Islamic Finance Explained

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All praise is to Allah, Creator of the heavens and the earth, and owner of the Day of Judgment. I bear witness that there is no-one worthy of worship other than Allah (SWT), and that The Prophet Mohammed (SAW) is his final messenger.

This paper covers:-

A. INTRODUCTION

Ever since the collapse of the Ottoman empire, Muslims globally have, with varying degrees of success, continually attempted to bring Islamic principles to bear on contemporary issues in order to bring about a more 'Sharia-compliant' form of existence. Of all the effort being exerted, perhaps no attempt has been more visible in the West than the Islamic Finance experiment.

Today Islamic Finance boasts global assets in excess of $1Trillion and is a market growing at between 10-15% per annum. Muslims globally are estimated at 1.5 billion representing one if four of the worlds population. Almost ever major western Bank has an Islamic Finance window ensuring they catch a slice of the action. Many dedicated Islamic Banks have also been set up in recent times with a view to capturing this market. Globally, Islamic Financial Institutions now number over 300 in total with rapid growth forecasts. The UK Government has also played a major role in trying to make the City of London the global centre of Islamic Finance by extending support wherever possible including the abolition of double stamp duty on Islamic Mortgages.

Unfortunately though, accompanying this apparent success has been a cloak of suspicion over the entire industry. Critics (both Muslim & Non-Muslim) have accused the Industry of being little more than a talking-shop and contributing little towards progressing the real aims of Islamic Finance. Many point out that the net result of Institutions in Islamic Finance is no different to Interest Based Banks on the high street. Countless questions are being asked from all corners. Perhaps the best way to provide the answers that count is to look at the origins of this unique phenomenon.

The origins of Islamic Finance, as with all things Islamic go back to the time of the Prophet Mohammed (peace be upon him). The life of the Prophet has been more extensively documented than any other human being in history. His companions meticulously recorded his every spoken word, action and instruction. Coupled with the Qur'an, the example of the Prophet Mohammed (peace be upon him) represents the bedrock of the Islamic Faith and in turn serves as a direct behavioural guide to over one Billion Muslims globally.

Amongst the many roles of the Prophet (peace be upon him), he happened to be a businessman serving as a trader for Khadija (May Allah be pleased with her) whose hand he accepted in marriage later as his first wife. The Prophetic example was the very epitome of fair-trade. Refraining from usury, ensuring transparency in transactions and total honesty earned him the title Al-Amin (The trustworthy) in pre-Islamic Arabia.

Many of the principles exhibited by the Prophet (peace be upon him) came as a direct result of Qur'anic orders such as the prohibition of Interest. Other rules seem to be derived more from his recorded sayings (Ahadith) eg the impermissibility of purchasing the unborn calf. In light of the Qur'an & Sunnah (recorded teachings of the Prophet Mohammed, peace be upon him) and in particular the ban on Interest, we can conclude the following as the key objectives of Islamic Finance.

B. KEY FEATURES OF ISLAMIC FINANCE

1. Equitable Distribution of Wealth – One of the least desirable features of an Interest Based economy is its persistent tendency to favour the rich over the poor. In doing so, *the rich get richer and the poor just get poorer*. When money is lent on an Interest bearing basis, the objective behind the borrowing is rarely considered in detail by the lender. Instead the lender focuses much more on collateral possessed by the borrower which can be exercised in the event of default. The latter approach has two massive disadvantages. Firstly, it concentrates the vast majority of that rare commodity of capital in the hands of the tiny wealthy elite possessing the collateral to command it out of the Bank. Secondly, by ignoring the reason behind the borrowing, the system ostracises potentially viable business projects in favour of those preferred by the wealthy elite. It surely follows that the wealthy elite do not have a monopoly over the best business ideas.

In sharp contrast Islamic Finance has totally prohibited Interest as a means of lending & borrowing capital. Instead Islamic Finance makes a clear cut distinction between Loan Capital & Investment. If one lends money to his fellow friend then all that is due back is the principal loaned and not a penny more. If however one invests in his friend's business venture then one is entitled to profits accruing as well as having to bear the burden of any resulting losses. The above approach defeats both ills identified in the Interest-based approach.

Firstly, mere possession of wealth by a person which can be loaned out is not allowed to generate a return. As a result the rich (who often inherit mountains of capital) cannot continue to get richer ad infinitum. Instead they must put their capital at some sort of risk to generate a return. In doing so they are highly likely to carry out a thorough due diligence check on the destination of their funds, which in turn is a valuable exercise for society as a whole as it ensures the best possible projects are not starved of much needed finance. The latter also solves the second major obstacle identified with the Interest-based system.

2. The Middle Path – Islam as a religion often perceives itself as the middle way. Between rejection & extremism lies the logic of Islam's balance. A system designed to bring perfect balance to the human psyche in every dimension of life. A perfect equilibrium, the very pursuance of which is a life-long objective in itself. This middle-path mindset is also exhibited well in the economic & financial world. This last century has seen the rise, and in the case of Communism, the fall of great empires. For many decades the Capitalist West battled it out with the Communist East. Politics aside, from an Islamic perspective both systems suffered from extremist defects. On the one hand, the Communist philosophy refused to reward private enterprise and instead insisted on operating a 'communal pot' arrangement. As a result many talented individuals were deprived of the incentive to exhibit their entrepreneurial talent. Worse still, many others fled from the communist countries to the West to allow them to keep their hard-earned remuneration. This pooling concept of sharing rewards equally regardless of the level of individual effort exerted clearly runs contrary to human logic.

Capitalism though went in the total opposite direction sponsoring the notion of '*every man for himself*'. Unfortunately this game-plan whilst avoiding the shortcomings of the communist approach instead gave birth to new type of social-ill. In capitalism's pursuit to promote individual enterprise, society's net interests were ignored. As such, a generation of bad business ideas were born which reward the individual but shamelessly punish society. Ventures such as casinos where society generally suffers a net financial loss but one or two individuals walk away with huge gains. Other ventures such as tobacconist concerns strike a dagger into the nation's health yet still function for individual profit. Alcohol also accounts for 70% of weekend crime thus costing tens of millions a year to the government which inevitably is paid for by the taxpayer. Despite the latter, alcohol licensing laws are further liberalised. The logic of pursuing the individual 'selfish Interest' at the expense of harming society will ultimately bring the house down.

There are many who undoubtedly recognise the flaws inherent within Capitalism, and indeed the concept of a mixed economy or 'Keynisan' economics was a direct attempt to combat market failures through a combination of regulation, taxes and subsidies. In this sense, there is consensus between Muslims and non Muslims of the need to tread a clear middle path between Capitalism & Socialism which recognises capitalism's central attraction in rewarding individual enterprise but curbs that spirit when it threatens society's collective interests. As such, gambling outlets, tobacconist concerns, Alcoholic brewers and the like are usually banned in an Islamic Economy or on occasion subject to extraordinarily tight regulation.

3. Money is a Medium of Exchange – The crucial difference within the Islamic economic approach is to deny to money the role of a commodity which can be traded for profit. Conventional economics always defined money as a key factor of production whose worth was determined by the rate of interest. Islam only permits money to be used as a medium of exchange. As such the bank issuing money cannot rely on collateral alone as the principal criteria in determining whether to extend a loan.

4. Asset backed Financing – Historically banks used to have tangible physical assets in their vaults over which ownership rights were granted in the form of paper money. Consequently each and every bank note represented an underlying asset held in the banks vaults. Modern banking has done away with this concept and banks now frequently issues twenty times more in paper currency than assets actually held. This ability to effectively print money gives modern banks an incredible amount of economic power for which they have carried out no corresponding real activity. This paper money can also lead to huge currency devaluations in times of economic crisis.

In more recent times, Britain has felt the detrimental effects of the trade in money, first with inflation and then with deflation. Every time the Banks inject more capital into the system (in view of a return), this adversely affects prices of goods and services. As the economy's goods and services did not experience a commensurate increase like the money supply did, the only natural outcome to maintain equilibrium will be for goods and services to increase in price thereby absorbing the extra capital. Thus the economist's definition of inflation being 'an increase in prices' is a rather sneaky misrepresentation of what has really happened which is an increase by bankers in the money supply leading to a decrease in the real value of money – this then causes a rise in prices as a bi-product of this artificial arrangement. Islam's unilateral, unequivocal ban on Interest has prevented trading in money.

5. Transparency in Transactions – Islam stresses transparency in transactions. A sale is rendered void if the purchaser is not made fully aware of what he is buying or if in fact a defect in the product is concealed by the seller. A perquisite to sale is clearly identifying the existence & quantity of the subject matter. Often, even the conditions of delivery are left unambiguous. The emphasis on transparency also has direct bearing on which types of contract are permitted to enter into. For example, a contract which is contingent on a future event eg you buy my car next year as long as it is worth £10,000 is not permitted. Much of the logic exists to avoid future squabbling on differing interpretations of contractual expectations. Islam also compels business transactions to be put in writing again to eliminate ambiguity and reduce the potential for future disagreements.

As we now have a clear understanding of what is acceptable and what is not, we can move onto analyse the various contractual forms via which Islamic Finance transacts.

C. CONTRACT TYPES

Given the above restrictions, modern day scholars have developed four principles modes of financing which can be applied to contemporary financial scenarios whilst adhering to Islamic principles.

These four modes are currently mostly used for home purchase plan solutions. However, they can also be applied to bank accounts, investments, or almost any type of financial instrument.

1. Murabaha *(Cost-Plus Pricing)*

In its simplest form, Murabaha refers to cost-plus pricing. Any manufacturer or retailer may incur a per unit cost of a product which is then subject to a profit mark up of say 15% to arrive at the final retail price. This form of pricing is not unique to Islamic finance but is commonplace in the Western world today. In Surah Baqarah in the Holy Qur'an we find Allah (SWT) saying that 'he has permitted trade and forbidden usury' *(S 2 v 285)*. This verse was revealed in response to allegations by the Kuffar (Non-Muslims) of Mecca that the practice of Murabaha (cost-plus pricing) coupled with Bai Mu'ajjal (deferred payment at a higher price) (see below) was akin to Interest as being practiced by the Makkans themselves. They argued that both transaction types resulted in a profit which meant that both involved Interest. Clearly though there were many differences between the 2 transactions, the most striking being that the Muslims were profiting from buying and selling a commodity, hence asset-backed finance; whilst the Makkans were simply loaning funds subject to Interest with no underlying commodity.

In recent times Murabaha has been the Instrument of choice for many financial products, be it a Mortgage, Trade Finance etc and much more. There are 2 critical features about Murabaha which make it extremely conducive and amenable to modern day financial transactions. The first is mentioned above ie that Murabaha can be coupled with Bai Muajjal (deferred payment at a higher price) when enacting a sale. This means that a retailer can purchase a product at spot, say for £1,000 and then sell it over a deferred basis for £1200 (being 12 monthly instalments of £100). This practise was expressly permitted by the Prophet Mohammed (SAW). As should now be evident, Murabaha in tandem with Bai Muajjal is a useful means of financing in the Islamic Mortgages arena. It allows the Bank to purchase the house at spot price and then sell it to the client over a deferred period thereby generating a profit for the Bank.

The second interesting feature about Murabaha pertains to risk transfer. With a Murabaha transaction, taking the above example, whilst it is imperative for the Bank to assume risk of the property from the point at which it buys the property to the point at which it resells the asset, the timeline between these 2 events is likely to be the time it takes to sign 2 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. The critical point to note with respect to Murabaha contracts clearly pertains to risk which must be borne by the Bank/Purchaser when purchasing an asset and then the critical shift in risk which occurs in the direction of the customer/buyer when the asset is sold.

2. Ijara (leasing)

Ijara lexically simply refers to 'leasing'. Any commodity, for example a car can be leased at a fixed cost per month pre-determined at outside. A standard hire-only agreement. Sometimes a separate agreement is signed in addition to the Ijara agreement which allow the asset at the end of the rental term to be sold by the Owner to the Hirer at a token price. This practise is known as *Ijara wa Iqtina* and in some respects is similar to contract purchase plans available today. There are however a few crucial differences between a conventional lease prevalent today and a true Islamic lease. The differences are summarised below;

A. *Risk & Responsibility of Asset* – Islamic Finance draws a clear distinction between the roles and responsibilities of the Lessor (owner of Asset) and the Lessee (Hirer). All capital costs relating to the asset such as its replacement in the event of theft, repair in the event of a fire or breakdown aswell as shipping costs are all the responsibility of the Lessor as he is the owner of the asset and as such should be responsible for ensuring it is in good working order. Conversely, expenses related to the day to day running of the asset eg fuel purchase, routine parts being changed and operating taxes would be the responsibility of the lessee/hirer as he is benefiting from the usufruct of the asset on a daily basis. Conventional leases unfortunately have blurred the boundaries somewhat with the lessee paying for the insurance and delivery costs pertaining to assets.

B. *Late Payment Penalty* – Conventional leases are accustomed to imposing Interest based penalties on late payment or default. Islamic Finance views any excess paid above the principal as Riba (Interest) and as such it is totally prohibited for the Lessor to charge penalties which are then kept by the Institution. This area of legislation has been a real hurdle for Banks designing Shariah- Compliant lease contracts. In fact, to date no real solution to this problem has been found. Some shariah-compliant leases have utilised a 'Maliki' jurists' opinion which allows the Bank/Lessor to charge a payment for default or late payment but the amount charged must be given to Charity. This ensures the financing institution does not benefit from the penalty charged. It must be stressed though that this solution is by no means ideal and the search continues for something better.

C. Lease payments when asset is inoperative – Though partially linked to point A, it is still worth stressing that under an Islamic lease the lessee's obligations to pay the rental will cease in the duration of the asset being inoperative. It is a fundamental duty of the Owner of the asset to ensure that it is in good working order.

D. Takafol Insurance – Conventional Insurance has always been at odds with traditional Islamic Scholarly thought. The principal reason cited is the presence of Gharar (extreme uncertainty) in the contract which the scholars have commented is unacceptable in Shariah. An alternative to this has been created in the from of Takafol (Islamic Insurance). Where possible, the Hirer should utilise Takafol and not conventional Insurance. For more information on Takafol, please read our paper on Takafol which can be accessed at www.1stethical.com/publications

3. Musharaka (Joint Venture)

Musharaka is the most desired form of financing in the eyes of the Shariah. All the essential elements promoted by Shariah 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 losses, the direct linking of capital investment to underlying assets based transactions and much much more. For more information on Musharaka, please read a paper by the author on Islam's problem with Interest & Islamic Alternatives to Financing which can be accessed at www.1stethical.com/publications

In its basic form Musharaka is a joint venture partnership where profits and losses are shared between the partners. In its most complex form, Musharaka is capable of bringing a worldwide revolution in the financial order attacking the heart of the Interest-based capitalist economy, and replacing it with a system which ensures distributive justice and prevents the control of capital by a wealthy elite.

Some basic rules of Musharaka are as follows;

1. Profits are shared as per the agreement of the partners whilst losses are shared pro-rata investment.
2. Contribution to the Musharaka Fund can be via liquid assets or illiquid assets. Once the assets are in the fund they are pooled for all of the partners' benefit.
3. A sleeping partner cannot take more than his share of investment as profit.

In its ideal form a Musharaka Fund will attract halaal capital from Investors and in turn re-invest it into viable business ventures in the community. This prevents Muslim Businesses from having to go to the banks for Interest Based Loans.

Diminishing Musharaka (DM) - Recent times have witnessed a shift in emphasis away from Ijara towards Diminishing Musharaka (DM) as a mode of financing Islamic Mortgages. Many of the major Islamic Mortgage providers have either already switched to DM or are planning to do so imminently. DM is a hybrid financing technique involving both Ijara & Musharaka elements and works in the following manner;

- Client identifies a property, say for £120,000. Bank usually requires a deposit of say £20,000. This takes the Bank's equity to £100,000 and the client's equity to £20,000.
- The Bank then splits the ownership of the asset into distinct individual segments, say 10 segments valued at £10,000 each.
- Now each payment made by the homebuyer to the Bank has 2 distinct components. The first component being pure rent, reflecting the fact that part of the property is being rented from the Bank which owns the property.
- The second part of the payment is termed an *'on-account'* payment which goes into a separate monetary pot for the client. Each time the 'on-account' pot accumulates to £10,000 this amount is paid to the Bank in exchange for one additional share.
- When the final share in the property is purchased by the homebuyer from the Bank, the house becomes the sole property of the homebuyer.
- The Bank is at liberty to segregate the ownership of the house into as many segments as it wishes valued at whatever price, as long as they cumulatively total the cost price of the house.
- Theoretically DM is superior to Ijara in that it confers actual ownership of the property (albeit in stages) much quicker to the purchasing client than an Ijara arrangement which only transfers the asset at the end of the mortgage term. In addition, any appreciation in market value of the property will exclusively benefit the homebuyer.

4. Modaraba

Modaraba ranks alongside Musharaka as Islamic Finance's preferred financing methods. Again, Modaraba embodies the spirit of profit-sharing as well as active management of capital linked to assets. Modaraba differs from Musharaka in that it refers to an arrangement whereby 2 or more parties engage in a venture where one or more of the parties invests the capital in the venture and the remaining parties bring their expertise to the venture.

This combination of capital and expertise is then employed into profitable ventures. At outset the appropriate profit percentages would have been agreed between the parties, for example a 40% profit share for those bringing purely their expertise to the venture (referred to as Modarib) whilst 60% of the profit is paid to those who invested the capital (referred to as Rabb-ul Maal). There are 3 rules worth noting about this arrangement.

Firstly, it is perfectly permissible to fix a percentage of profits (eg 40% of profit accruing) as remuneration for either party in this arrangement. What is prohibited is fixing a percentage return on the capital invested eg 7% return on capital. The latter of course is prohibited as it would tantamount to Interest.

Secondly, if the venture does not make a profit and in fact makes a loss then the Rabb-ul Mal (Investor/Owner of Capital) will have lost some of his investment in the business. The Modarib (Entrepreneur) does not personally contribute his own capital to make good the losses. The fact that the Modarib has made no profit return on the venture and his time has been wasted is a serious loss in its own right. He does not have to inject capital into the venture. The arrangement from outset was such that one party brings capital to the partnership whilst the other party brings the expertise, as a result they lose capital and the time expensed respectively in trying to generate a return.

Thirdly, it is perfectly acceptable for the Modarib to take genuine expenses incurred out of the Modaraba fund. He is not however permitted to take a salary. Any drawings taken from the fund will simply be an advanced subsequently deducted from the share of the profit due to be paid.

D. HISTORIC OVERVIEW & CURRENT STATE OF THE UK ISLAMIC FINANCE MARKET

The Early Years

The roots of Islamic Finance can be traced back to 1996 when the United Bank of Kuwait (now known as Ahli-United) launched the first ever Islamic Mortgage Product. The product was named *Manzil*. The Bank offered 2 types of financing structures, Murabaha over shorter periods (eg 15 years) & Ijara for longer periods. This approach reflected the desire to avoid a lengthy lock-in period at what would effectively be a fixed Rate under Murabaha. Initially take-up of the Manzil product was slower than expected. The extremely cautious British Muslim community tried was getting to grips with a brand new phenomenon. The thought of a Bank buying a property which it then sold for a higher price to a homebuyer over a number of years was an idea which seemed alien to many Muslims who felt it surely could not be acceptable. The singular biggest factor in favour of the Bank was their Shariah Scholar who was none other than the esteem Mufti Taqi Usmani (perhaps the most respected figure globally in Islamic Finance). On the back of the Mufti's sanctioning, Muslims did start taking the product up. To date, Al-Ahli United has sold nearly 1,000 such mortgages.

Having said the above, UBK was a lone provider in the Islamic Mortgage market in the early years and as such, in the absence of comparative offerings the Manzil product attracted a lot of criticism as being too expensive.

The Due Diligence Period

By 2001 many of the major Banking Institutions had started to research into Islamic Finance and its long-term commercial viability. For most Banks Islamic Finance's attitude of '*risk being inextricably linked with a return*' was a strange notion. Banks had been used to lending money rather than investing it, and in exchange for their lending, the Bank was accustomed to the guaranteed Interest rate as a return. So much so, that the Bank could seize the borrowers' assets in the event of non-payment. Islamic Finance was an altogether different proposition seeming to offer none of these securities for the Bank. Instead, it seemed to force the Bank into trading like all other Businesses if it wished to make a profit. This colossal contradiction lay at the heart of the due diligence process for many Banks. Could a happy medium be found which would expose the Bank to minimal risk but still be Shariah-Compliant? Gladly for the Banks, such a solution was found. The Shariah scholars allowed Banks to market the Ijara product (see contracts section) with the rental repaid by the homebuyer pegged directly to the prevailing Interest Rate (LIBOR). The Scholars accepted this as extremely undesirable in Islam BUT not impermissible. The general Muslim public only increased in its scepticism of the product.

It was at around this time that 1st Ethical Ltd received its licence to practice from the UK financial services watchdog, the FSA. 1st Ethical was the UK's first ever firm of independent financial advisers catering exclusively for the Muslim Community. If Islamic Finance in the UK was going to prosper, then the distribution channels to the community offered by 1st Ethical were critical in this process.

Now the stage was nearly set for the major Banks to complete their product designing and launch them on the market place. There was however one final obstacle which required Governmental intervention – namely, double stamp duty!

Governmental Intervention

Despite all the efforts of the Banks to design Islamic Mortgages in a more affordable fashion than the Al-Ahli product, the existence of double stamp-duty was still a big put-off for many Muslims. The Islamic Mortgage relies upon 2 purchases; one initially by the Bank and the second by the customer. The Bank simply passes its stamp duty charge onto the customer meaning 2 lots of stamp duty for the customer. In a historic decision, after pressure from The Bank of England and numerous Islamic Organisations and Banks, the Government lifted the double stamp duty barrier in 2003. This meant that Islamic mortgages were now only subject to a single stamp duty. Ever since that historic decision the UK Government has kept a keen watchful eye on Islamic Finance ensuring that a level playing field is maintained for Muslim customers in relation to the general marketplace. Whilst things are not yet perfect, the UK situation is much more advanced than any other non-Muslim nation.

The UK Islamic Finance Boom

From early 2003 onwards most Banks started launching products into the Islamic Finance Market. The biggest name was HSBC Amanah who rolled out an Ijara product under the supervision of Mufti Taqi Usmani. As HSBC was a household name, the entire Islamic

Finance Industry benefited from its presence and credibility in the field. Soon after NatWest lunched ABT finance which specialised in Islamic commercial finance. NatWest ABT offered the Murabaha model only. The Bank of Ireland had also been offering a Murabaha based commercial offering.

At around the same time a unique community collective known as Ansar Finance (based in Manchester) started offering Islamic Mortgages to its members. The key difference between Ansar and just about all the other Islamic Mortgage providers was that Ansar's seed finance was from its members who were Muslim. As such, the allegation of seed funding being haraam did not apply the way it did for other western banks. It won Ansar a lot of admirers. Prior to offering Islamic Mortgages, Ansar had been set up as a collective offering small Halaal personal Loans to members. This practise is still in operation today.

As the months rolled on, more and more Banks got in on the act. United National Bank (UNB) came up with an Ijara Mortgage offering, whilst the Arab Banking corporation via its Al-Buraq team teamed up with Bristol & West to offer an Ijara product too. Lloyds TSB also then decided to offer a Shariah-compliant bank account with no Interest payable. There were **2 key developments** during this boom stage which are noteworthy.

Firstly, in 2004, the UK witnessed the truly historic launch of the Islamic Bank of Britain (IBB). The British Government had become the first non-Muslim Government to grant a licence to a fully-fledged Islamic Bank. IBB initially started its product offerings with just Bank accounts but then rapidly moved into personal finance and is now contemplating many more shariah-compliant products. It now has over 10 branches nationally and is still expanding.

IBB did however use the highly controversial Tawarruq financing mechanism to launch its personal finance division. This product caused disputes even amongst its staunchest supporters. Tawarruq is a financing arrangement whereby the net effect is to give a personal loan to a customer with a return built in for the Bank. The controversy though lies in how the Bank makes a profit internally within the transaction. As mentioned above, Islamic Finance is an asset-backed system which avoids money being made on money. Tawarruq has 2 major flaws from a Shariah perspective. Firstly, parts of the overall transaction do not involve an asset in any real sense. Secondly, some forms of Tawarruq where an asset was involved result in the Bank buying and then reselling the same asset at a higher price to the original seller. This practice of Tawarruq is normally only sanctioned as a last resort by Shariah scholars in times of extreme need. As such the debate on the validity of Tawarruq between those for it and those against it has centred around whether not the Muslims are in a 'last resort' scenario.

The second development worth noting came in 2005 when 1st Ethical launched 'The Musharaka Fund'. This fund invites Investment from UK Muslim Investors and then re-invests those funds as venture finance into UK Muslim Businesses such as Dental Practices, Optical Practices etc. The launch of the fund was undoubtedly a groundbreaking first step on the long road to implementing a true Islamic financial system. It was an ideal which many felt was simply too utopian and could never be achieved. Well, they were proved wrong as Musharaka declared a fist annual dividend of 14.7%. The fund hopes to boost its size and outreach over the next few years extending its operations to countless Muslims.

London – The Global Centre for Islamic Finance

In June 2006, the Chancellor Grown Brown gave a landmark speech declaring his desire to see London become the global centre for Islamic Finance. He cited countless benefits for the UK should such an occurrence become a reality. 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 monitoring it. The stage is now set for many decades of retail Islamic Finance to ensue – the real question though is *'what form will the new generation of Sharia-Compliant products take?'*. Will risk-averse Banks ensure they continue to simply mirror conventional products or will Islamic Finance see a golden age with a series of true risk –sharing Musharka / Modaraba products seeing the light of day?

Appendix A contains a listing of all the major organisations in Islamic Finance today including their product offerings and contact details.

E. FREQUENTLY ASKED QUESTIONS ON ISLAMIC FINANCE

The following are 4 frequently cited concerns with respect to Islamic Finance and the list is by no means exhaustive. Numerous works have been dedicated to this subject matter alone and the counter-arguments forwarded to the objections proposed.

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

Any financial system which seeks to organise and regulate mankind's affairs should be fair 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 with it, 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 can never claim to be equitable and just. In fact, Islam currently and all its predecessor forms have unilaterally banned Interest. Parts of the Bible still bear references to the prohibition of usury. The church was locked in an intense battle with the Banking fraternity for centuries over the legitimacy of Interest before the church ultimately lost and banking quarters prevailed. The church recognised that such a financing system could never be truly aligned with society's best Interests in the long-term.

Islamic Finance at its heart 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, transparency in transaction are all the hallmarks of the Islamic Financial system.

2. *Both Conventional Finance and Islamic Finance transactions result in a profit for the Bank and as such aren't the 2 the same!*

Just because 2 different transactions may yield the same end result does not make them the same. What needs to be studied carefully is the underlying mechanics behind each transaction and their compliance with the Shariah. This objection is actually well answered in Surah Baqarah when the Makkans used to accuse the Muslims of engaging in a trade the same as their own. They argued that as Muslims were making a profit (by buying and selling) and the Makkans too were profiting (via Interest based Loans), the net result was profit on each side and as such both actions were equally commendable or equally deplorable. Allah (SWT) replied to this perverse analogy by commenting that 'Indeed Trade is permitted but usury is prohibited' (Surah Baqarah v 275 – 281). Clearly Allah (SWT) was clarifying that the net result of a profit on each side is not at all the issue here, instead the means of obtaining that profit is the basis of a legitimate transaction. The Makkans were forwarding usurious loans to the general public which were rolled up with hefty interest charges on default of payment. A practice which barely represented any real risk for Makkan merchants yet was the source of untold misery for the poor. Meanwhile, the Muslims were buying and selling goods, bearing the risk of ownership between purchase and sale and charging a legitimate mark-up for their trouble.

3. Many Islamic Banks link the repayment of Islamic Mortgages 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 a transaction. Linking a transaction's return to the Interest rate is also heavily despised 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. The scholars cite the following example to illustrate the point. Imagine 2 brothers with 2 distinctly 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 equally 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.

Anytime a new product hits the shelves it will inevitably be a little more expensive than one would hope. This occurrence in part is due to research and development costs expensed needing to be recovered in addition to perhaps a risk-premium attached to a new product. Couple the latter with the extra shariah-compliance and monitoring costs involved with launching this type of product and you can see how such a product may be a little more expensive. It is however a basic law of economics that as more of a product is retailed, economies of scope kick-in and make future per-unit costs cheaper. In addition, the presence of competition in a marketplace always assist in giving the consumer a better deal. True to form, Islamic financial products have cheapened in recent times and are now on occasion even cheaper than conventional products. The allegation of Islamic products being more expensive is really no more than a myth these days.

F. SUMMARY & CONCLUSIONS

All over the world Muslims are engaged in countless attempts to bring back a more Islamic form of existence. In the UK and many other western countries, the most visible and tangible evidence of this is the effort being exerted in the field of Islamic Finance. The desire to create an alternative force of finance away from the cursed Interest based system is a perpetual goal for Muslims. Unfortunately though in the West there are very few Islamic Financial Institutions and as such the progression towards an ideal risk-sharing financing mechanism has been steady at best.

Ironically, the incubation period for Islamic Finance in the West has occurred mainly under the auspices of conventional western banks with Islamic finance windows. It is somewhat of a paradox that the very institution which a successful Islamic Finance economy would wish to banish, namely the Interest-Based bank, happens to lie at the heart of the fragile Islamic Finance experiment in the West. The Bankers are often the principal sponsors of this effort in the West. Islamic history is nonetheless full of such ironies, for example Moses being raised in Pharoah's palace and then many years later going on to rule the entire Kingdom.

The principal challenge for western banks engaging in Islamic Finance has been the diametrically divergent agendas sponsored by each philosophy. Conventional Finance believes in return without risk, whilst Islamic Finance prohibits the latter and enforces the opposite. There will inevitably come a fork in the road whereby the Islamic Finance Agenda is simply too 'risky' for the conventional Banks to proceed with any further. With the advent of this eventuality fast approaching the West, the time for fully-fledged Islamic Banks and Private/Community-based Islamic Financial initiatives will come into their own. Till then though, the Bankers will continue to profit and the consumers will gain products just about acceptable under Shariah with a strong bias towards hedging Bank risk.

In closing, we traced the roots of Islamic Finance in the UK back to the Manzil product in 1996 since which time countless institutions have entered the marketplace. With the abolition of double stamp-duty in 2002 a wave of interest has gripped the industry with many of the major institutions still profiting from it today. The product range has arguably become more Islamic as the mortgage offerings moved from Murabaha to Ijara and then to Diminishing Musharaka. We have also witnessed in recent times the authorisation of the UK's first fully-fledged Islamic Bank and in addition the launch of the World's first truly Shariah-compliant Venture Finance Fund (The Musharaka Fund). Progress is undeniably being made, albeit principally in developing home purchase products. In the short term is seems there will be an increasing choice in bank deposit, credit card and investment choices as well. It does seem inevitable that Islamic Finance will move critically towards a much desired goal of allowing Muslim consumer to have a full portfolio of halal financial services. The likely sponsors of this shift will be Islamic Banks & Private / Community-based Muslim initiatives.

In so far as achieving the founding principles underpinning Islamic finance, especially an equitable distribution of wealth, it is clear there will be no tangible change until conventional banking learns to manage risk differently, and secondly Islamic Finance principles filter up to the extremely wealthy elite, who own the majority of the worlds assets. This perhaps is the long term objective which all within Islamic finance must work towards, and which at present is proving very difficult to achieve.

APPENDIX A

INDEX OF ISLAMIC FINANCIAL INSTITUTIONS IN THE UK

(in alphabetical order)

The UK Islamic Finance community is a strange assortment of Conventional Banks, Muslim/Islamic Banks, Investment Houses, community partnerships & niche consultancies. The following is a brief description of the firms involved aswell as their specialist areas and product offerings,

1st Ethical

- **Profile –** License granted in 2001. Practicing as a specialist Shariah-Compliant Tax Consultancy, and Independent Financial Advisory Bureau. Award-winning firm which has been extensively featured in national Media. 1st Ethical is highly instrumental in the challenge to educate the UK Muslim community with regards to Islamic Finance. 1st Ethical launched the groundbreaking Musharaka Fund in 2005. National team of consultants.
- **Current Product Range –** Independent Advice on Shariah-compliant Investments & Pensions. Extensive suite of tax solutions to mitigate various UK Taxes as well as Islamic Wills Services.

- **Products Planned** – More Shariah-compliant investments & Tax solutions
- **Contact:** Bashir Timol - 01204 559914

Al-Ahli United (United Bank of Kuwait)

- **Profile** – First provider of Islamic Mortgage in UK. However since then has not really capitalised on initial inroads made.
- **Current Products** – Murabaha & Ijara Based Islamic Mortgage
- **Planned Products** - None
- **Contact** – Jenny Lacey – XXXXXXXXXX

Al-Buraq

- **Profile** – Part of Arab Banking Corporation, Al-Buraq was launched in *2003*. The organisation aims to bring a series of Shariah-Compliant products to the marketplace within a short space of time.
- **Current Product Range** – Islamic Mortgage (Ijara Based)
- **Products Planned** - ????????????
- **Contact**: Keith Leach - 00000000000000

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Ansar Finance

- **Profile** – Unique, admirable community collective which was set up in 1998. Ansar has since inception provided Interest-Free Loans to members. Approximately 1000 members now who each donate at least £10 per month to the cause. In recent Times Ansar has also ventured into Islamic Mortgages.
- **Current Products** – Islamic Mortgage (Diminishing Musharaka)
- **Planned Products -** ????????????????
- **Contact** – Ali Akbar – 0161 225 8900

Bank of Ireland

- **Profile** – Conventional Bank with a small Islamic Finance operation based out of Leeds office. For some years now Bank of Ireland has offered a Commercial Murabaha proposition for those who can get through its stringent vetting procedure.
- **Current Products** – Islamic Mortgage (Murabaha)
- **Planned Products** – *None*
- **Contact** – Nigel Thompson – *0113 246 1931*

Children's Mutual

- **Profile** – Mutual fund provider with major presence in Baby Bond investment market. Children's mutual teamed up with Scottish Widows Investment Partnership to launch UK's only Shariah-compliant Baby Bond.

- **Current Products –** Shariah-Compliant Baby Bond
- **Planned Products –** None
- **Contact –** XXXXXXXXXXXXXXXXXXXXXX

European Islamic Investment Bank

- **Profile –** Launched in 2006 as Europe's first ever Islamic Investment Bank. Start up capital of £200m.
- **Current Products –** Bespoke investment arrangements for institutions.
- **Planned Products -** ????????????????????????
- **Contact -** ????????????????????

HSBC Amanah

- **Profile –** Islamic Finance wing of HSBC Holdings PLC. Started operations in UK in 2003 with Islamic Mortgage contract. Now on a rapid product development programme. 18 people dedicated nationally to HSBC Amanah.
- **Current Products –** Islamic Mortgage (Diminishing Musharaka on a Trust Basis). Takafol (Islamic Insurance). Islamic Bank Account (no return paid)..
- **Planned Products –**
- **Contact –** Amjid Ali

Islamic Bank of Britain (IBB)

- **Profile –** UK's first ever stand alone, fully-fledged Islamic Bank. IBB was launched in 2003 accompanied by a major media frenzy. The Bank currently has 8 Branches and is still expanding.
- **Current Products –** Islamic Bank Accounts (Current & Savings), operating on Modaraba Basis. Personal Finance (Tawarruq Basis).
- **Planned Products –** Car lease on Ijara Basis
- **Contact –** Sultan Chaudhrey –

Lloyds TSB

- **Profile –** High Street UK Bank starting Islamic Finance operations.
- **Current Products –** Islamic Bank Accounts (no return paid).
- **Planned Products -** ????????????????????
- **Contact –** Paul Sherrin -

NatWest ABT

- **Profile –** Major UK clearing Bank starting off operations in Islamic Finance market.
- **Current Products –** Islamic Commercial Mortgage on Murabaha Basis

- **Planned Products** - ????????????????????
- **Contact –** Bob Miller - ??????????????

United National Bank

- **Profile –** Merger of the Allied Bank of Pakistan & Bank of Pakistan. Starting marketing Shariah-compliant products in 2003.
- **Current Products –** Ijara Based Islamic Mortgage
- **Planned products –** None
- **Contact –** Humayoun Bowker - XXXXXXXXXXXXXX