ETHICAL BANKING THE ISLAMIC MORTGAGE IN THE UNITED KINGDOM

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ABSTRACT

This paper examines some micro economic and financial aspects of Islamic House finance. The system of Islamic mortgages is compare to the conventional system using illustration from banking practices in the United Kingdom. The principles differences between the two systems are found to be that equity ownership is shared under an Islamic system where as this is not the case under a conventional system.

I. INTRODUCTION

Islamic banking is a growing phenomenon, which came into existence to satisfy the financial needs of devout Muslims (1.6 billion Muslims around the world) who observe the prohibition of Riba (usury). Many economists[1] have studied the macro-economic properties of banking institution in the framework of an isolated and ideal Islamic economy. In the age of integrated global financial markets, the instantaneous transformation of an entire financial sector to profit-and-loss sharing is very unlikely: so what is the outlook for Islamic banking?

Khan (1986) has noted that the abolition of interest-based transactions is not a subject alien to Western economic thought. Fisher (1945), Simons (1948) and Friedman (1969) have argued that the current one-sided liability, interest-based financial system can be fundamentally unstable. There are many such examples; the German hyperinflation of the 1920s, oil shock inflation's in Europe of the 1970s; and banking crises in Japan, East Asia, Russian and Argentina default and Enron bankruptcy, and so on.[2] The occurrence of crises is the result of a complex of factors emanating from over exuberance, greed, underestimation of risk, overexposure, currency failures, asset depreciation, faulty regulation, illiquidity, macroeconomic shocks and accountancy maladministration. Zarqa (1983), Khan (1986), Chapra (2000), El-Gamel (2000) and Abdul Gafoor (1997), have illustrated the macroeconomic stability that can form a profit and loss sharing system, an Islamic form of banking would replace interest-based transactions that characterize Western transactions.

II. SIZE AND POTENTIAL

According to the International Association of Islamic Banks (IAIB), by 1998 there were 176 Islamic banks and financial institutions operating in 38 countries. These institutions had total assets of $148 billion, paid up capital of $7.3billion, and generated $1.2 billion in aggregate net profits latest year of operation. Sir Howard Davies, chairman of the Financial Services Authorities in the UK said "*there was a gap in the market for retail sector Islamic banking products, which would cater to nearly two million UK Muslims*". There are approximately 3 million Muslims permanently resident in the UK with estimated saving of around £1 billion, while over half a million Muslims visited Britain in 2001, spending nearly £600 million[3]. The 5,000 richest Muslims in the UK have liquid assets of over £3.6 billion, according to wealth analysts' data monitor[4] HSBC, the UK-listed bank, which has £2 billion assets under management and three Islamic funds, is predicting growth of assets under management of up to 40 per cent for year 2002[5].

III. THE UNITED BANK OF KUWAIT IN THE UK

The Islamic Investment Banking Unit (IIBU) of the United Bank of Kuwait (UBK) in London has been offering Islamic house financing since 1997. The products, named as Manzil Murabaha (Home Purchase Plan) and Manzil Ijara.

MANZIL MURABAHA HOME PURCHASE PLAN

The Murabaha plan is based on the principle of trading or buying and selling goods at a profit IIBU contracts with the vendor and pays the deposit required when the contracts are exchanged. The sale price from IIBU to the client is the price paid by IIBU to the vendor, plus the return IIBU pays its investors, plus administrative expenses and a profit margin. The property after sale to the; buyer is registered in the buyers name and the buyer repays IIBU fixed monthly installments.

MANZIL IJARA HOME PURCHASE PLAN

Ijara is proving to be most popular method of house finance. This is because it is more flexible than Murabaha if the client wishes to pay bank early or if the client wish to make additional, 'lump sum' payments. The key features are:

i. The client identifies the property that wish to buy and agree the purchase price with the seller in the normal way.
ii. IIBU will then sell the property to the client as detailed in an agreement titled 'Promise to Purchase' The purchase price between IIBU and client is the same price as the original purchase.
iii. At the same time Client will enter into a lease with IIBU which details client rights to occupy the property.
iv. The client pays IIBU monthly payment which is calculated so that part is applied towards the purchase of the property from IIBU and part of it is rent.
v. The payments are fixed every 12 months, April to April. At the beginning of April each year, IIBU will reassess the rent and payments are likely to vary.

Client may purchase the property from IIBU at any time by paying the bank the balance of the purchase price.

IV. CONVENTIONAL MORTGAGE

For example the price is £ 100,000.00 the banks require 10 % deposit if the bank agrees to give a 30-year mortgage of £90,000, at an annual interest rate of 8 %, the monthly payments would be £660.39. Each payment will consist partly of interest due and partly the repayment of principal. The buyer will make 360 monthly payments, which add up to a total of £237,740.40 paid to the bank accruing £147,740.40 interest to the bank.

TABLE I: CONVENTIONAL MORTGAGE

Payment Number	Monthly Payment	Interest	Principal	Balance after Payment
1	£ 660.39	£ 660.00	£ 60.39	£ 89,939.61
2	£ 660.39	£ 599.60	£ 60.79	£ 89,878.82
3	£ 660.39	£ 599.19	£ 61.20	£ 89,817.62
….				
120	£ 660.39	£ 527.13	£133.16	£ 78,951.84
….				
240	£ 660.39	£ 384.83	£ 295.56	£ 54,428.98
….				
359	£ 660.39	£ 8.70	£ 651.69	£ 653.09
360	£ 660.39	£ 7.30	£ 653.09	£ 0.00
Total	£ 237,740.40	£ 147,740.40	£90,000.00	

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V. ISLAMIC MORTGAGE (CO-OPERATIVE BANK)

Just as in the conventional arrangement, the coop bank will require some down payment. That will be client initial equity share. Let's assume client make the same down payment of 10 %, or £10,000. The coop bank puts up the remaining £90,000. Now client and the bank are co-owners. If client occupy the house, client will be required to pay rent to the owners. But client are also allowed to increase his/her ownership share at any time by making additional payments to the coop bank, in effect, buying out the bank's interest in the house. As client do so, his/her proportionate share increases while the coop bank's share decreases and the distribution of the rent payments will change accordingly.
The big question, of course, is what is a fair amount for the monthly rent? It might be reasonable to assume that it is equal to the monthly payments client would have made under the conventional mortgage arrangement, in this case, £660.39. At the outset, client will receive 10 % of that rent as his/her ownership share and the co-op bank will receive 90 percent, Let also assume that client apply his/her share of the rental payments to increasing his/her share of the ownership. Table 2 is an abridged amortization table which shows the respective returns to client and the coop bank. Under this arrangement, client will own 100 % of the property after making the 350th payment. Client will have paid total rent of £231,018.30. The bank's total share will have been £141,018.30. This is a saving of more than £ 6,000.00 or 4.1% over the amount of interest paid on the conventional mortgage.

TABLE II: SHARED EQUITY MORTGAGE

With Rent Equal to Conventional 8%. 30 Year Monthly Payment
Owner's share applied to repurchase: No additional principal Payments

Payment Number	Payment Amt.	Client Share	Coop Bank's Share	Client Equity	Client Equity %	Coop Bank's Equity	Coop Bank Equity %
1	£ 660.39	£ 60.04	£ 594.35	£ 10,066.04	10.07	£ 89,933.96	89.93
2	£ 660.39	£ 60.48	£ 593.91	£ 10,132.52	10.13	£ 89,867.48	89.87
3	£ 660.39	£ 66.91	£ 593.48	£ 10,199.43	10.20	£ 89,800.57	89.80
…							
24	£ 660.39	£ 76.83	£ 583.56	£11,711.34	£ 11.71	£ 88,288.66	88.29
….							
120	£ 660.39	£ 144.54	£ 515.85	£ 22,030.94	22.03	£ 77,969.06	77.97
…							
240	£ 660.39	£ 318.43	£ 341.96	£ 48,536.24	48.54	£ 51,463.76	51.46
…							
359	£ 660.39	£ 652.52	£ 7.87	£ 99,461.37	99.46	£ 538.63	0.54
360	£ 660.39	£ 538.63	£ 3.56	£ 100,000.00	100.00	£ 0.00	0.00
Total	£ 231,018.30						

VI. COMPARISON ANALYSES

To fully appreciate the advantages of the shared equity approach, we need to examine the numbers pertaining to higher conventional mortgage interests rates. Table 3 shows the figures for conventional mortgages at 8, 10 and 12 percent interest, along with figures for comparable shared equity mortgages. It can be seen how seemingly small changes in the interest rate cause enormous increases in the amount of money that client must pay back. At 12 % interest, for example, client will repay £333,270.00 on his/her £90,000 loan over 30 years, giving the bank interest income of £243,270.00. However, a shared equity mortgage with the same monthly payment of £925.75 would give client full ownership in 20 and 5/6 years. The total rent shares to the coop bank would be only £141,323.14, saving the client over £100,000.

TABLE III: CONVENTIONAL MORTGAGE SUMMARY

Comparative figures for different interest rates
30 year conventional mortgage: £ 90,000.00 principal; £ 10,000.00 down

Interest Rate	Monthly Payment	Total Payback	Total Interest	Total Principal
6 %	**£ 539.60**	**£ 194,256.00**	**£ 104,256.00**	**£ 90,000.00**
8 %	**£ 660.39**	**£ 237,740.40**	**£ 147,740.40**	**£ 90,000.00**
10 %	**£ 789.81**	**£ 284,331.60**	**£ 194,331.60**	**£ 90,000.00**
12 %	**£ 925.75**	**£ 333,270.00**	**£ 243,270.00**	**£ 90,000.00**

TABLE IV: SHARED EQUITY MORTGAGE

£ 90,000.00 initial bank equity (90%); £ 10,000 initial buyer's equity (10%)
Buyer's share of monthly rent applied to repurchase of bank's share

Monthly Rent	Total Payout	Bank's share of Rent	Principal	Payment required to complete buyout	Years required to complete buyout
£ 539.60	**£ 230,879.35**	**£ 140,879.35**	**£ 90,000.00**	**428**	**35. 2/3**
£ 660.39	**£ 231,018.30**	**£ 141,018.30**	**£ 90,000.00**	**350**	**29. 1/6**
£ 789.81	**£ 231,167.29**	**£ 141,167.29**	**£ 90,000.00**	**293**	**24. 5/12**
£ 925.75	**£ 231,323.14**	**£ 141,323.14**	**£ 90,000.00**	**250**	**20. 5/6**

The figures in table 3 assume that the fair rent in each case is equal to the mortgage payment. That assumption, however, may be too far fetched. Let's assume that, in every case, the fair rent is equal to the mortgage payment at 8 %, or £660.39. Under these circumstances, any amount paid over and above that figure would be directly applied to increasing his/her equity share rather than being split between client and the coop bank. The lower part of the Summary Table 4 shows the figures for monthly payments equivalent to those at the 10 and 12 percent mortgage rates. With payments of £789.81, client will achieve complete ownership in only 13 and 1/12 years, having paid the bank rent shares of only £54,481.83, saving client almost £189,000 or 77.6 % over the conventional mortgage with the same monthly payment.

TABLE V: SHARED EQUITY MORTGAGE

£ 90,000.00 initial bank equity (90%); £ 10,000 initial buyer's equity (10%)
Buyer's share of monthly rent applied to repurchase of bank's share

Total Payment	Monthly Rent	Total Payout	Bank's Share of Rent	Principal	Payment required to complete buyout	Years required to complete buyout
£ 789.81	**£ 660.39**	**£167,562.16**	**£77,562.16**	**£90,000.00**	**213**	**17. ¾**
£ 925.75	**£ 660.39**	**£144,481.83**	**£54,481.83**	**£90,000.00**	**157**	**13. 1/12**

VII. CONCLUSION

Islamic principles of interest are concerned with issues of fairness and justice rather than efficiency narrowly defined. These principles focus on the necessity of sharing risk in a fair and stable society, and upon problems of exploitation in markets where power is asymmetric this is the real Riba (usury) issue.
Our case analyses shows that the principles differences between Islamic and conventional housing finance is that the former is equity based and the latter is debit based. In an Islamic mortgage situation both the bank and the client share ownership [equity] and therefore share the risk of equity ownership. In conventional banking the client owns all the equity and the banks loan to the client is secured on the value of the property.

NOTE

[1] Khan 1995, Ahmed 1992, Umer Chapra.M 2000 and Abdul Gafoor. A.L.M 1997.
[2] The Economist December 31st 1999
[3] Birmingham Post Birmingham (UK); Sep 21, 2002 John Duckers.
[4] Nicholas Stephens Data monitor
[5] Financial Times; London; Feb 25, 2002. Mawson James.

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