Summary

The past two years have seen several significant developments in the field of Islamic banking and finance in the UK. EIRIS has monitored developments and consulted with key players and consultants to compile a short introduction to this fast growing area. This paper includes a brief discussion of:

- Islamic economics and finance - key concepts
- Market scope and outlook
- Major Islamic investment institutions and products
- Relationship between ethical investment and Islamic principles

Overview

September 2004 saw the public launch of the UK based Islamic Bank of Britain which has recently received regulatory approval to take deposits from the Financial Services Authority (FSA).

The new bank is the latest in a series of ventures seeking to meet the needs of Muslim investors. In July 2003, HSBC, the UK’s biggest bank became the first mainstream institution to launch an Islamic home finance product specifically aimed at British Muslims. The last year has seen further moves by a range of providers both in the UK and abroad, to develop this growing market.

Whilst the diversity of opinions amongst Muslims means that some products can never satisfy all competing religious viewpoints, moves over the past two years by major banks and regulators to develop Islamic financial products in the UK have been welcomed by people with otherwise contrasting views, for helping to broaden and open up the market.

In regulatory terms much of this process was encouraged by the establishment of a special Bank of England working group to look at financial products compatible with Sharia (Islamic law), following the lobbying of regulators by Muslim community organisations, including the Muslim Council of Britain.
The group's work led to the 2003 UK Budget abolishing the previous 'double payment' of stamp duty, required on the purchase of homes via Islamic mortgages. (This arose because the lender on an Islamic mortgage typically assumes initial ownership of the property and agrees a form of rent combined with promise to purchase by the borrower, thereby causing two transfers of ownership.) Although a relatively minor change in relation to the overall cost of buying a house the 2003 Budget stamp duty amendment was seen as a highly symbolic official recognition of both the needs of Muslim investors and the potential of Islamic finance as a market.

Demand for financial products compatible with Sharia (Islamic law) is continuing to increase amongst the growing number of British Muslim professionals, as can be seen by the success of financial advisers and institutions specialising in this type of ethical investment. At a grassroots level, there is also reportedly much increased discussion of ethical issues to do with investment and consumerism.

As over half the UK's 1.8 million Muslims are aged under 25, the scope for further growth in developing Islamic financial products appears considerable. For international banks, the added and more significant attraction of developing this area is the potential synergy for their operations in mainly Muslim countries. Growth is likely to be boosted with the launch of further niche products expected in 2004 -2006.

**Islamic Economics and Finance - Key concepts**

Over the centuries, the world's financial system has been shaped by many different factors and events. Islamic views of finance and trade are based on the core principles of fairness and trust and have much in common with traditional Judeo-Christian viewpoints.

In the present day the influence of religion is considered to be largely limited to shaping individual opinions and moral attitudes towards capitalism rather than setting and managing the system itself. In this sense, talk of an Islamic economic system is analogous to talk of a Buddhist or a Socialist economic system. That is to say, it is a highly influential philosophy which shapes the ethics, opinions and behaviour of a large proportion of the world's population, but in the main exists more as an alternative ideal rather than as a major driving component of the global economy.

This is considered by many to be as true in practice for people living in states with Islamic constitutions as it is for people living in the West or Muslim countries with secular constitutions. Islamic banks and financial products occur in one form or another in all countries with large Muslim populations, but are not dominant and mainly co-exist only as a minority alternative alongside conventional banks.

Differences in philosophy and practice between specialist Islamic banks mean that whilst many core principles are commonly accepted, there is a historically large body of debate and jurisprudence on how to operate
Islamic finance in practice. Islam therefore makes a bigger impact globally by the way it influences the behaviour of individual Muslims within the conventional economy rather than by its creation of alternative economic models and institutions. For example, because the predominant Islamic interpretation of usury extends to forbid all payment or receipt of any interest it is commonplace for many Muslims to operate only interest free accounts in conventional banks and/or to give away any interest they receive on savings.

Philosophically, the banning of transactions involving *riba* (usury) in the Qur’an shares many similarities with views about the undesirability of usurious transactions in the Torah and Bible. The continuing prevalence amongst Muslims of a strong injunction against paying or receiving any form of interest is perhaps partly a reflection of economic status as a majority of the world's Muslims live in poor developing countries and/or are only recently participating in the formal global economy.

A key religious factor explaining why some wealthier Muslims with conventional bank accounts, nonetheless still often give away or refuse interest is the principle of *Zakat*, (Islamic almsgiving.) Along with faith, regular prayer, fasting and pilgrimage, *Zakat* forms one of the five basic principles or 'pillars' of Islamic practice. *Zakat* institutionalises the systematic giving of 2.5% of one's wealth each year to benefit the poor. It does not include charitable gifts given out of individual generosity and is not a replacement for taxes, but is seen as a form of compulsory worship, purification and redistribution. As it necessitates a regular reassessment of net wealth *Zakat* is thought to help concentrate the mind in encouraging compliance with *Sharia* in all financial dealings.

**Three key ideals of Islamic economics (in addition to *Zakat*)**

- As with other spheres of Islamic life, *Sharia* makes a clear distinction between what is *halal* (lawful) and what is *haram* (forbidden) in pursuit of economic activity. Investments in religiously unacceptable activities or businesses that harm the wider interest are therefore considered unlawful.
- Acknowledging an individual's right to retain legitimately acquired surplus wealth whilst discouraging hoarding, monopolistic activities, and excessive materialism.
- Aiming to encourage social justice without inhibiting individual enterprise.

There is therefore always an inherent Muslim preference for financial products and businesses based upon shared risk taking and ownership. In practice, Muslims around the world adopt diverse ethical attitudes to their financial dealings. For example both co-operatives and venture capital investments may attract preference as they both share risk, equity and profit. The pragmatic approach adopted by Muslim investors is reflected in the rulings of specialist *Sharia* scholars and committees, who commonly help set the differing policies adopted by different Islamic finance products. The table overleaf lists the major categories of product specifically marketed as *Sharia* compliant.
Market scope and outlook

In the past, barriers to growth of the UK Islamic finance market have included:

- High charges and costs, such as that associated with double stamp duty.
- The main focus of the sector being on international high net worth individuals, even though UK Muslims are predominantly from poorer minority ethnic groupsiv
- Wide ranging views and disagreement about what exactly constitutes Islamic banking and/or scepticism about the religious validity of products available.

The nature of this area means that the latter factor will always be a consideration. Because of this, one might expect the sector to be led by mutually owned Muslim led organisation. In practice however, the likelihood is that growth will be driven as much by major commercial banks (who have the advantage of economies of scale) seeking the Muslim market, as it will by specifically Muslim institutions. In 2002 for instance, HSBC, the UK listed global bank had three Islamic funds and £2 billion of assets under specialist management and was predicting growth rates in coming years as high as 15% to 40%.v

Demographic and social changes makes the Islamic finance market increasingly attractive. The 2001 Census showed that for the first time over half the UK's 1.8m Muslims were born in the UK, with a large proportion living in London and the South East. Being predominantly second and third generation the group has taken on characteristics of a settled community and is making more long term financial decisions.vi All indications therefore suggest growing demand for riba-free alternatives not just for home finance but for other types of savings vehicles. Sharia compliant share issues, ISAs, student loan schemes, pension plans and takaful (insurance) products are all potential growth areas. As competition increases, a greater diversity of products and providers competing across a wider spectrum of ethical preferences is likely to emerge.
## Major Islamic investment institutions and products

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<tr>
<th>Types of product</th>
<th>Providers/policies</th>
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<tr>
<td><strong>International wholesale Islamic Banking and Insurance Providers.</strong></td>
<td>♦ In 1999, the International Association of Islamic Banks estimated there were 176 specialist Islamic banks and financial institutions operating in 38 countries. These institutions had total assets of $148 billion, paid up capital of $7.3 billion, and generated $1.2 billion in aggregate net profits.</td>
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<td>London is a major centre of wholesale Islamic banking due to the UK’s trade with the Middle East and the global attraction of mainstream UK regulation.</td>
<td>The London based Institute of Islamic Banking and Insurance lists the following institutions as members and/or providers of all types of Islamic investments:-</td>
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**International Islamic Investment Indices**

The 2 best known global investment index providers Dow Jones and FTSE both have well-established Islamic investment indices.

These have been revamped in recent years to take account of growing global interest and are increasingly overlapping with criteria that are popular with leading SRI (socially responsible investment) funds.

The criteria adopted by these indices are potentially very influential.

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<th>Dow Jones - several indices based on following factors</th>
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<td>• Industry Type: Excluded are companies that represent the following lines of business: alcohol, tobacco, pork-related products, financial services, defence/weapons and entertainment.</td>
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<tr>
<td>• Financial Ratios: Excluded are companies whose total debt divided by trailing 12-month average market capitalisation is 33% or more; those whose cash plus interest-bearing securities divided by trailing 12-month average market capitalisation is 33% or more; and those whose accounts receivable divided by total assets is 45% or more.</td>
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<th>FTSE Global Islamic Index Series (GIIS)</th>
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<td>&quot;the result of analysing and screening 2,400 companies included in the FT&amp;SP Actuaries World Index - selected c.110 companies whose business activities are in compliance with the terms and conditions of the Sharia</td>
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By way of guidance these principles will exclude stocks whose core activities are, or are related to the following:

- Banking or any other interest related activity / alcohol/ tobacco/ gaming/arms manufacturing/ life insurance /pork production/ packaging and processing or any other activity related to pork/ sectors / companies significantly affected by the above / companies whose gross interest bearing debt to total assets exceeds the percentage permitted under Islamic Sharia from time to time (This list is not exhaustive and is produced as basic guidance to the broad principles involved.)

**Niche products aimed at UK Muslims**

Small but growing sector presently focused on Islamic mortgages.

- Ahli United Bank PLC (aka United Bank of Kuwait.)
- The United National Bank (UNB)
- HSBC PLC (Ammanh Finance section)
- Islamic Bank of Britain launched 2004

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<th>There are two main versions of Sharia compliant mortgage products. Murabaha based on Trading is where the bank contracts to buy the property from the seller and sell it to the borrower at a higher price.</th>
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<td>More popular is the principle of 'leasing' or Ijara where</td>
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<td>• The bank buys the property and agrees to sell it to the borrower for the same price spread over a term of up to 25-30 years.</td>
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<tr>
<td>• During this time the borrower pays the bank rent for living in the property</td>
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<td>• Regular reviews take place of the rent paid to the bank.</td>
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**NB:** This is a simplified version of the concept. Variations tried in other countries include a co-operative shared ownership model, whereby the purchaser gradually increases the proportion of shares owned in the property. A key principle for Islamic mortgages is the assumption of ownership (and thereby the risk of sharing in falling house prices) by the lender.
Relationship between ethical investment and Islamic principles

Faith and conscience have always been influential amongst factors encouraging people to invest ethically. Not surprisingly there is considerable overlap between Islamic principles and many longstanding concerns of the ethical investment movement, with the former's focus on *riba* /interest being the main distinguishing factor.

In the past, this overlap has been partly obscured by the relatively narrow focus of many existing Islamic funds on 'sin related' lifestyle criteria such as alcohol and gambling, to the exclusion of what some have argued are more important issues from a religious point of view such as the arms trade and environment.vii This picture is beginning to change as more and more Muslim investors are looking at issues such as the environment, fair trade, animal testing and genetically modified organisms and encouraging *Sharia* scholars to take such previously neglected criteria on board.

In the coming year EIRIS will use its experience as Europe's leading independent provider of information on ethical issues for investors with different ethical viewpoints to:

- Develop information and consultancy services for clients interested in offering *Sharia* compliant products
- Introduce new customised information services for Muslim investors and clients
- Promote further dialogue about Islamic finance issues in the UK and Europe

Ethical Investment Research Service,

October 2004

Sources

This publication is intended as a brief introduction to this area. EIRIS takes no position on issues of Islamic jurisprudence and no endorsement or criticism is intended of any of the products mentioned in this discussion paper. As noted, many different views exist. The Institute of Islamic Banking and Insurance in London is a useful starting point for information about existing providers and concepts ([www.islamic-banking.com](http://www.islamic-banking.com)). An alternative more questioning viewpoint and network also based in London is provided by [www.islamic-finance.com](http://www.islamic-finance.com)

Disclaimer

Clients using this information should do so with caution and not rely on this information in making any investment decisions. EIRIS does not and cannot give financial advice and recommends that individuals seek independent professional advice. While every effort is made to ensure the accuracy of the information presented, EIRIS cannot accept responsibility for any errors or omissions. It is important to note the date of this document as circumstances may have changed since then.
Footnotes

1 Islamic Bank of Britain plc received a licence to take deposits on 6 August 2004, FSA reference number 229148, www.fsa.gov.uk. The application was initiated by Joint Venture Partners (IJVP) a Bahrain-based Islamic investment house supported by some UK Muslim venture capitalists.

2 Office for National Statistics http://www.statistics.gov.uk

3 Successful experience of Islamic financial products co-existing with conventional banking products in Malaysia presents a very positive outlook because Malaysia has a very similar financial regulatory structure to the UK and has actively set a target for Islamic investments to constitute some 20% of the country’s financial sector by 2010.

4 Bangladeshis and Pakistanis form around half of all UK Muslims. They earn considerably less than other minority ethnic groups and are twice as likely not to have a bank or building society account as the general population. New Policy Institute www.poverty.org.uk.


6 Muslim Council of Britain committee report

7 Many works exist on the relationship between faith, money and the environment, an influential Muslim example of which is Islam and Ecology edited by Fazlun M Khalid and Joanne O’Brien, Cassell, 1990.