

Islamic finance has been developed in its modern form over the past three decades, although its key principles, as set out in the side panel, remain unchanged. This IFSL report features the countries and sectors that are leading the way as well as setting out the challenges to its further development around the world. London is establishing itself as the key Western centre of choice for Islamic finance.

GLOBAL MARKET FOR ISLAMIC FINANCE

The global market for Islamic financial services, as measured by Sharia compliant assets, is estimated to have reached \$531bn at end-2006, having grown by over 10% a year from about \$150bn in the mid-1990s (Chart 1). Islamic commercial banks accounted for 75% of the assets \$397bn, and investment banks 13%, \$66bn. The balance is made up by Sukuk issues \$44bn; assets of equity funds and other off-balance sheet investments \$14bn and assets of Takaful providers \$10bn. Standard & Poor’s has estimated that the potential market for Islamic finance could be \$4 trillion, over seven times its current size.

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 \$154bn, Saudi Arabia along with other Gulf states, and Malaysia (Table 1). The UK, in 9th place, is the leading Western country with \$10bn of reported assets, largely based on HSBC Amanah.

The market for Islamic financial services has developed in a number of key ways, with respect to emerging centres of expertise; a broadening geographical spread of customers; an increasing number of providers; and the growing range of Sharia compliant financial services being marketed.

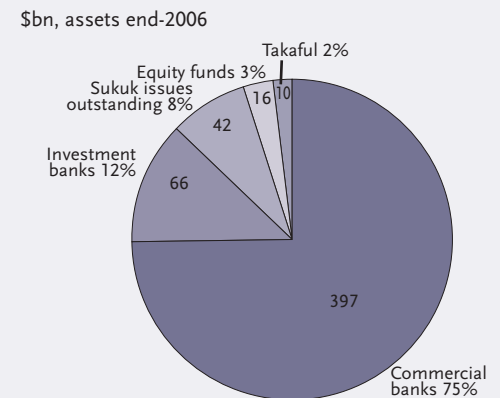
Islamic finance: principles and development in the modern era

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.

Chart 1 Global assets of Islamic finance



Total assets end-2006: \$531bn

Source: IFSL estimates based on The Banker, Ernst & Young, World Islamic Funds @ Capital Markets Conference

Table 1 Leading countries for Sharia compliant assets

Identified assets, \$bn	Banks		Total	% share
	Banks	Takaful		
Iran	152.9	2.0	154.9	32.8
S.Arabia	68.5	1.6	70.1	14.8
Malaysia	64.1	1.2	65.2	13.8
Kuwait	37.3	1.2	38.4	8.1
UAE	34.9	1.0	35.9	7.6
Bahrain	25.6	0.8	26.4	5.6
Pakistan	15.9	---	15.9	3.4
Lebanon	14.3	---	14.3	3.0
UK	10.4	---	10.4	2.2
Turkey	10.1	---	10.1	2.1
Qatar	9.1	0.3	9.4	2.0
Bangladesh	4.3	0.3	4.6	1.0
Sudan	4.1	0.7	4.8	1.0
Egypt	3.8	0.1	3.9	0.8
Jordan	2.6	0.1	2.7	0.6
Indonesia	2.2	0.2	2.4	0.5
Others	2.6	0.8	3.3	0.7
Total	462.7	10.2	472.8	100.0

Source: The Banker

Emerging centres of expertise Bahrain, Dubai/UAE and Kuala Lumpur have strong historical positions and future ambitions as centres for Islamic financial services. Riyadh, Qatar, and Singapore also have aspirations to become centres for Islamic finance. London is positioning itself 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. Initiatives to develop Islamic finance in the UK are set out on page 4.

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 both within and outside the Arab world. Key future markets include:

- Other Arab countries such as Egypt, Turkey, Lebanon and Syria.
- Other Asian countries such as Indonesia, which has the largest indigenous Muslim population in the world, 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. Moreover, 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.

Historic providers of Islamic finance are facing competition from newly established providers and from conversion of conventional institutions.

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 equity funds are evolving. Products that may be the subject of innovation include private equity, hedge funds and derivatives. Significant challenges, outlined on page 6, need to be addressed if the potential of these markets is to be fulfilled.

Banking Existing Islamic banks have started to build on their natural competitive advantages including customer loyalty, sensitivity to religious practices and stable base of deposits. Conventional banks also have moved to open Islamic 'windows' through setting up branches, creating Sharia compliant subsidiaries or converting to become fully Sharia compliant banks. In a survey by the Banker, balance sheet assets of Sharia compliant bank assets totalled \$463bn in 2006, of which \$397bn were in commercial banks and \$66bn in investment banks. It is estimated that about 55% of the total bank assets were in Islamic banks and 45% in Islamic windows of conventional banks.

Malaysia and Pakistan have over 20 banks supplying Islamic financial services; Kuwait and Bahrain each have 17; and Iran, Saudi Arabia and Bangladesh each have around 10. (Table 2). Three UK banks reported to the Banker's survey, although there are estimated to be 23 in total. Market share of Islamic banks in Malaysia and the Gulf Cooperation Council (GCC) has been rising. In Malaysia between 2003 and 2006 the share of Islamic banks

Table 2 Banks providing Islamic financial services

Sharia compliant assets of commercial & investment banks						
	Number of banks			Sharia compliant assets \$bn		
	Commercl. banks	Investmt. banks	Total banks	Commercl. banks	Investmt. banks	Total banks
Iran	11	---	11	152.9	---	152.9
S.Arabia	9	1	10	40.4	28.1	68.5
Malaysia	22	3	25	62.8	1.2	64.1
Kuwait	6	11	17	28.1	9.2	37.3
UAE	6	1	7	34.9	0.0	34.9
Bahrain	4	13	17	10.0	15.6	25.6
Pakistan	20	2	22	14.4	1.6	15.9
Lebanon	1	1	2	14.2	0.1	14.3
UK	2	1	3	10.0	0.5	10.4
Turkey	4	---	4	10.1	---	10.1
Qatar	2	4	6	0.5	8.6	9.1
Bangladesh	10	---	10	4.3	---	4.3
Sudan	7	1	8	4.0	0.1	4.1
Egypt	2	---	2	3.8	---	3.8
Jordan	2	2	4	2.5	0.1	2.6
Indonesia	3	---	3	2.2	---	2.2
Others	13	1	14	2.0	0.6	2.6
Total	124	41	165	397.0	65.7	462.7

Source: The Banker

Chart 2 Sukuk global issuance

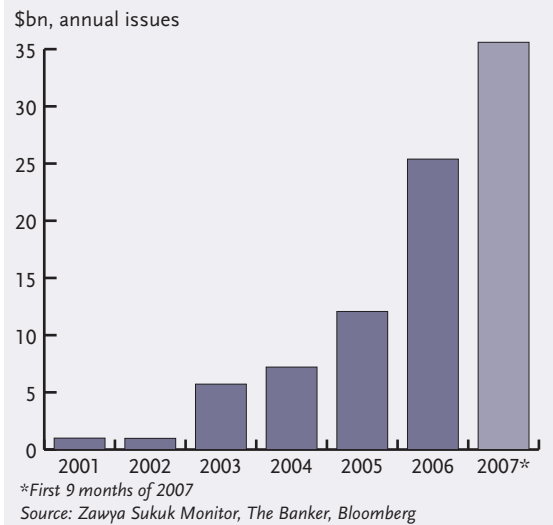
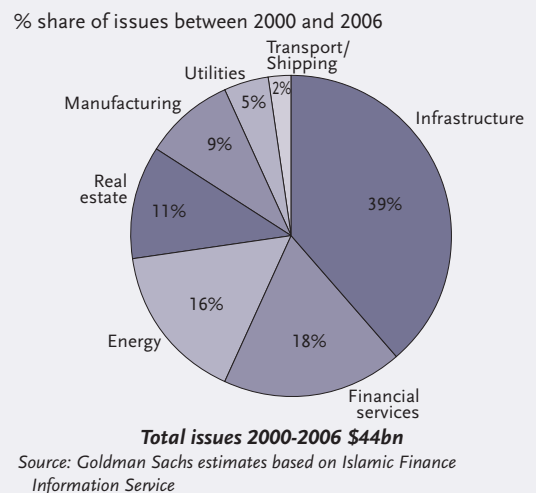


Chart 3 Sectors for global Sukuk issuance



increased from 9% to 12% while in the GCC it rose from 13% to 17%. Within the GCC, Kuwait and Saudi Arabia are the countries in which Islamic banks' market share is highest and has grown the fastest.

Sukuk are issues of Islamic notes that represent an alternative to conventional bonds. Issuance of Sukuk has grown rapidly from \$1bn a year in 2001 and 2002 to \$12bn in 2005, \$27bn in 2006 and \$36bn in the first nine months of 2007 (Chart 2). The market was dominated by Malaysian issues in the early years but GCC issuance has been rising. Pakistan has also entered the market with about a fifth of its issuance in the first half of 2007 being Sukuk, up from no issues at all in the same period of 2006. Only a quarter of Sukuk are listed with the remainder being over the counter. Dubai is the main centre for listings followed by London, where at least eight Sukuk have been listed. Turnover in the secondary market in London was estimated at \$2bn a month in 2007. The largest sukuk to date were those issued by Dubai-based Nakheel Group for \$3.5bn early in 2007: they were listed in both Dubai and London. Data from Bloomberg published by The Banker indicates that in the first nine months of 2007 the major underwriters of Sukuk were Citibank, HSBC and BNP Paribas.

While sovereign sukuk issues by Bahrain and Malaysia played an initial role in establishing the market, about 80% of issues between 2001 and 2006 have been by corporates. The most important market for Sukuk corporate issues totalling \$44bn over this period has been infrastructure, with issuance of \$17bn, 39% of the total (Chart 3). The next largest markets were for financial services 18%, and energy 16%. The commitment to a substantial programme of infrastructure investment totalling up to \$1,000bn over the next ten years in the GCC should provide considerable potential for further expansion of Sukuk.

Islamic funds The market for Islamic funds has expanded significantly over the past decade, with the total number of Sharia compliant funds having risen from around 150 in 2000 to over 350 in 2006. The market for equity funds alone has grown from 9 funds with an aggregate value of \$0.8bn in 1994 to to over 120 funds with a value of \$16bn in 2006 (Chart 4). Out of 71 managers of equity funds identified by Failaka International, 29 are located in the Middle East, 18 in Asia, and 24 elsewhere, including 9 in the UK and 7 in the US (Table 3). Investment in GCC private equity has been prompted by privatisation incentives.

Investment in equity funds should receive additional impetus following the construction by Standard & Poor's of three equity indices that track the stocks of companies that are judged to be Sharia compliant in the US and Japan. These have been designed as an alternative to conventional indices. Over the past five years they have shown a high degree of correlation with conventional indices, particularly those based on US securities. In the UK iShares has launched three tracker funds - World Islamic, Emerging Markets Islamic and USA Islamic - on the London Stock Exchange. These Exchange Traded Funds (ETFs) will allow Muslim investors to track markets in accordance with Islamic law.

Takaful, similar to mutual insurance, is a risk sharing entity that allows for

Chart 4 Islamic equity funds worldwide

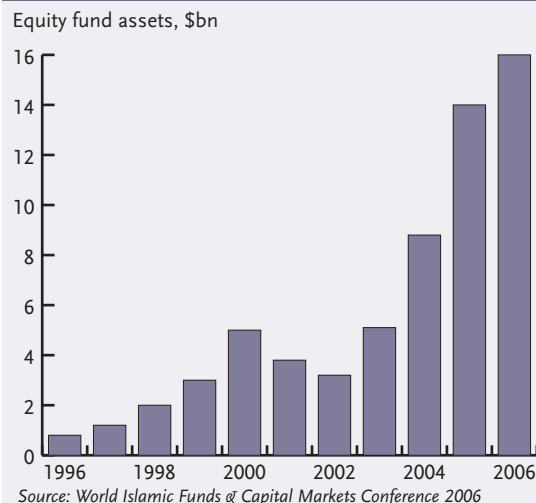
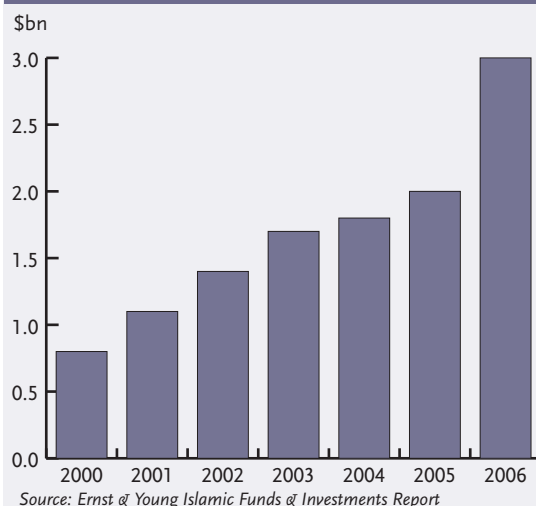


Table 3 Location of Islamic fund managers

Country	Fund managers	Equity Funds
Saudi Arabia	15	69
Malaysia	14	20
UK	9	10
US	7	10
Bahrain	4	8
Kuwait	4	8
Qatar	4	4
Singapore	3	7
UAE	2	16
Others	9	9
Total	71	161

*Excluding currency and trading funds
Source: Failaka International

Chart 5 Takaful global premiums



the transparent sharing of risk by pooling individual contributions for the benefit of all subscribers. Drawing on the survey by the Banker estimated assets of Takaful firms are \$10bn. Premiums are estimated to have reached \$3bn in 2006 have grown by around 20% a year from \$0.8bn in 2000 (Chart 5). The Takaful market is concentrated in Malaysia, Saudi Arabia, Iran and Kuwait (Table 4). Penetration of Takaful is low being only 6% in Malaysia and 1% in Saudi Arabia. GCC and other countries with Islamic majorities are under-insured so should represent a strong growth opportunity, particularly with regard to life insurance, as Sharia compliant products are developed. Prudential was given approval in 2006 to launch a Takaful business in Malaysia in partnership with Bank Negara Malaysia.

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. A key feature of the development of London and the UK as the 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'. Central to this has been the establishment of an enabling fiscal, legal and regulatory framework:

Supportive Government policies Government policy has been increasingly supportive of the development of Islamic financial services in recent years because it has been seen to contribute to broader government objectives such as combating social exclusion and promoting London and the wider UK as a global financial centre.

Establishment of appropriate fiscal and regulatory framework 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.

Establishment of fully Sharia compliant institutions The three full Sharia compliant banks established in the UK puts it in the lead in Western Europe. The Islamic Bank of Britain became the first stand-alone retail Islamic bank in the country. European Islamic Investment Bank, AIM-listed in 2006, was created with the aim of recycling surplus institutional and private liquidity from the Gulf into Sharia compliant asset classes in Western markets. Opening in 2007, The Bank of London and The Middle East offers

Table 4 Takaful business

Takaful companies & assets by country		
	Number of companies	Assets \$bn
S.Arabia	12	1.6
Sudan	12	0.7
Bahrain	4	0.8
Indonesia	4	0.2
Malaysia	4	1.2
Iran	4	2.0
Singapore	3	---
Brunei	2	0.3
Qatar	2	0.3
Bangladesh	2	0.3
UAE	2	1.0
Kuwait	2	1.2
Others	14	0.6
Total	67	10.2

Source: The Banker, Institute of Islamic Banking & Insurance

Table 5 Islamic banks in western countries & offshore centres

Number located in each country, 2007	
UK	23
US	20
Switzerland	5
France	4
Luxembourg	4
Ireland	3
Germany	3
Cayman Islands	2
Canada	1
Italy	1

Source: The Institute of Islamic Banking and Insurance

Sharia compliant investment banking to businesses and high net-worth individuals globally.

Establishment of an 'Islamic window' by major Western banks. Around 20 conventional banks have set up units to provide Islamic financial services. These include Arab Banking Corporation, Barclays Bank, BNP Paribas, Deutsche Bank, HSBC Amanah, Lloyds TSB and UBS. Including the three fully Sharia compliant Islamic banks there are around 23 banks in the UK supplying Islamic financial services. This is more than four times that of any other country in western Europe. Switzerland has five and France and Luxembourg each have four (Table 5).

Other developments A number of major law firms in the UK including Allen & Overy, Clifford Chance, Eversheds, Denton Wilde Sapte, Norton Rose, and Trowers and Hamlin are active in Islamic finance. The UK has a successful record as a trading centre for Islamic products as large quantities of commodity-based Murabaha agreements are exchanged daily through the London Metal Exchange (LME). This has for years been a key mechanism for Islamic financial institutions to manage their assets and liabilities.

Providers are looking to build on mortgage products with new savings and commercial property finance products also under development. IBB headquartered in Birmingham is taking the opportunity to spread the market for services in the Midlands, Manchester and Wales. Albaruq approved mortgage business totalling over £100m in the first half of 2007. Lloyds TSB in 2006 became the first UK bank to launch a student account for undergraduates.

The Government is continuing to play a key role with, for example, a review being undertaken by National Savings & Investment, the state-owned savings bank, on the possibility of the Government issuing retail Islamic products. The Government is also reviewing the possibility of issuing Sharia compliant government bonds.

The outcome of both government initiatives and private sector responses to market opportunities is reflected in the establishment of various aspects of Islamic finance in the UK. In summary:

- A total of 23 banks in the UK supply Islamic financial services, more than the rest of western Europe combined.
- Nine fund managers provide the opportunity to invest in 10 funds, exceeded only in number by Saudi Arabia and Malaysia.
- Secondary market in Sukuk estimated at \$2bn a month in 2007.
- Trading in commodity-based Murabaha agreements through the LME.
- Growing market for retail mortgage and insurance business.
- Development of legal expertise.
- Sharia compliant ETFs launched by iShares
- A variety of educational and training products in Islamic finance launched by professional institutions, universities, business schools and other training providers (see side panel).

Ongoing initiatives are intended to build on London's existing competitive advantage with regard to its large size and international reach; deep and efficient markets, liquid secondary markets; and cluster of expertise.

Islamic finance qualifications provided from the UK

UK organisations have collaborated with other institutions to provide qualifications in Islamic finance that can be accessed internationally:

Securities and Investment Institute (SII) The Islamic Finance Qualification (IFQ) is a joint initiative between the SII, a leading professional body for the UK securities and investment industry, and the Ecole Supérieure des Affaires (ESA), a leading business school in the Middle East. The IFQ covers Islamic finance from both a technical and Sharia perspective, providing the first international benchmark in the area of Islamic finance.

Chartered Institute of Management Accountants (CIMA) The CIMA Certificate in Islamic Finance (Cert IF) represents the first global qualification to be offered by a professional chartered accountancy body to focus on Islamic finance. CIMA has worked closely with the International Institute of Islamic Finance Inc. to develop a relevant and highly applicable qualification.

Cass Business School The Cass Executive MBA Dubai programme has been developed by the Cass Business School in collaboration with the Dubai International Financial Centre (DIFC). The course is designed for managers in the Gulf, Middle East and surrounding regions.

Islamic Institute of Banking and Insurance (IIBI): IIBI offers a Post Graduate Diploma and has received approval from the UK's Qualifications and Curriculum Authority (QCA) for the inclusion of optional modules in Business Management qualifications. These are the first ever qualifications in Islamic Finance to have been approved by the QCA.

Other institutions offering degrees and other courses in Islamic finance include Durham University's Islamic Finance Programme and Markfield Institute of Higher Education.

Qualifications offered by these various providers give candidates an understanding of Sharia compliance in a business context and therefore equip them for key positions in Islamic finance industries.

CHALLENGES IN THE DEVELOPMENT OF ISLAMIC FINANCE

There are a number of key challenges in the development of Islamic finance which can be summarised under a number of headings:

Inadequate legal and regulatory framework Many countries with Muslim majorities still do not have an enabling legislation covering the authorisation of Islamic banks. In this respect the UK is well ahead of such countries in facilitating Islamic finance. At the international level the issuance in 2006 of two standards on Capital Adequacy Standards and the Guiding Principles of Risk Management for Institutions offering Islamic Financial Services, should facilitate appropriate assessment of regulatory capital.

Inconsistent financial reporting and inadequate accounting framework The quality and transparency of financial reporting and disclosure in Islamic financial industry differs significantly across jurisdictions. The UK, Malaysia and Bahrain provide examples of best practice. Inadequate financial reporting is linked in part to the lack of a global framework which would provide international standardisation of rules and principles governing accounting practices. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), based in Bahrain, has been working with its 160 members in 40 countries to enhance accounting and auditing standards for the industry since its establishment in 1990.

Insufficient Sharia convergence and harmonisation While diversity in Sharia opinions is enshrined in Islamic law, there nevertheless needs to be harmonisation of products, operations and systems in order to ensure compliance. There has been some convergence between GCC and Malaysian models. The UK has tended to adopt the GCC model due to strong links between the UK and the Gulf and also because in aggregate the Gulf forms the largest market. Convergence is hindered by differences of opinion between scholars. There is a shortage of scholars with expertise in the application of Sharia law to financial products.

Shortage of skills While the market for Islamic finance has made large strides there is a shortage of people with suitable qualifications. This applies not only at the scholarly level, indicated above, but also in the wider industry. In this context the UK therefore has a major opportunity to become the leading Western centre for education and training.

Limited secondary market The secondary market for Sukuk although growing remains sparse. This reflects the limited secondary markets in emerging financial centres such as Dubai where most Sukuk have so far been issued. London's competitive advantages as a financial centre include its size and reach, sophisticated markets and expertise. This should in due course facilitate the further development of Sukuk secondary markets.

IT systems The specialist nature of Islamic finance means that customised IT systems may be required. Banks and other providers are therefore looking to develop IT systems that can handle not only the specific characteristics of Islamic finance but also cope with growing demand and the increased diversity of products.

Islamic financial instruments

There are a variety of Islamic financial instruments which can be used individually or in combination. Some of the main types are summarised below:

Ijara - Leasing: Ijara involves a contract where a bank buys and then leases an item – perhaps a consumer durable – to a customer for a specified rental over a specific period. The duration of the lease, as well as the basis for rental, are set and agreed in advance. The bank retains ownership of the item, taking it back at the end of the contract.

Mudaraba - Profit sharing agreement: Mudaraba refers to an investment on your behalf by a more skilled person. It takes the form of a contract between two parties, one who provides the funds and the other who provides the expertise and who agree to the division of any profits made in advance.

Murabaha - Contract for purchase and resale: Murabaha allows the customer to make purchases without having to take out a loan and pay interest. A bank purchases the goods for the customer, and re-sells them to the customer on a deferred basis, adding an agreed profit margin. The customer then pays the sale price for the goods over instalments, effectively obtaining credit without paying interest.

Musharaka - Joint venture: Both the entrepreneur and the investor contribute to the capital of the operation in varying degrees and have a prearranged agreement in the sharing of risk and return.

Sukuk - Financial certificate that can be seen as the equivalent of the bond. Sukuk are securities that comply with Islamic law and its investment principles which prohibit the charging or paying of interest. Sukuk can be classified according to the extent of their tradability in the secondary markets.

Takaful - Insurance: Takaful is a system of mutual insurance, which is based on mutual cooperation, responsibility, protection and assistance between groups of participants.

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