

The Opportunity for Islamic Banking

Islamic banking is not a new concept. The basic practices and principles date back to the time of the Prophet Muhammad during the early part of the seventh century. Islamic finance was practised predominantly in the Muslim world throughout the Middle Ages, fostering trade and business activities.

In northern Africa, the Mediterranean, the Baltic States and as far East as present day China, Muslim merchants became indispensable middlemen for trading activities. It is claimed that many of the concepts, techniques, and instruments were the foundation for European financiers and businessmen.

Modern Islamic banking is now over 25 years old. However, it has only been in the last few years that it has become a commercial proposition that is acceptable to both financial institutions and Islamic ethics.

What have ethics to do with finance?

Islam prohibits anything deemed to be economically or socially injurious. Most non-Muslims know about the Islamic ban on liquor, pork, gambling and pornography. However, *riba* - or interest – is also prohibited under the *Shariah* (the Islamic law).

Individuals are permitted to seek economic well-being, but must not participate in any economic activity that is *haram* (unlawful). While acknowledging the individual's right to ownership of wealth legitimately acquired, Islam makes it obligatory on the individual to spend his wealth judiciously and not to hoard it, keep it idle or to squander it.

An individual may retain any surplus wealth, but Islam seeks to redistribute wealth for the well-being of the community as a whole. In particular the destitute and deprived sections of society are supported by the distribution of Zakat (a wealth tax levied upon Muslims).

Inheritance laws restrict the accumulation of wealth by families passing it on generation to generation. Many of the economic laws weigh against wealth accumulation, but no tax on inheritance is prescribed by the *Shariah*. However, the leadership may levy other kinds of tax under given circumstances. For example, where privately owned farming land is kept idle for more than three years, the State may confiscate that land and allow it to be farmed.

Viewed as a whole, the economic system envisaged by Islam aims at social justice without inhibiting individual enterprise beyond the point where it becomes not only collectively injurious but also individually self-destructive.

To act within these standards, the Islamic financial system must employ the concept of participation in the enterprise. Funds are utilised on a profit (and loss) sharing basis. Islamic banks are often structured to retain a clearly differentiated status between shareholders' capital, clients' sight deposits, and client's investment deposits in order to ensure correct profit-sharing according to Islamic Law.

Investments do not imply higher risk and speculation. It is argued Islamic financial institutions can provide potential profit in proportion to the risk and are thereby contemporary as well as complying with the *Shariah*. In addition, the concept of profit sharing, may encourage better discrimination and more focused resource management.

The scale

Mit Ghamr Bank was established in Egypt during the early 1960's and worked on an interest-free basis although it was not overtly Islamic basis. The first full-fledged Islamic Bank was established in Dubai in 1975 [1]. Today, Islamic banking is estimated to be managing funds to the tune of US\$ 200 billion. Its clientele are not confined to Muslim countries, but are spread over Europe, United States of America and the Far East.

Islamic banking continues to grow at a rapid pace because of its value-orientated ethos that enables it to draw finances from both Muslims and non-Muslims alike. There are over 250 Islamic financial institutions operating world-wide: 27 Muslim and 16 non-Muslim countries.

London in the United Kingdom (UK) has become the largest international centre for Islamic finance outside the Muslim World, largely as a result of the City's role as a centre for Middle Eastern and Asian banking. Treasury management facilities are provided on behalf of Islamic

banks in the Gulf, and Islamic fund management and promotion is becoming more significant. Possibilities for Islamic electronic financial services are opening up, and London is a major centre for information gathering and dissemination on the Islamic banking industry.

Recent developments in Islamic finance include the provision of Islamically acceptable shares and mortgages. Muslims can trade stocks on the Dow Jones following the launch of the Islamic Market Index and houses can be financed without resorting to 'haram' interest.

The road to modern Islamic finance has been rocky, with debates and accusations that Islamic banking is a wolf in sheep's clothing. Iqbal Khan, chief executive of Amanah Finance - an Islamic bank - believes that progress is both real and legal.

"Islam teaches us that money should be channelled toward the production of real goods and services and not the 'financial economy' such as hedge funds and derivatives," says Khan. "It keeps us in touch with the real economy and away from speculation."

During 2001, HSBC was the first international bank to enter the market with the acquisition of Amanah Finance. Citibank Islamic Bank was established many years ago, Standard Chartered set up an Islamic window that never came to much and UBS entered the market last year. The potential market is huge and attractive and whilst many banks are keen Barclays bank has declared an interest. They will undoubtedly be watching HSBC's performance very closely.

Tarek El Diwany, editor of www.islamic-finance.com and author of "The Problem With Interest"¹ is concerned about the attitude of Western banks. "Islamic finance is not a product to be offered to a niche market. It is a system. It must be promoted and implemented as a system," he says.

Western banks will hope that this isn't so. Mohamed Ariff, a professor at the University of Malaya suggests that the opportunity for traditional 'competitive' banks is very real. He says: "It is sometimes suggested that Islamic banks are rather complacent. They tend to behave as though they had a captive market in the Muslim masses who will come to them on religious grounds."

In America, whilst the mainstream banks have been hesitant, a handful of Islamic financial institutions have been established. Lariba, the American Finance House was established in 1987, but has recently been accepted into the financial community. Freddie Mac, the mortgage industry body has welcomed Lariba into the fold.

Dr. Yahia Abdul-Rahman, founder of Lariba called the development "historic". He adds: "Working with Freddie Mac will provide American Finance House - Lariba with much needed liquidity to meet the growing demand for Islamic Home Financing in the American-Muslim community. This also will provide, in the near future, members of the community, who want to invest their savings according to Islamic law, with proper Islamically- sanctioned investment instruments."

But are Islamic banks merely following the paradigms of interest-based system? Does the system really differ from interest-based lending? "Where the monetary system is concerned, I am beginning to feel that this is something that cannot be achieved by the private sector alone, Islamic or otherwise" writes El Diwany. He goes on to say that the monetary system, as a whole, must be challenged and calls for greater support from Government: "We must redefine the meaning of the words legal tender."

Before we look at the issue of what is and is not riba, let's examine the modes of finance offered by Islamic banks.

Islamic finance

An Islamic bank does not normally lend money except on a no interest basis. These loans are called *Qard Hasanah* which means a "benevolent loan".

The bulk of financing by Islamic banks is business finance on a cost-plus (murabahah) basis. Like conventional banks, the proportion of their financing that is conducted on an equity basis is negligible, although Islamic investment companies devote a much greater focus on this area.

By funding a business using equity, any loss is usually shared based on the ratio of the capital invested by each party. The profits, however, are shared based on an agreed ratio. Rates of returns are therefore replaced by ratios.

Outside profit and loss (PL) financing, there are six main financial vehicles:

- Murabahah (cost-plus sale)
- Bay Mu'ajjal (deferred payment sale)
- Bay' Salam (purchase with up-front payment and deferred delivery)
- Bay' Istis'na (made to order construction with up-front payment)
- Ijara (leasing)
- Ju'ala (completion of a specified task for a specified fee).

The single largest mode of financing adopted by Islamic banks is on the basis of Murabahah. Murabahah in ancient Islamic times was a particular kind of simple sale in which a purchaser agreed to pay a seller an agreed rate of profit on an item in the seller's inventory. The seller would be trusted to disclose the correct cost price of the item to which this profit rate would be applied, and hence the buying price determined. In this form murabahah had little in common with financing transactions.

In view of the difficulties and risks associated with modern, large scale, Islamic banking, Murabaha - for all practical purposes – has been transformed from the sale transaction to a mode of finance.

How does it work? The bank, at the request of its client, purchases the specified goods from a third party. Immediately upon the transfer of ownership of the goods, the bank sells them to the client at cost plus an agreed fixed profit margin. The client then takes physical possession of the goods and undertakes to pay the price to the bank either in instalments or in lump sum, at an agreed later date.

In practice, there is no gap between payment by the bank and delivery of the goods. The bank therefore has no risk relating to the goods - provided they are not purchased speculatively. Whilst the bank gets a return at a pre-determined rate, there is no relation to the operational results of the entrepreneur.

The most significant Islamic financial product to be launched for the Muslim community in the United Kingdom was the Manzil home purchase plan. It was launched in 1997 by the United Bank of Kuwait providing Murabahah financing through a trading mark-up contract.

Once the client has chosen a suitable property and agreed a price he approaches the bank for Manzil financing. An application form is completed together with a direct debit mandate for the monthly payments if the request for financing is approved by the bank's credit committee.

The client must pay 0.1% percent (minimum £176) of the purchase price of the house, so that the bank can commission an independent valuation of the property. The bank also seeks references regarding the customer's financial position, usually from an employer or accountant and current bank.

For Murabahah to be legitimate under Islamic law, the bank, as financier of the property, must be the first owner. It is therefore the bank, and not the client, who contracts with the vendor and pays the deposit required when contracts are exchanged.

The sale price from the bank to the client has to allow for administrative expenses, a return to the bank's investors and a profit margin. The client pays the purchase price through fixed monthly payments over a period of up to 15 years.

A modification of the Murabahah scheme is the Manzil ijara scheme for house purchase. It has proven considerably more popular than original Murabahah house purchase plans, being a lease up to 25 years. It has the potential for reduced rental payments and early settlement.

A down payment of 20% of the value of the property is required for all Manzil financing, which is higher than for conventional mortgages, but ensures that the client has a significant equity stake in the property from the outset.

Individuals have the right to purchase the entire property from the bank at any time, since under the Manzil ijara scheme the property is still registered in the bank's name. The tenant or lessee agrees at the outset to eventually purchase the entire property at the original price that the bank paid without any mark-up.

The monthly payments by the client therefore comprise three elements. The first represents the repayments of the funds that the bank has used to purchase the property. The

second is the rent on the property, which is the source of the bank's profit. The rental rate is linked to one year LIBOR and the rental amount is adjusted to reflect repayments of the purchase price that have already been made.

The third element of the monthly payment, referred to as insurance rent, is to recover the cost of the insurance that the bank has to pay on the property. Over time the monthly payments may increase or reduce or both, depending on the size of the first repayments element that the client decides he can afford. Early repayment could be potentially unprofitable for the bank, unless it can obtain a higher return by reinvesting the funds.

Riba and other negative forces

Tariq Husain, a spokesman for ANZ Investment Bank in London observes that Islamic banks are using the instrument of Murabahah and Ijara within the framework of the conventional benchmarks like Libor etc. where the net result does not differ much from interest-based transactions.

So does Islamic home financing really conform to the requirements of the Shariah? Two decades ago The Council of Islamic Ideology of Pakistan decided that "mark-up does not differ in essence from the interest system." They declared that the methods were not true profit and loss sharing and should be kept to a minimum.

The Council's view was that "It would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back door for dealing on the basis of interest." El Diwany agrees. He points to the cynicism of a number of Western bankers, economists and journalists. "They question the difference between the interest-based system and its Islamic counterpart. However, even they concede that the PL system of Islamic banking, if practised in earnest, could ensure socio-economic justice across the globe."

On a practical rather than philosophical level, there are many other issues. In the UK a house purchaser under the available Islamic schemes will attract stamp duty twice! The first time is when a lender buys the property and the second time when it is transferred to the mortgagor.

The prospect of owning your own home may make this barrier insignificant to many Muslims, however there is another less obvious issue. Under the Basel Accord, mortgages carry a weighting of 50% for capital adequacy. Under Basel II proposals this will be reduced to 20%.

This does not apply to Islamic mortgages. Supervisors have commented that they have no discretion for anything other than 100% capital treatment since the property is ostensibly owned by the bank.

Rodney Wilson, a professor of economics and finance at Durham University's Middle Eastern unit points out another issue that has put the brakes on the Western expansion into Islamic banking. Under the banner of "the war on terrorism" UK and US Governments have relaxed the protection of individuals' data held by banks.

"The vast majority of Muslim clients will have nothing to hide, but they may still be concerned that their privacy could be compromised," Wilson comments. The war in Afghanistan could also have a negative impact on Muslim sentiment toward Western banks. "For ideological reasons, a minority of Muslims may find it very difficult to put their money in a British or an American bank. Many other Muslim investors could be concerned about being overly dependent on the Western banking system," Mr. Wilson adds.

Husain believes that there is increased animosity toward American banks in Muslim countries. However he suspects that Muslim investors have been choosing to move funds out of US banks for financial rather than ideological reasons.

"The dollar has depreciated in recent months and Gulf investors who have assets denominated in dollars are not getting the returns they used to get on their money. Some investors will clearly be looking for opportunities to diversify their holdings across different markets and currencies," Mr. Husain says. "During times of crisis, many investors seek safe havens. This factor could be why Switzerland is currently attracting a steady flow of Muslim funds."

Conclusion

The principle of Islamic banking – ethical investments and a system of socio-economic justice – is a wonderful ideology. However, it seems poles apart from conventional banking and the interpretation of riba seems to confine Islamic credit to a niche.

In Malaysia Islamic funds have grown to 8% of all banking assets over the last 10 years. It is now growing at a rate of 48% and is expected to reach 20% by 2010². In the UK the potential for domestic investment is also huge.

Malaysia and Bahrain are the two largest centres for Islamic finance in the Muslim World. Outside of the Muslim world, the UK is the largest international financial centre, mainly due to historical involvement in Middle Eastern finance.

HSBC's Amanah Global Equity Fund is marketed to foreign investors, rather than the British Muslim community. HSBC and other Western banks have been concentrating on very high net worth individuals and see little gain in cross-selling Islamic products to existing clients.

It is easier for HSBC, like other British retail banks, to offer conventional loans and savings products rather than to introduce differentiated products for a potential market of Muslim clients who do business with the bank in any case.

And yet, the British Muslim community comprises 5% of the population. To tap into the opportunity the Bank of England has established a working group. British bankers and Islamic financiers are looking at the legislative and regulatory barriers that need to be overcome.

In the mid-1990's Bank of Scotland launched a mortgage product that required no interest payments. The scheme was based on the value of the property at the end of the life of the mortgage. As an interest-free mortgage it had some attractions from a Shariah perspective, although whilst the repayment could exceed the amount originally loaned by the bank, it was not allowed to fall below it. Unfortunately this product was withdrawn.

UK Government action to make the Islamic market viable, offers the promise of non-interest based mortgages that could be potentially far cheaper. Such action could revolutionise banking in the UK.

The mountain of mammon, it seems, is gradually moving to Mohammed.

| [Author:](#) Murray Bailey

References

1. The problem with Interest, by Tarek El Diwany, Ta-Ha, 1997
2. Speech by Governor of the Central Bank of Malaysia, at the Malaysian Banking and Financial Summit 2002. see www.bri.org/review/r020528c.pdf

Murray would like to thank Tarek El Diwany for his review of and assistance with this article.