

Ethical Banking Islamic House Financing in The United Kingdom: A Comparative Study

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Abstract

This study examines some micro economic and financial aspects of Islamic finance: House finance. It is part of more general study of the role and states of Islamic finance in the modern global financial sector. The system of Islamic mortgages is compare to the conventional system using illustration from banking practices in the United Kingdom, Canada and United states. Murabaha and Ijara are compared. 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. Were an Islamic system to be adopted worldwide, a most unlikely event, the world financial system might be more stable and fair.

The paper begins by outline some basic principles of Islamic finance: Murabaha and Ijara in relation to financing house purchase. Conventional Untied Kingdom mortgage finance is compare to Islamic house financing using the case study approach. The paper examines the differences between the two and goes on to discuss specific problems of housing finance under Islamic principles in the Untied Kingdom the paper conclude with a discussion of the implications of the case examples for Islamic finance generally.

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 economists¹ 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. But the Islamic view has its critics: and not only among mainstream economists. Perhaps the strongest condemnation of profit/lost sharing in the literature that is fundamentally to an Islamic approach, is Ahmad (1992):

“The sad reality is that though every one concedes that Islam prohibits interest, there is not a single Muslim country which is running its financial institutions without resorting to interest. The fact is that no one knows how to do it, and when political pressure mounts, they can only resort to some kind of subterfuge... It is not clear whom we are cheating...The worst part of the story is that Islamic economists, as a body in their International Monetary and Fiscal Conference held in Islamabad in 1981, gave their unreserved approval to this arrangement. So far this is the best that Islamic economics has to offer, viz., change the name of interest and you have abolished interest”.

Even though the Islamic banks have attracted a great deal of enthusiasm and support, they have also been subject to a number of other criticisms. These are related either to their inability to come up to standard performance expectations, to the fallibility certificates of their Islamic credentials. One of these criticisms is their inability to get away from the trappings of conventional banks.³ According to Islamic banker Atif Abdulmalik⁴, *one affective way of doing new things is ‘to leverage concepts and ideas that have been developed in conventional banking and to adapt them for Islamic banking’.*

The lending activities of Islamic banks are confined primarily to the secondary modes: financing short-term trade and lease operations of large and well-established firms and corporations who get credit facilities from both conventional and Islamic banks. They do not seem to have played any significant role in financing small and

¹ Khan, 1995, Ahmed, 1992, Umer Chapra.M, 2000, and Abdul Gafoor. A.L.M, 1997

² The Economist December 31st 1999

³ This seems to be a general feeling and was expressed by Rodney Wilson Sept 1996, in the following words “ Often it has been a case of adapting and modifying conventional instruments so that they can be seen to be Islamically legitimate.”

⁴ Trends in Islamic banking - Warren Edwardes Delphi risk Management 18 April 2002

medium scale businesses, farmers, industrialists, or craftsmen, or providing venture capital.⁵

While they mobilize resources from the Muslim countries, a substantial part of their financing goes to large, *triple A* corporations in the West, thus depriving the Muslim world of the benefit of its own resources.⁶ Moreover, the rates of return they charge seem to be closely related to the London Interbank Offer Rate (LIBOR). Therefore, there seems to be a feeling that in egalitarian terms their overall performance is not only not better than that of conventional banks, but may in some respects be even worse⁷ and more expensive.

Size and Potential

There is no doubt of the potential of Islamic finance to unlock funds, and forge par excellence a niche market. Islamic banker Atif Abdulmalik: *'If we stricture a product in an Islamically acceptable manner, not only are we conducting our business in accordance with Islam but also, from a business point of view, differentiating ourselves and carving out a niche in the wider, extremely competitive financial services industry'* Beyond that, considering that the 10 largest Muslim states have a combined GDP of \$1.2 trillion, and there are 150 Million Muslims resident in non Islamic countries, it is obvious that the sector is likely to develop a sizeable clout⁸.

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*

⁵ See the address of Saleh Kamel while accepting the IDB Award on Islamic Banking for the year 1996, Arab News, 22 October 1997, P. 15.

⁶ Homoud, 1994, PP. 75-76; T.Khan, 1995; Khan and Mirakhor, 1994, P.20.

⁷ Umer Chapra. M, The future of Economics: An Islamic perspective, The Islamic foundation 2000

gap in the market for retail sector Islamic banking products, which would cater to nearly two million UK Muslims". There are over 2 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 million⁹. The 5,000 richest Muslims in the UK have liquid assets of over £3.6 billion, according to wealth analysts' data monitor¹⁰ 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 2002¹¹.

II. The Practice of Islamic House Financing In the UK.

i. 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.

⁸ Trends in Islamic banking - Warren Edwardes Delphi risk Management 18 April 2002

⁹ Birmingham Post Birmingham (UK); Sep 21, 2002 John Duckers.

¹⁰ Nicholas Stephens Data monitor

¹¹ Financial Times; London; Feb 25, 2002 Mawson James.

Murabaha Based Mortgage

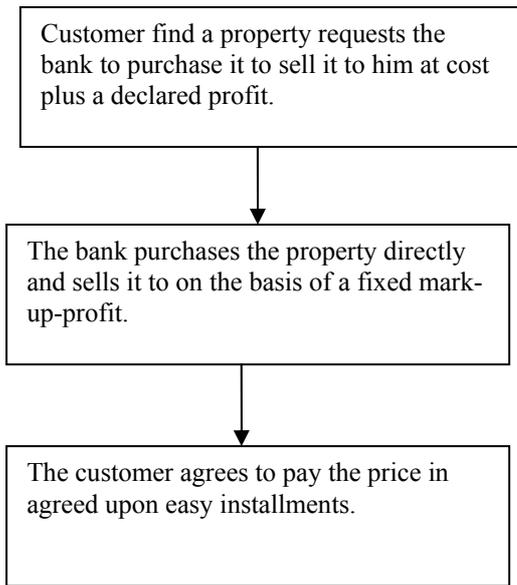


Figure 1

The key features are:

i. Clients identify the property that wish to buy and agree the purchase price with the seller of the property in the normal way.

ii. The IIBU will buy the property, and immediately sell it to the client at a higher price. This is calculated depending on the property value, payment terms (up to 15 years) and the amount of the first payment.

iii. When purchased, the property is registered in client's name. The sale between client and the bank is recorded in the Murabaha Contract.

iv. Clients first payment to the bank is made on the day of completion and is client's initial contribution is a minimum of 20% of the purchase price.

Manzil Ijara Home Purchase Plan

Two versions of the Ijara house are illustrated in the figure 2 below.

Two Versions of Ijara based Mortgage

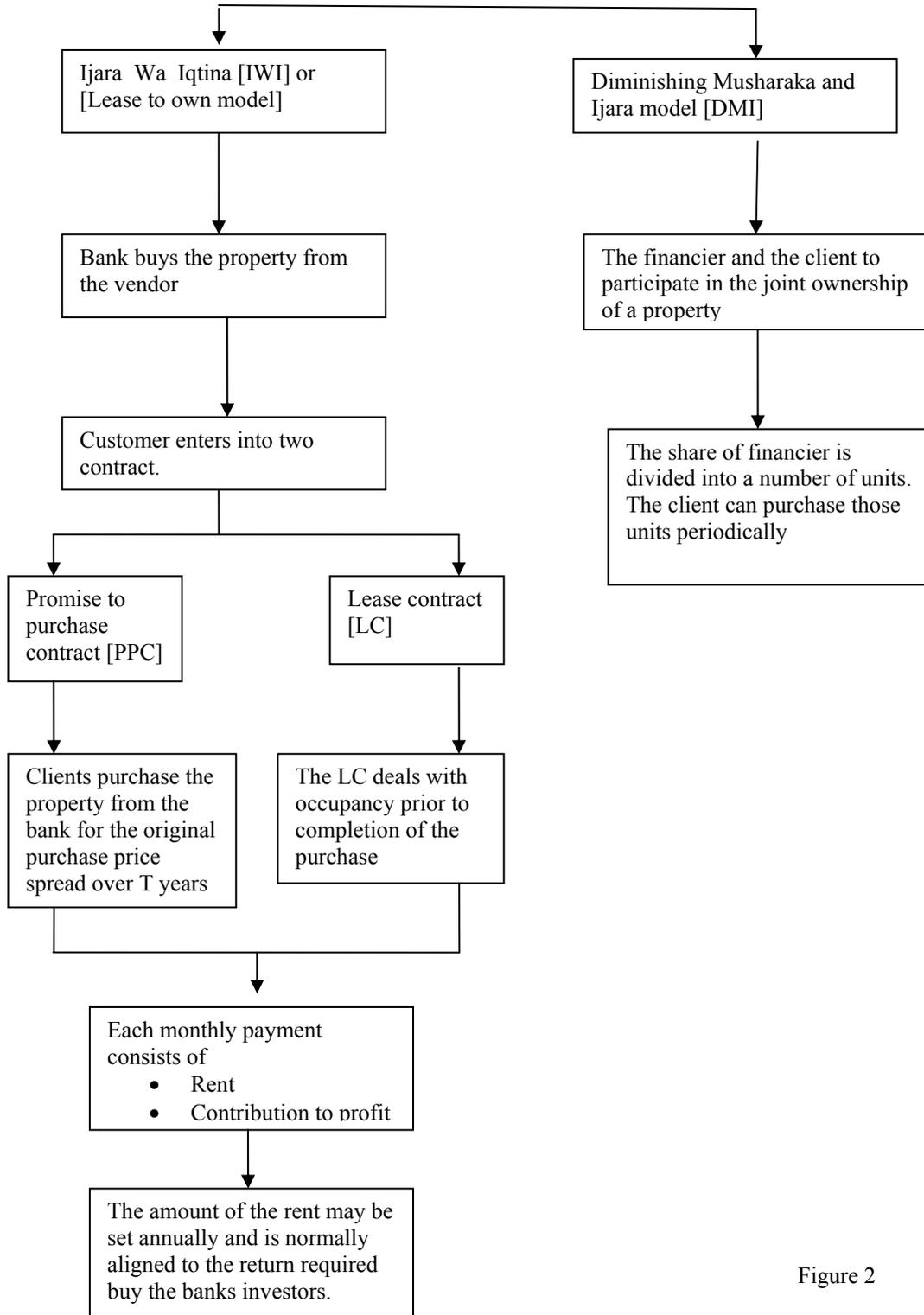


Figure 2

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 of Ijara are described below:

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

ii. *Al Baraka Bank*

Former Al-Baraka Bank in London (Now an investment company Dallah Al Baraka LTD) provided long-term Islamic mortgages to its clients between 1988 and 1991.

The operations were similar to the Diminishing Musharaka and Ijara [DMI] model whereby:

- i. Al-Baraka and its client would sign a contract to purchase the house jointly, the ownership share being determined by the financial contribution of each of the parties.

- ii. Al Baraka would expect a fixed predetermined profit for the period of the mortgage
- iii. The client making either monthly or quarterly repayments over a 10-20 year period, which covered the advance plus profit share.
- iv. There was some debate if the profit share could be calculated in relation to the market value of the property, but this was rejected as frequent revaluation of the property would be expensive and administratively complicated. Furthermore, given the fluctuating prices in the London property market, there would be considerable risk for the bank

III. Islamic House Financing Elsewhere.

i. *Islamic Co-operative Housing Corporation, Canada*

Islamic Co-operative Housing Corporation (ICHC) uses the IWI model and runs the scheme as follows:

- i. Prospective Homebuyer must become a member of the ICHC by paying \$75 membership fee plus buy at least 6 shares of \$100 each in each calendar year in order to keep the membership active.
- ii. Shares can be sold or transferred any time to any member of the housing cooperative. Shares need to equal 10% of the outstanding mortgage balance, in the cooperative for at least six months.
- iii. Client choose a property but client must have shares equivalent to at least 20% of the first \$100,000 of the property value and 40% of the difference between \$100,000 and the actual price up to \$200,000. The minimum required shares must be with the cooperative for at least six months.
- iv. Client pay fair and mutually agreed occupancy charges (rent) to the housing cooperative in proportion to your and coops ownership in the house.

v. Monthly occupancy charges will be reduced from the following month in the proportion of additional shares client buy any time during the year.

vi. As a result of sale/transfer of the housing unit any gain or loss realized will be divided as follows:

a) 90% to the member and 10% to the ICHC if the member has already acquired more than 50% shares.

b) 80% to the member and 20% to the ICHC if the member has acquired 50% or less shares.

The capital gain or loss will be shared after making an adjustment for authorized improvements, expansions and certain legal expenses incurred by the member. To complete the ownership of the occupied housing unit, the member will have to accumulate shares equivalent to the cost of the housing unit plus one class 'G' Preferred share. The cost of the above Class 'G' preferred share will be determined by the board as 10% of the difference between the present fair market value of the said housing unit minus the actual cost, the cost of authorized major improvements and expansions and certain legal expenses.

ii. *MSI housing Fund, Houston*

MSI housing Fund Houston, Texas [USA] applies the DMI model in its share Key Features:

i. MSI Housing Fund purchases a house of customer's choice in a partnership with the customer.

ii. Customer required investing at least of 20%of the purchase price or \$10,000 for a minimum period of six months with MSI and Housing Fund provides the remaining 80%.

iii. The home is purchased with the title document showing Housing Fund

as the co-owner instead of mortgage-holder.

iv. Customer, called a resident owner pays fair market value monthly rent proportionate to Housing Fund's ownership. In addition, resident owner can choose to buy-out Housing Fund's ownership in a period ranging from five to fifteen years depending on his/her budget.

v. This additional payment, which reduces Housing Fund's ownership every month, is added to monthly rent to arrive at total monthly payment. As a result, more of the monthly payment is applied towards purchase of ownership each month.

vi. Unlike mortgage, Housing Fund shares the cost of insurance and property taxes consistent with its status co-owner.

vii. In the event that a house has to be sold, with mutual agreement, prior to complete buy out of Housing Fund equity, sale proceeds are divided between the resident owner and Housing Fund according to their proportionate ownership, unlike a conventional mortgage where the balance must be paid off before homeowner gets anything.

iii. *A Comparison between Islamic and Conventional Mortgage.*

Conventional Mortgage	Islamic Mortgage
The lender advances funds to the borrower and charges [interest] for the use of their money.	Based on trade [Murabaha] and leasing [Ijara], Islamic mortgages are Interest free.
Credit references, sources of income to be able to retune the loan before 65 birthdays.	Credit references, sources of income to be able to retune the loan before retirement age.
Most of the lender has no lower limit to the property value.	Minimum property value £50,000.
Up to 125% of the property value.	Up to 80% of the property value
Life insurance and building are	There is no compulsory life and building

mandatory in most cases.	insurance are required.
Lender never owns the property.	The bank puts itself in the position of owner of the property. Higher risks.
Payment term up to 40 years.	Murabaha up to 15 years minimum 5 years Ijara up to 25 years minimum 7.5 years
Income Multiples Up to 5 times primary annual income sole applicant.	Murabaha 2.5 times primary annual income Ijara 3 times primary annual income sole applicant
Arrangement fee usually up to £500.	Arrangement fee of 0.75% of the property value less the first payment.

IV. Islamic and Conventional Mortgage Comparison

i. 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 1: Amortization schedule for a 30 year conventional mortgage at 8% interest:

£ 90,000 principal

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	

ii. *Islamic Mortgage*

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.

Let's compare this arrangement with the conventional mortgage in the example given above. 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 coop 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 2: 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						

Problems in Provision of Islamic House Financing in the UK

A document jointly prepared by Barclays Group, HSBC, Union Bank of Switzerland, Ihlal UK, and United Bank of Kuwait lists the following major barriers to provision of Islamic house financing in the UK:

- i. Under current regulations on lease agreements, the product has to be 100% risk weighted. In other words, HSBC (Amanah Finance) says, *it has to set aside the full amount of the property to cover the full value of the house in case the buyer cannot afford to pay the rent, whereas a conventional mortgage has a risk weighting of only 50%*¹².
- ii. Unlike a conventional mortgage, the proposed product would require two sets of solicitors. Islamic institutions would also want an exemption from a second set of solicitors.
- iii. The inability to obtain financial assistance from the state in cases of

financial hardship.

Discussion and Criticisms

Discussions have been taking place with the Bank of England and the financial services authority (FSA) on these issues and Khan is confident that they will be resolved in time so that HSBC (Amanah Finance) can begin offering Islamic financial products in year 2003. That is not inconceivable as the regulatory authorities have already approved Islamic mortgages in the US. Khan believes that Islamic finance potentially has appeal for the mainstream as well as Muslim consumers because of its ethical basis. "Islam teaches us that money should be channeled toward the 'real' economy, the production of real goods and services and not the 'financial' economy such as hedge funds and derivatives," he argues. "It keeps us in touch with the real economy and away from speculation"¹³.

Perhaps one of the most damaging criticisms is that while relying on the secondary modes of financing they do not seem to be fulfilling faithfully the conditions laid down by the *Shari'ah* for the permissibility of these modes. This criticism may or may not be right. However, what provides credibility to it is the secretiveness and lack of adequate transparency on the part of these banks about their operations¹⁴. A second criticism is that the certificates about their Islamic credentials are issued to them by their own internal *Shari'ah* boards. No one doubts the integrity of the members of these boards, who are highly qualified and well-respected *Shari'ah* scholars. They are, nevertheless, employees or paid advisers of these banks and there is a possibility of conflict of interests.

¹² Mark Tran Monday May 27, 2002; Guardian

¹³ Mark Tran Monday May 27, 2002; Guardian

V. 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.

Putting aside the penetrating comment by Ahmed (1992), that we noted earlier in the paper about hypocrisy in the current practice of Islamic banks, let us deal with the realm of the ideal. Consider an ideal situation in which Islamic principles of interest were adhered to by a substantial proportion of the world financial system. What they have in common is a prohibition of usury, or excessive interest rates. Could such an idealized system conceivably survive as a foundation of banking in a hypercompetitive global financial environment? Pure logic would dictate that this is not possible in a profit-maximizing world: that is if *excessive* includes interest rates that reflect high risk situations or situations of capital shortage: both of which would require high interest rates that might be considered usurious. We remarked at the beginning of the paper on the recurrent crises in the financial sector. Maladministration, deception and ethical behavior lie at the root of many of these problems: Enron and WorldCom are just two examples. The Islamic approach

¹⁴ Muzzam. Ali, Januray 1997, P. 6.

emanates from a foundation set of ethical principles. So discussion of Islamic finance in connection with global financial practices introduces an ethical dimension that is welcome. Also as Khan (2002) points out an Islamic system of finance might create a more stable world financial market.

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