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The 1st Ethical Charitable Trust Guide To:

Explaining Islamic Finance

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This guide is an abridged version of a research paper which can be downloaded from www.1stethical.com/publications

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Introduction

All praise be to Allah, Creator of the heavens and the earth, and Owner of the Day of Judgement. We bear witness that there is no-one worthy of worship other than Allah (SWT), and that the Prophet Muhammed (SAW) is His final messenger.

Ever since the demise of the great Muslim empires, and the subsequent dominance of Western ideas and policies, Muslims have continually strived to resurrect the tradition of applying Islamic principles to contemporary issues. Of all the effort being exerted, perhaps no attempt has been more controversial than the Islamic Finance experiment.

Global Islamic Finance is a market growing at between 10-15% per annum with assets in excess of $1 Trillion. Many mainstream Western financial institutions have incorporated departments dedicated to the research and development of Islamic Finance, and many stand-alone 'Islamic Banks' have sprung up over the last few years. These changes are occurring both in Muslim and in Western countries, and are driven by a global trend amongst Muslims to become more observant of their faith.

In the UK the Government is actively trying to establish the City of London as the global centre of Islamic financial activity, and the Bank of England was the first central bank internationally to abolish 'Double Stamp Duty' on Islamic home purchase plans.

Notwithstanding these developments, critics have accused the Islamic Finance industry of being little more than a talking-shop which at best, is contributing little towards progressing the real aims of Islamic Finance and at worst is engaged in outright deception.

This guide is an attempt to tackle the ignorance and lack of information surrounding the Islamic Finance industry by focusing on three crucial issues:

1. **To clarify the authentic aims of Islamic Finance;**
2. **To evaluate the current development of this fledgling industry;**
3. **To outline what challenges need to be overcome if Islamic Finance is to truly develop as a viable alternative to Capitalism;**

Key Features of Islamic Finance

Islamic Finance seeks to regulate certain economic activities in order to achieve the following objectives;

1. Equitable Distribution of Wealth

An interest based economic system will always lead to wealth being concentrated in the hands of the few at the expense of the many. This is because lenders will always prefer to loan money to those with the most collateral, who in turn will use the money to generate further profits. Consequently the global interest based economic system ensures the vast majority of the world's finance is commandeered by a tiny fraction of the overall population.

Islamic Finance has prohibited the payment of interest when lending or borrowing capital. Capital must be put at some sort of risk in order to justify a return. In doing so banks, and crucially the underlying account holders, receive a share of profits and not just a fixed rate of interest.

By engaging in risk and sharing in the bank's profits, the underlying account holders are more likely to receive a far greater slice of wealth compared with the interest normally received on deposit accounts. This in turn would lead to a much fairer distribution of wealth in society.

> *The richest 225 people own more wealth than the poorest 2.5 Billion*
>
> *United Nations Development Report, 1998*

2. The Middle Path

Muslims are required to follow the 'middle path' in all matters. With regard to economics this can be defined as a path between unregulated markets on one side and excessive regulation on the other. While it is true that Islam rejects the Communist principle that private enterprise should not be permitted, it is equally fair to say that Islam also rejects unbridled Capitalism that permits individuals to disregard society's net interests in pursuit of personal wealth.

The accepted practice of government economic intervention in capitalist economies perhaps highlights the fact that certain economic activities - of harm to the collective interests of society - should be monitored and restricted. Islamic Finance is in full agreement with the ideas of regulating economic activity but seeks to define the boundaries through divine guidance.

3. Transparency in Transactions

Islam stresses the need for transparency in transactions. A sale transaction, for example requires the existence, quantity and quality of the subject matter to be clearly stated in order for the sale to be considered valid. Islam also compels business transactions to be put in writing in order to eliminate ambiguity and reduce the potential for future disagreements.

4. Asset Backed Financing & the Nature of Money

Shariah law stresses the importance of only trading in assets of 'inherent value.' Any asset with 'inherent value' can be bought or sold at a profit, for example a computer can be purchased for £800 and sold for £1000.

It then follows that an asset without any inherent use or value cannot be traded, for example a new £20 note is worth exactly the same as a used £20 note. The note has no inherent use in its own right and simply serves as a determinant of value; hence it cannot be traded for profit.

Trading in money often leads to detrimental consequences such as the boom and bust economic cycle and as such, loaning idle capital in exchange for a profitable return runs contrary to Islam's desired approach.

Islamic Modes of Finance

Modern day Islamic scholars and academics have developed four modes of Shariah complaint financing that are designed to work within the prevailing capitalist economic framework.

It is true to say that in order to achieve this balance numerous concessions have been afforded to financial institutions that would not apply if a viable interest free economic system existed. The stated intention behind making these concessions is to encourage the evolution of just this type of alternative system.

There is great debate as to whether financial institutions are abusing these concessions and whether the time has come for these concessions to be revoked in order to enforce the implementation of genuine Islamic Finance ideals.

Although the following modes are currently implemented mostly within the context of Islamic home purchase products, they have the potential to be applied to almost any type of financial instrument or scenario.

1. Murabaha (Cost-Plus Pricing)

In its simplest form Murabaha refers to 'cost-plus' pricing, whereby commodities are bought and then sold at a predefined marked-up price.

Murabaha is very popular with banks because it facilitates charging higher prices on deferred payment terms.

Critics would point out that the timeline between the purchase and the sale is likely to be the time it takes to sign the two contracts. As a result, the bank experiences an extremely small amount of risk in exchange for a comparatively profitable return on an asset-backed basis.

Example

A client approaches the bank with the details of a property they wish to purchase. The client signs a 'promise to purchase' agreement with the bank before the bank purchases the property. The banks carries out due diligence on the property before purchasing the asset. Before selling the property to the client the bank marks up the price of the property. The client enters into an agreement with the bank to purchase the property for a fixed price over a fixed period of time. The bank buys the property and sells it to the eventual purchaser in a 'back-to-back' transaction that is conducted almost instantaneously.

2. Ijara (Leasing)

Ijara is probably best understood in the context of current Islamic home purchase products. Having said this, any qualifying commodity can be leased at a fixed cost. Ijara based plans require banks to purchase the property identified by the eventual home owners who are in turn required to reside in the property as tenants over a fixed period of time. Rental payments are accompanied by 'on account' payments which accrue in a separate fund. At the end of the tenancy agreement the monies accumulated in this fund are used to purchase the property outright. This practice involves the bank promising to sell the asset to the tenant at the out-set. Under Shariah this promise is treated differently to the tenancy contract itself. This distinction is crucial as Shariah law prohibits the concept of operating a contract that is contingent on the implementation of a second contract.

Ijara Continued...

The bank also agrees to sell back the property at the original purchase price, not its market value at the time of sale. This is also normally against Shariah but has been permitted where the asset is not for business use (e.g. home).

Example

A client approaches a bank with the details of a property they wish to buy and move into, but cannot afford to do so.
The banks carries out due diligence on both client and property before purchasing the asset. The bank then assumes ownership of the property and the client enters into the tenancy agreement with the bank. Monthly payments to the bank consist of rent and an element towards the purchase the property. Capital accumulates 'on account' with the bank and at the end of the tenancy agreement will amount to the same sum the bank originally purchased the property for. The client may exercise their promise to purchase sooner if they have the funds available. At this point the client purchases the property with the 'on account' funds.

3. Musharaka - Joint Venture Financing

Musharaka is the most desired form of financing in the eyes of Islamic Finance. All the essential elements promoted by Islamic Finance are to be found at the forefront of a Musharaka contract - the absence of interest, the presence of risk, the spirit of sharing profits and proportionate losses, and the direct link between capital investment and underlying asset based transactions

In practice Musharaka involves a bank obtaining an equity share in an asset or business in lieu of a conventional loan. Some of the basic rules of Musharaka are as follows;

- Profits are shared as per the agreement of the partners whilst losses are shared on a pro-rata basis against the investment.
- Contribution to the Musharaka fund can be via liquid assets or illiquid assets. Once the assets are in the fund they are pooled for the benefit of all partners.
- Sleeping partners must take a share of profits in direct proportion to their initial investment.

4. Modaraba

Modaraba ranks alongside Musharaka as one of Islamic Finance's preferred financing methods. Modaraba also embodies the spirit of profit-sharing as well as active management of capital linked to assets. Modaraba differs from Musharaka in that contributions made by the partners consist of capital investment or expertise rather than just capital investment. This combination of capital and expertise is then employed into profitable ventures.

The three key rules governing a Modaraba contract are;

- The percentage share of profits must be fixed in advance. A percentage of profits can be specified as return, but not a percentage of capital investment as this would be akin to interest.
- In the event of a loss occurring, the Rabb-ul Maal (investor/owner of capital) solely bears this burden. The Modarib (expert) does not need to contribute towards the loss.
- It is perfectly acceptable for the Modarib to take genuine expenses incurred out of the Modaraba fund, but is not however permitted to take a salary.

Diminishing Musharaka (DM) - Recent times have witnessed a shift in emphasis away from Ijara towards Diminishing Musharaka (DM) as a mode of financing Islamic home purchase plans. Many of the major providers have either switched to DM or are planning to do so imminently. DM is a hybrid financing technique involving both Ijara and Musharaka elements. Murabaha, Ijara, and Diminishing Musharaka are Shariah compliant modes of finance that rely on concessions that enable them to 'fit' into a modern day interest based economy. Scholars and academics have permitted these modes on the condition they are a stepping stone to true Musharaka/Modaraba financing. Banks are, however, very reluctant to embrace Musharaka financing as this requires them to accept the risks associated with equity financing and move away from the guaranteed income they crrently enjoy. Critics of Islamic finance suspect banks will never adopt Musharaka and therefore question the wisdom in permitting the concessions on which Murabaha, Ijara, and DM rely. Investment banks and venture capital firms do offer equity based finance, but only deal with the higher risk end of the market that is defined by those with insufficient collateral to obtain conventional interest based finance. Investment banks are therefore able to charge much higher rates of return than those available from conventional interest based banks. Other commentators are of the view that as contemporary Islamic financing has only been in existence for three decades or so, and considering that the interest based capitalist system has taken several centuries to evolve to its present form, it is premature to pass judgment on the banks' ability, or lack thereof, to embrace the true spirit of Musharaka/Modaraba.

Example

The client identifies a property they wish to purchase over a fixed period and enters into a DM agreement with the bank. In this arrangement the bank purchases the property and agrees to sell it to the client 'piece by piece' over a fixed period. The monthly payments are similar to the Ijara plan except 'on-account' payments (see Ijara example) are used to purchase additional equity in the property. This occurs during the term of the contract rather than having to wait until the end of the contract. When the final share in the property is purchased by the homebuyer, the house becomes the sole property of the homebuyer. DM is superior to Ijara in that it confers actual ownership of the property (albeit in stages) much quicker than an Ijara arrangement which only transfers the asset at the end of the home finance term.

Historic Overview of the UK Islamic Finance Market

The Early Years (1996-2001)

The United Bank of Kuwait (now known as Ahli United) launched the first ever Islamic home finance product (Manzil) back in 1996, which was based on a Murabaha contract. Initially take-up of the Manzil product was slower than expected which was largely down to the unfamiliarity of the concepts amongst the British Muslim community. The bank was however assisted by the presence of a well known Islamic Finance scholar, Mufti Taqi Usmani, on their Shariah advisory board. To date Ahli United has sold nearly 1,000 such home finance plans. Ahli United was a lone provider in the Islamic home finance market in the early years and attracted a lot of criticism for being too expensive and restrictive.

The Due Diligence Period (2001-2003)

By 2001 many of the major banking institutions began to recognise the commercial potential of the global Islamic Finance market and started developing products of their own. Owing to the inflexibility of the Murabaha product the Shariah scholars allowed banks the additional choice of the Ijara contract.

Governmental Support (2003-)

The purchase and resale required for Islamic home purchases resulted in double stamp duty which significantly increased the costs of Shariah compliant financing. Under pressure from the Bank of England, numerous Islamic organisations and financial institutions, the Government lifted the double stamp duty barrier in 2003. This historic decision paved the way for many institutions to develop commercially viable home purchase products, and cemented the UK's leading role in the global Islamic Finance industry.

The UK Islamic Finance Boom (2003-)

HSBC's decision to launch 'HSBC Amanah' heralded the entry of mainstream banks into the Islamic Finance arena. Soon afterwards NatWest launched Alif Baa Taa (ABT) commercial finance based on the Murabaha model along with the Bank of Ireland. Thereafter United National Bank, Arab Banking Corporation (Al-Buraq) and Lloyds TSB all established Shariah complaint product offerings.

Shariah scholars then devised the concept of Diminishing Musharaka (DM) that enabled clients to buy back shares in a house from the bank at regular intervals, rather than at the end of the contract as was the case with Ijarah. The launch of DM represented the introduction of a product that could be favourably compared on cost and flexibility with conventional interest based loans. It is worth stressing DM was only achieved as a result of the experience gained from the earlier introduction of Murabaha and Ijarah.

At around the same time a unique community collective known as Ansar Finance (Manchester) started offering Islamic home finance to its members. The key difference between Ansar and just about all the other Islamic home finance providers was that Ansar's seed finance was from its members who were mainly from the Muslim community. This won Ansar many plaudits from the Muslim community.

High Street Islamic Bank and the Musharaka Fund Launched 2004 - 2006

2004 witnessed the launch of the UK's first stand alone bank completely based on Islamic principles - The Islamic Bank of Britain (IBB). The UK underscored its position as the first Western country to grant a licence to a fully-fledged Islamic bank. IBB initially started its product offerings with regular current and savings accounts but then rapidly moved into personal finance and is now contemplating a number of Shariah-compliant products. It has over 12 branches nationally and it is expected to grow rapidly.

The second development worth noting came in 2005 when 1st Ethical Limited launched the 'Musharaka Fund'. This fund invited investment from the UK Muslim community and then reinvested those funds as venture finance into UK Muslim businesses such as dental practices, optical practices etc. The launch of the fund was the first serious attempt to implement pure Musharaka and move away from the concession approach favoured by the conventional banks.

London – The Global Centre for Islamic Finance (2006-)

During a landmark speech at a major international conference on Islamic Finance in June 2006, the Chancellor Gordon Brown declared his desire to see London become the international global centre for Islamic financial activity. He also fully pledged his support to any legislative changes required in ensuring a level playing for Islamic products. The FSA (Financial Services Authority) has also taken a keen interest in this area and dedicated specialist resource to help develop the requisite regulatory framework.

Summary - What Does the Future Hold for Islamic Finance?

There is undoubtedly a growing demand for Islamic financial products both in the UK and globally. The success of the Islamic Finance industry in meeting this demand will depend in great measure on overcoming the increasingly sceptical reaction of Muslims to the permissible nature of the products being offered. This scepticism in turn will only be successfully overcome if banks can embrace risk and move towards Musharaka based solutions.

Progress has undeniably been made over the last three decades, albeit principally in developing home purchase products. In the short term there will be an increasing choice in bank deposit, credit card and investment products. It seems that Islamic Finance will move critically towards the much desired goal of allowing Muslim consumers to have a full portfolio of suitable financial products. The likely sponsors of this shift will be the existing Islamic 'windows' within conventional banks alongside standalone Islamic banks and private/community-based initiatives.

Western investment banks and venture capitalist firms appear to converge with the Musharaka model far better than conventional interest based banking. The next stage in the process will require the development of Shariah compliant investment banks that operate on a genuine equity basis, albeit with those clients who do not have already access to conventional finance. This is where the Islamic Finance experiment is currently. Given the investment banking model is well established, there is every reason to expect this stage to be achieved in the next few years.

Moving on from this stage will be much tougher as it will require the application of equity based finance to clients who do have access to conventional interest based finance. This will mark a step into the breach, with investment banks being forced to compete with interest based banks for the same business. It will be embarked upon only by those who are implementing Islamic Finance as part of their faith, and not solely as a business venture. Developments to date have allowed the Muslim community to overcome many hurdles that have resulted in true Musharaka now appearing in the distant horizon.

We conclude by praying that the Almighty (SWT) is pleased with this guide, and makes it a means through which the true message of Islamic Finance can be easily understood and implemented. Any mistakes are due to our weakness, whilst any guidance can only come from our Creator (SWT).

Frequently Asked Questions

What follows is a list of four commonly asked questions. You are advised to read the literature on 1st Ethical's website www.1stethical.com for further information.

1. Why do Muslims need an alternative to the prevalent interest based financing system?

Any financial system which seeks to organise and regulate people's affairs should be equitable and just. Muslims are by no means alone in highlighting the countless fallacies in the present interest based system; a system which rewards those who possess capital over those who take risks, a system which has a persistent tendency to favour the rich over the poor, and a system which has successfully indebted at least half of the world's population. Such a system can never claim to be equitable or just. In fact, Islam, like many faiths, has banned interest. Parts of the Bible still bear reference to the prohibition of usury. The Church was locked in an intense battle with the banking fraternity over the legitimacy of interest before the Church ultimately lost and banking quarters prevailed.

At its heart Islamic Finance divorces capital from an inherent right to return. Instead the factor of entrepreneurship must be present for a return to be justified. Risk-sharing, profit sharing, ethical investment, social considerations and transparency in transactions are all hallmarks of the Islamic financial system.

2. Both conventional finance and Islamic Finance result in a profit for the bank. What is the difference between profit and interest?

Just because two transactions may yield the same end result does not make them identical in the eyes of Shariah. What needs to be studied carefully is the underlying mechanics behind each transaction and their compliance with Shariah.

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3. Many Islamic banks link the repayment of Islamic home finance to the prevailing interest rate - surely this is Haraam?

Interest in all its forms and guises is despised in Islam and forbidden as part of any transaction. Linking investment return to the interest rate is also discouraged BUT is not prohibited in Islam. Why? Because there is a fundamental difference between interest per se and a transaction which has its return linked to interest. Islamic scholars cite the following example to illustrate the point. Imagine two brothers running separate businesses. One brother unfortunately decides to deal in liquor (totally prohibited in Islam) whilst the other decides to open a hardware store. If the brother with the liquor store sets himself a profit target of 15% per annum then all this profit is prohibited (haraam) in Islam as his underlying trade of dealing in alcohol is prohibited. If however his brother dealing in hardware looks at the profit margin of 15% in the liquor trade and decides to peg his return in hardware to 15%, one can say this is undesirable but can never claim it be Haraam, simply because the underlying activity being conducted (hardware sales) is implicitly Halaal.

4. Why are Islamic products usually more expensive that their conventional counterparts?

Price differences are in part due to higher research and development costs, as well as banks requiring a 'risk-premium' from an untested new product. There are also extra Shariah-compliance and monitoring costs involved. These costs will diminish over time as Islamic Finance becomes more mainstream. The ever increasing level of competition also helps drive down prices.

It is true to say that the allegation of Islamic Finance products being too expensive is much less of an issue today than it was a few years ago.