

OVERVIEW

The global market for Islamic financial services, as measured by sharia compliant assets, is estimated by IFSL to have reached \$951bn at end-2008, 25% up from \$758bn in 2007 and three quarters up on the 2006 total (Chart 1). However, 2009 may have seen a pause following strong growth of previous years. Commercial banks account for the bulk of the assets with investment banks, sukuk issues, funds and takaful making up the balance.

Key centres are concentrated in Malaysia and the Middle East including Iran, Saudi Arabia, Malaysia, Kuwait, UAE and Bahrain (Chart 2). Islamic finance is also developing in Asian countries such as Bangladesh, Pakistan and Indonesia, as well as North African countries such as Sudan and Egypt. The UK, in 8th place, is the leading Western country and Europe’s premier centre with \$19bn of reported assets, largely based on HSBC Amanah. Assets in other Western countries are currently small but a number of countries, particularly France, are looking to develop a presence in Islamic finance.

While the Islamic finance industry initially has been less affected by the financial crisis and global economic downturn, there are ongoing challenges, particularly for the sukuk market and for some Islamic banks. The sukuk market fell back in 2008, but despite recovery in issuance to \$20bn during 2009, is being tested by its ability to deal with several defaults. A \$10bn loan by Abu Dhabi staved off the threat of a potential default by Dubai World on its repayment on the Nakheel \$4bn sukuk in December 2009. Quality issuers of sukuk continue to attract demand from investors.

Islamic banks have not been immune to the effects of the financial crisis and downturn: some have suffered a higher rate of non-performing loans than conventional banks, mainly due to their exposure to falling real estate markets. Revenue and profitability has suffered in both 2008 and 2009 and liquidity is a significant restraint for some banks.

While London has been providing Islamic financial services for 30 years, it is only in recent years that this service has begun to receive greater profile. An important feature of the development of London and the UK as the key Western centre for Islamic finance has been supportive government policies intended to broaden the market for Islamic products. The outcome is reflected in the establishment of various aspects of Islamic finance in the UK:

- 22 banks including five that are fully sharia compliant, more than in any other Western country. Two Islamic banks were granted licences in 2008.
- 20 Sukuk issues raising \$11bn listed on London Stock Exchange, exceeded only by Dubai Nasdaq.
- Seven sharia compliant exchange-traded funds (ETFs).
- 20 law firms supplying services in Islamic finance.
- Advisory services provided by Big Four professional service firms.
- Institutions offering educational and training products in Islamic finance.
- Off-exchange trading in commodity-based agreements linked to LME contracts.

Chart 1 Global assets of Islamic finance

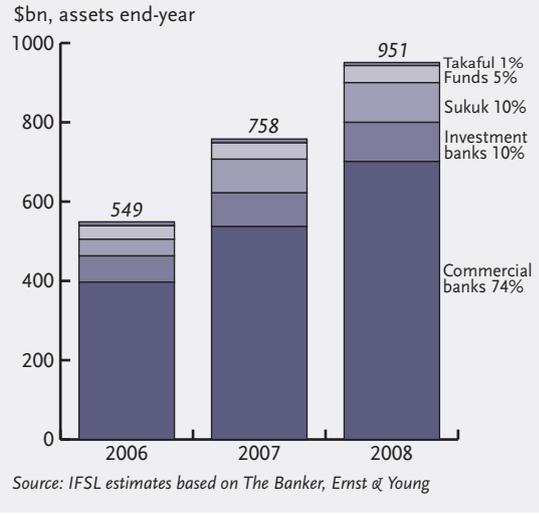
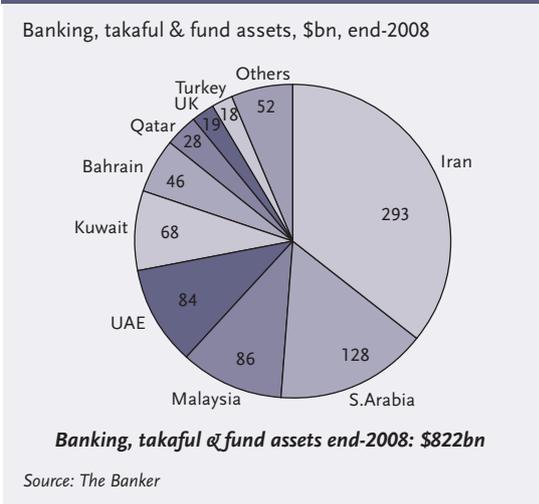


Chart 2 Geographic breakdown of Islamic finance



GLOBAL MARKET FOR ISLAMIC FINANCE

As mentioned in the overview, IFSL estimates that the global market for Islamic financial services, as measured by sharia compliant assets, is estimated to have reached \$951bn at end-2008, 25% up from \$758bn in 2007 (Chart 1). Assets have grown from about \$150bn in the mid-1990s. Islamic commercial banks accounted for 74% of the assets, investment banks 10%, sukuk issues also 10%, funds 5% and takaful 1%.

Assets that can be allocated to individual countries from The Banker's survey of 500 organisations reveal that the leading countries for sharia compliant assets are Iran with \$293bn, Saudi Arabia \$128bn and Malaysia \$87bn (Table 1). These are followed by other Gulf states including UAE, Kuwait, Bahrain and Qatar. The UK, in 8th place, is the leading Western country with \$19bn of reported assets, largely based on HSBC Amanah. Countries with most of the 302 firms reporting to The Banker's survey include Malaysia with 37, Bahrain 34 and Kuwait 30. Iran, Sudan, Saudi Arabia and Indonesia each have between 20 and 23 firms supplying Islamic finance (Table 1).

Broadening geographical customer base for Islamic services The market is currently most developed in Malaysia, Iran and the majority of countries that form the Gulf Co-operation Council (GCC). However, Islamic finance is moving beyond its historic boundaries in these countries into new territories. Markets where Islamic finance is developing include:

- Other countries in the Middle East and North Africa such as Turkey, Sudan, Egypt, Jordan and Syria.
- Other Asian countries such as Indonesia, which has the largest indigenous Muslim population in the world, as well as Hong Kong, Singapore, Bangladesh, Pakistan and China.
- Western countries in Europe and North America. Countries such as the US, France, Germany and the UK each have indigenous Muslim populations of between one and five million, although Russia has much the largest in Europe with 30m. The customer base in Western countries is not necessarily restricted to Moslems: other customers may be attracted by the ethical and environmental basis of Islamic finance.

Following the lead set by the UK, other Western countries, such as Japan and France, are looking to make the appropriate regulatory and legal reforms that would facilitate provision of Islamic financial products. London is seeking to consolidate its position as the gateway to Islamic finance in Western Europe. Providers in London are likely to focus on services that complement those available in other centres. Government strategy for the development of Islamic finance in the UK is set out on page 7.

Sharia compliant financial services

Banking and sukuk - the issue of Islamic notes - represent the forms of Islamic finance that are most well established, although takaful (insurance) and funds are also evolving. Products that may be the subject of innovation include private equity and private wealth management.

Table 1 Islamic finance by country

Banking, takaful & fund assets, \$bn, end-2007 & end-2008						
	Total 2007	Total 2008	Banks	Takaful	Others	Number of firms*
Iran	235.3	293.2	290.6	2.6	---	23
S.Arabia	92.0	127.9	127.1	0.8	---	20
Malaysia	67.1	86.5	84.4	2.1	---	37
UAE	49.1	84.0	83.0	1.0	---	18
Kuwait	63.1	67.6	57.4	0.2	10.0	30
Bahrain	37.4	46.2	44.2	0.4	1.6	34
Qatar	21.0	27.5	25.3	0.4	1.8	16
UK	18.1	19.4	19.4	---	---	6
Turkey	15.8	17.8	17.8	---	---	4
Bangladesh	5.7	7.5	7.5	---	---	15
Sudan	5.3	7.2	7.0	0.2	---	22
Egypt	5.7	6.3	6.3	---	---	3
Pakistan	6.3	5.1	5.1	---	---	18
Jordan	3.3	4.6	4.5	---	0.1	6
Syria	0.6	3.8	3.8	---	---	2
Iraq	---	3.8	3.8	---	---	1
Indonesia	3.4	3.4	3.2	0.2	---	20
Brunei	2.7	3.2	3.2	---	---	1
Others	7.2	7.1	6.5	0.4	0.2	26
Total	639.1	822.1	800.1	8.3	13.7	302

*Includes only those firms submitting data to survey
Source: The Banker

Banking Islamic banks have been perceived favourably since the onset of the financial crisis in 2008 as they have been less exposed to losses from investment in toxic assets. However, they have not been immune from the effects of the crisis and the subsequent economic downturn. Some Islamic banks have suffered a higher rate of non-performing loans than conventional banks, mainly due to their exposure to falling real estate markets. Revenue and profitability has suffered in both 2008 and 2009 and liquidity is a significant restraint for some banks.

In its World Islamic Banking Competitiveness Report 2009/10 McKinsey & Company recommended that many Islamic banks need to take action in a number of core areas in order to:

- Enhance and diversify their business mix, by tapping into new business lines such as personal finance asset management and various areas of investment banking.
- Upgrade risk management in order to address credit and liquidity constraints. This would also include avoiding excessive exposure to real estate.
- Reduce operational costs and improve service quality to maintain competitiveness.
- Explore growth opportunities in the international markets, especially where any excess capital can be better deployed in underdeveloped markets.

Islamic banks compete not only with each other but also with all other banks offering conventional finance, particularly those that have established Islamic 'windows'. In the Banker's survey, balance sheet assets of sharia compliant banks rose 29% from \$622bn in 2007 to \$800bn in 2008, of which \$701bn were in commercial banks and \$99bn in investment banks.

In the UK, five fully sharia compliant banks have been established putting it in the lead in Western Europe (Table 2). The Islamic Bank of Britain (IBB) became the first stand-alone retail Islamic bank in the country in 2004 and was followed between 2006 and 2008 by The European Islamic Investment Bank (EIIB), The Bank of London and The Middle East (BLME), European Finance House and Gatehouse Bank. IBB is the only bank with a high street presence having eight branches and around 50,000 customers. EIIB provides investment banking services including trade finance, private equity and asset management. BLME offers Sharia compliant investment, corporate and private banking to businesses and high net worth individuals globally. European Finance House offers a range of investment products and services to clients that include companies and wealthy investors. Gatehouse Bank is a wholesale investment bank operating in capital markets, institutional wealth management, Treasury business and advisory services.

In addition to the five sharia compliant banks, there are an estimated 17 conventional banks that have set up windows in the UK to provide Islamic financial services (Table 2). HSBC Amanah is the only conventional bank with an Islamic window to report to the Banker's survey: its assets of \$16.5bn account for 85% of the UK's identified assets, with a further 6% from BLME and 4% from the HSBC parent bank

Table 2 Islamic banks in UK

Fully sharia compliant	
Bank of London and The Middle East	
European Finance House	
European Islamic Investment Bank	
Gatehouse Bank	
Islamic Bank of Britain	
Islamic windows	
Ahli United Bank	
Alburaq	
Bank of Ireland	
Barclays	
BNP Paribas	
Bristol & West	
Citi Group	
Deutsche Bank	
Europe Arab Bank	
HSBC Amanah	
IBJ International London	
J Aron & Co.	
Lloyds Banking Group	
Royal Bank of Scotland	
Standard Chartered	
UBS	
United National Bank	

Table 4 Islamic banks in western countries & offshore centres

Number located in each country	
UK*	22
US	9
Australia	4
France	3
S. Africa	3
Switzerland	3
Canada	1
Cayman Islands	1
Germany	1
Ireland	1
Luxembourg	1
Russia	1

Source: The Banker *IFSL estimate for UK

Table 3 Assets of Islamic banks in UK

Shariah compliant assets, \$m	Year-end				% change 2008-09
		2006-07	2007-08	2008-09	
HSBC Amanah Finance	Jun-09	13960	15194	16537	9
Bank of London and the Middle East	Jun-09	1279	1196	1119	-6
HSBC	Jun-09	---	570	698	22
European Islamic Investment Bank	Jun-09	757	648	555	-14
Islamic Bank of Britain	Jun-09	289	337	394	17
European Finance House	Jun-09	---	94	n.a.	---
Gatehouse Bank	Dec-08	---	15	108	610
Total		16285	18055	19411	8

Source: The Banker

(Table 3). The 22 Islamic banks in the UK substantially exceeds that in any other western country or offshore centre (Table 4). The UK market for Islamic mortgages has grown to about £500m, some 0.3% of the total UK mortgage market.

Sukuk are issues of Islamic notes that represent an alternative to conventional bonds. Issuance of sukuk increased rapidly from \$1bn a year in 2002 to \$34bn in 2007 (Chart 3). In common with the broad-based slowdown in global capital market activity, sukuk issuance fell away during 2008 to \$15bn, as a result of a decline in asset valuation, a lack of liquidity and a lack of market confidence. The ruling from the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) that questioned the sharia compliance of some sukuk structures also acted as a break on issuance in 2008.

Sukuk issuance rose from the low point of Q4 2008 to reach \$6bn in each of Q3 & Q4 2009, resulting in an annual total of \$20bn, up by 30% on 2008. Most issuers in 2009 have been government or quasi government organisations. Uncertainty has arisen from the financing problems at Dubai World, resolved for the time being by a \$10bn loan from Abu Dhabi. This has brought concerns about settlement of sukuk defaults into focus with key issues set out in the side panel. In the meantime, quality issuers of sukuk are continuing to attract demand from both Islamic and non-traditional investors.

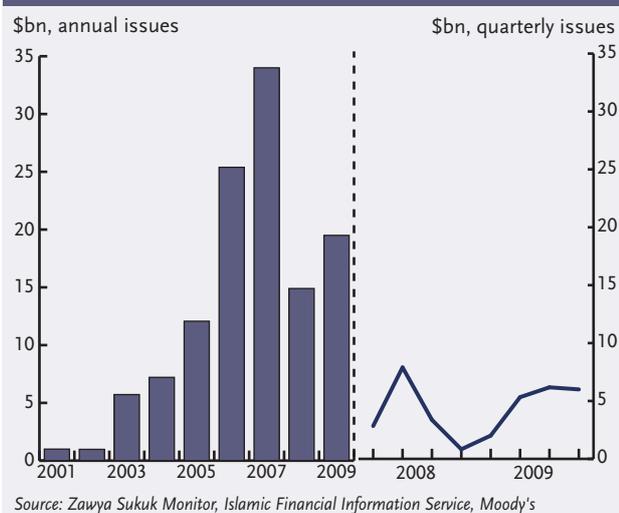
Malaysia is the main country in the global market, but Indonesia and Singapore have come into the market more strongly in 2009. According to Islamic Financial Information Service (IFIS), the main factors hindering revival of the sukuk market in the GCC are troubled Kuwaiti investment companies, the real estate market in the UAE and the availability of credit in Saudi Arabia.. There was one sukuk listing in Nasdaq Dubai and two on the London Stock Exchange in 2009. This has brought the Dubai total at end-2009 to 21 listings totalling \$18bn and to 20 listings in London worth \$11bn.

Long term prospects for sukuk are positive, with three factors having a role in fostering growth in demand when market conditions improve:

- There is a commitment to a substantial programme of infrastructure investment in the GCC totalling up to \$1,000bn over the next ten years, some of which will be financed through Sukuk.
- Recent years have shown that there is an appetite and demand for investment in Sukuk that goes well beyond Islamic investors amongst those investors that wish to gain exposure to diverse but high quality assets.
- Governments and regulators in a variety of countries have recognised the important role that Sukuk can play in capital markets and have been giving priority to developing their countries as Sukuk centres. In addition to Dubai and the UK, these include Bahrain, Hong Kong, Malaysia, Japan, Pakistan, Singapore and South Korea.

Islamic funds The market for Islamic funds has been expanding steadily. EurekaHedge estimates that the total number of sharia compliant funds reached 680 funds by end-2008 having risen more than threefold from around 200 in 2003. Ernst & Young estimates that the total value of these funds has

Chart 3 Sukuk global issuance



Managing sukuk defaults

The sukuk market is having to deal with its first defaults following those by Saad, Investment Dar and the East Cameron Gas Company. A default by Dubai World on its Nakheel sukuk was narrowly averted.

Underlying concerns remain as sukuk defaults have yet to be tested in the courts. With regard to Dubai World, SJ Berwin noted that 'there is no guidance on whether any of the many types of security provisions granted under a sukuk issue of this nature are legally enforceable'. The firm also note that 'key sukuk documents are governed by English law and there is a risk that the Dubai courts may choose not to enforce judgements by English courts'.

There may also have been an assumption among investors that the Dubai government would step in to meet payment obligations if Dubai World encountered financial difficulties, although the prospectus indicated that Dubai World does not offer any such guarantee. In the event a \$10bn loan by Abu Dhabi staved off the threat of a potential default by Dubai World on its repayment on the Nakheel \$4bn sukuk in December 2009. However there may be a need for refinancing in the medium term.

If a satisfactory settlement on defaults can be reached eventually, particularly with respect to how sukuk holders are treated, it will provide an important test of the market. It could be potentially beneficial in the longer term to the sustainability and development of the sukuk market if regulators, practitioners and investors learn from the outcome.

grown from \$20bn in 2003 to \$44bn in 2008 (Chart 4). Equity funds account for the largest segment: 40% of funds, with fixed income 16% and real estate & private equity 13% (Chart 5). Cash, commodities and other funds make up the balance. Over half of funds, 58%, are invested in a portfolio covering the Middle East and Africa. A further 20% are in a global portfolio, 15% in Asia, 6% in America and the residual 1% elsewhere.

The bulk of Islamic funds are small scale with two thirds being less than \$100m and many of these having attracted only \$10m to \$15m. The domicile of funds is heavily concentrated with nearly two thirds of the total number of funds being in five jurisdictions: Malaysia 23%. Saudi Arabia 19%, Kuwait 9%, Luxembourg 7% and Bahrain 6%. Cayman, Ireland and Indonesia each account for a further 3-4% each, but the remaining 25% is divided between a further 23 countries, including 1% in the UK.

Eurekahedge estimates that the average return on Islamic equity funds was 22% in 2009, recovering from an average drop of 28% in 2008. This was close to the return on the global equity index, up 25% in 2009 following a fall of 37% in 2008. The largest Islamic equity funds, according to Failaka, are the US-based Amana Funds, which it estimates account for 95% of Islamic funds in the US totalling \$2.3bn in 2009.

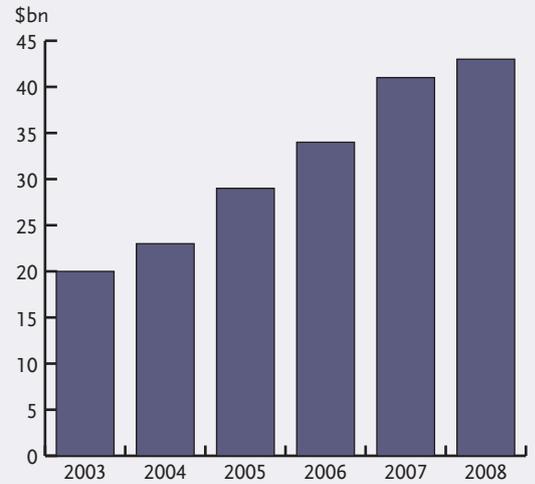
There has been a substantial decline globally in the number of new fund launches since the 2007 peak. In the UK new offerings in 2009 have included:

- BLME launching a sharia compliant money market fund, the first of its type to be launched in Europe.
- Qatar Islamic Bank - European Finance House launching its Global Sukuk Plus Fund.
- Gatehouse Bank and DDCAP announced the launch of a fund in early 2010 to invest capital in structured trade finance transactions. DDCAP is a wholesale Islamic market intermediary company.

This followed a more active year in 2008 when four exchange traded funds (ETFs) were listed on the London Stock Exchange. Other offerings in 2008 included a fund of equity funds, the first of its type globally by SEI; the first sharia compliant retail capital-protected equity fund in the UK by Alburaq; and the launch by FTSE Group of the FTSE Bursa Malaysia Hijrah Sharia Index, in association with Bursa Malaysia.

Takaful, similar to mutual insurance, is a risk sharing entity that allows for the transparent sharing of risk by pooling individual contributions for the benefit of all subscribers. The global market remains at an early stage of development and is estimated at \$8.3bn in 2008, up from \$6.6bn in 2007 (Chart 6). Iran, where takaful is the compulsory form of insurance, is the largest market, with assets totalling \$2.6bn (Table 1). It is followed by Malaysia, with premiums of \$2.1bn, UAE \$1.0bn and Saudi Arabia \$0.8bn. Together, these four countries account for over three quarters of the global market. Smaller markets for takaful with annual premiums of over \$100m have developed in Kuwait, Bahrain, Qatar, Sudan and Indonesia. Penetration of takaful is nevertheless low in these and other countries with Islamic majorities. Takaful represents a strong growth opportunity, particularly with regard to life insurance, as sharia compliant products are developed.

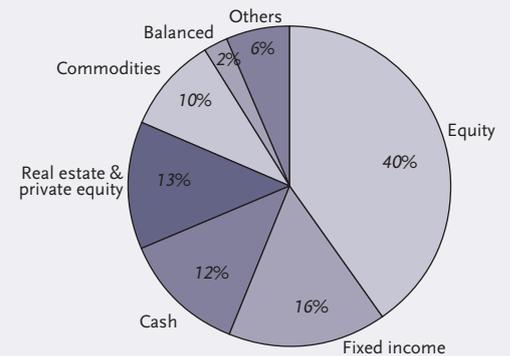
Chart 4 Islamic funds worldwide



Source: Ernst & Young Islamic Funds & Investments Report 2009

Chart 5 Global asset distribution by type of fund

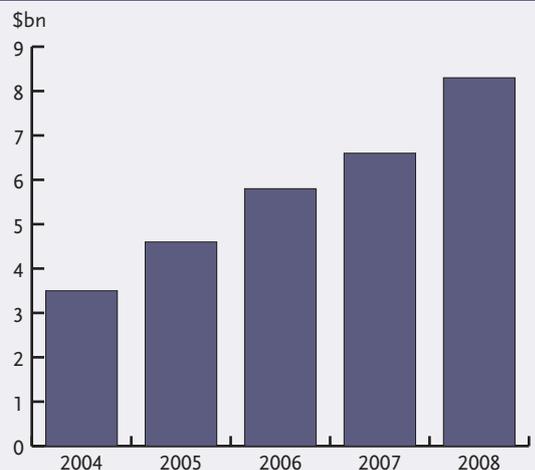
Distribution of Islamic assets, \$bn, end-2008



Islamic fund assets end-2008: \$43bn

Source: Ernst & Young Islamic Funds & Investments Report 2009

Chart 6 Takaful global premiums



Source: Ernst & Young, The Banker

The takaful market in the UK remains at an early stage of development. Principle Insurance, authorised by the FSA in 2008, was the first sharia compliant independent takaful company in the UK, but it stopped taking new business in 2009. The remaining takaful available in the UK is restricted to HSBC Amanah's home insurance offering. Prudential was given approval in 2006 to launch a takaful business in Malaysia in partnership with Bank Negara Malaysia.

Other financial products The range of products generated by Islamic finance has broadened steadily. In the UK in 2007 Merrill Lynch structured the first sharia compliant credit default swap for a UK power company involving GCC investors. In 2008, Barclays Capital and Sharia Capital Inc. of the US launched the first Islamic fund of hedge funds. Sharia compliant public private partnerships (PPP) are also under consideration.

The UK has a successful record as a trading centre for Islamic products as commodity-based LME contracts are traded off exchange. This has been a key mechanism for Islamic financial institutions to manage their assets and liabilities. In 2008 ETF Securities launched a sharia compliant precious metal exchange trade commodity platform, based on platinum, palladium silver, gold and a basket of other metals.

Law firms The UK is a major global provider of the specialist legal expertise required for Islamic finance, with 20 major law firms providing legal services in Islamic finance (Table 5).

Professional service firms The Big Four professional services firms - PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte - have each established an Islamic finance team in London providing specialist services including advice on tax, listings, transactions, regulatory compliance, management, operations and IT systems.

Education and training There is a growing demand for skills as Islamic finance expands and UK institutions are at the forefront of providing qualifications for the global industry.

Courses in Islamic finance are offered by the Chartered Institute for Securities and Investment (CISI), Chartered Institute of Management Accountants, Association of International Accountants, Cass Business School and the Institute of Islamic Banking and Insurance. These courses have been key to the development of Islamic finance qualifications in the UK. One new development in January 2010 has been the launch by Aston Business School of an Islamic Finance and Business Centre.

In a separate initiative, the Islamic Finance Council UK has developed a pioneering 'Scholar Professional Development Programme' in conjunction with the CISI. The objective of the course is to teach conventional finance to Shariah scholars worldwide. Partners for this programme include the Central Bank of Bahrain and the International Shariah Research Academy for Islamic Finance (ISRA) that is backed by Malaysia's Central Bank.

Beyond Islamic finance, the UK education offering that majors in Islam spans the full range of qualifications starting from 16 year-old school level through vocational and career-based qualifications as well as undergraduate and postgraduate degrees.

Table 5 Law firms in UK offering Islamic finance legal services

Allen & Overy LLP
 Ashurst LLP
 Baker & McKenzie LLP
 Berwin Leighton Paisner LLP
 Clifford Chance LLP
 Dechert LLP
 Denton Wilde Sapte
 Eversheds LLP
 Herbert Smith LLP
 King & Spalding International LLP
 Linklaters
 Lovells LLP
 Milbank, Tweed, Hadley, & McCloy LLP
 Norton Rose LLP
 Simmons & Simmons
 SJ Berwin LLP
 Stephenson Harwood
 Taylor Wessing LLP
 Trowers & Hamblins LLP
 White & Case LLP

Source: Chambers @ Partners

GOVERNMENT STRATEGY FOR DEVELOPMENT OF ISLAMIC FINANCE IN THE UK

London has been providing Islamic financial services for 30 years, although it is only in recent years that this service has begun to receive greater profile. An important feature of the development of London and the UK as the key Western centre for Islamic finance has been supportive government policies intended to broaden the market for Islamic products for both sharia compliant institutions and firms with 'Islamic windows' (see side panel).

A key aspect of supportive government policy has been the establishment since 2003 of an enabling fiscal and regulatory framework in the UK for Islamic finance. There have been a number of initiatives which are intended to form part of a continuing process:

- The removal in 2003 of double tax on Islamic mortgages and the extension of tax relief on Islamic mortgages to companies, as well as individuals.
- Reform of arrangements for issues of bonds so that returns and income payments can be treated 'as if' interest. This makes London a more attractive location for issuing and trading Sukuk.
- Initiatives by the Financial Service Authority to ensure that regulatory treatment of Islamic finance is consistent with its statutory objectives and principles.

Following a review into the case for issuing sharia compliant government bonds, the UK Government announced in November 2008 that this would not offer value for money at the present time. The situation has since been kept under review by the Government. Investors would welcome a UK Government sukuk as it would provide more liquidity in the secondary market and act as a benchmark for UK companies that might consider issuing sukuk.

During 2009 the UK Government has been following through on other initiatives designed to support the UK as a centre for global finance and to ensure conventional and alternative finance are treated on the same basis. Specifically, it has been undertaking a consultation on the legislative framework for those alternative finance investment bonds (AFIBs) or sukuk that are structured to have similar economic characteristics to conventional debt instruments. Following this consultation, the Government announced on 21 January 2010 that it intends to introduce measures to provide 'clarity on the regulatory treatment of corporate sukuk, reducing the legal costs for these types of investments and removing unnecessary obstacles to their issuance'.

BARRIERS TO DEVELOPMENT OF ISLAMIC FINANCE

The global development of Islamic finance requires that further progress is made in addressing a number of barriers. These may be broadly grouped within the following headings including: taxation and regulation; standardisation; awareness; and skills. More details on these barriers are detailed in the The December 2008 UK Government paper on 'The development of Islamic finance in the UK: the Government's perspective'.

Government policy on the development of Islamic finance in the UK

"The Government's policy objectives for Islamic finance are clear. First, to establish and maintain London as Europe's gateway to international Islamic finance. Second, to ensure that nobody in the UK is denied access to competitively priced financial products on account of their faith. The Government's approach to achieving these objectives is characterised by the principles of fairness, collaboration and commitment.

Significant progress towards meeting these objectives has been made. The UK is now the leading centre for Islamic finance outside of the Gulf Cooperative Council and Malaysia. London and Birmingham now host the only standalone Islamic financial institutions in the EU. UK consumers can now access a wide range of Shariah compliant retail financial products and services, which are regulated to the same standard as conventional financial products, conferring the same degree of consumer protection"

Source: HM Treasury 'The development of Islamic finance in the UK: the Government's perspective', December 2008

Islamic finance: principles & development in the modern era

Principles The underlying financial principles in Islamic finance have remained unchanged historically since their development over 1,400 years ago. Financial products must be certified as sharia compliant by an expert in Islamic law. Certification requires that the transaction adheres to a number of key principles that include:

- Backing by a tangible asset, so as to avoid 'speculation' (gharar).
- Prohibition of interest payments (riba).
- Risk to be shared amongst participants.
- Limitations on sale of financial assets and their use as collateral.
- Prohibition of finance for activities deemed incompatible with sharia law (haram), such as alcohol, conventional financial services, gambling and tobacco.

Modern development Modern Islamic finance emerged in the mid-1970s with the founding of the first large Islamic banks. Development initially occurred through marketing of a steadily expanding supply of sharia compliant financial instruments. This supply-driven model contributed to relatively slow growth until the mid-1990s, since when demand has increasingly driven the development of Islamic financial instruments. Rising awareness and demand for Islamic products, along with supportive government policies and growing sophistication of financial institutions, have together raised the rate of growth.

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IFSL Research:

Report author: Duncan McKenzie

Director of Economics, Duncan McKenzie
d.mckenzie@ifsl.org.uk +44 (0)20 7213 9124

Senior Economist: Marko Maslakovic
m.maslakovic@ifsl.org.uk +44 (0)20 7213 9123

International Financial Services London
29-30 Cornhill, London, EC3V 3NF

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Andrew McHallam,
Deputy Chief Executive
a.mchallam@ifsl.org.uk +44 (0)20 7213 9121

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