and potentially increasing demand.
68. Therefore the potential development of a retail offer by NS&I should be delayed until this point to maximise the potential return customers could receive and thereby increase demand for the offer.
69. This would also provide the best opportunity to achieve the scale required to fit with NS&I's remit of providing cost-effective financing.
70. However it is unclear whether the development of a Sharia'a compliant retail offer by NS&I would have the desired effect of stimulating the market. Indeed, the risk is that, in order for NS&I to generate the scale to meet its remit, it may have a negative impact by damaging the performance of existing players, and deterring the entry of potential new ones.

71. Therefore further work will be undertaken once the government sukuk and secondary market is established, or in eighteen months time whichever is sooner, to understand the extent to which NS&I offering a retail product will stimulate the market and the impact this will have on organisations which offer sharia'a compliant retail savings products.

National Savings and Investments

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