An Analysis of Islamic Banking and Finance in West: From Lagging to Leading

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Abstract

The main purpose of this paper is to highlight the unprecedented growth of Islamic banking and finance in West with focus on United Kingdom. It captures the advancement of Islamic banking and finance in U.K over time It is observed that origin of Islamic finance in the UK can be traced back to early 1980s, however, real significant development was not made until the last decade of 20th century. The factors contributed to recent success of Islamic finance in UK include unprecedented Government support, fastest growing Muslim population, 9/11 factor, petro dollar wealth of Middle East etc. The future of Islamic finance in UK seems bright thought not without serious challenges. The potential size of industry suggests that Islamic finance will continue to be a darling of West for a long time to come.

Keywords: Islamic Banking and Finance (IBF), Interest, Shariah, Financial Services Authority (FSA)

1. Introduction

This paper reviews developments in Islamic Banking and Finance (IBF hereafter) in West by focusing on United Kingdom (UK). The key aim of this review is to highlight and provide an account of developments that has made Islamic finance in UK from an almost 'no-go area' to a 'sought after' issue. The UK is a representative country for this purpose in Europe for several reasons. It is the first country to publicly declare its intent to adopt and push Islamic Finance. Gordon Brown, Former Prime Minister and then Chancellor of Exchequer, made his intention clear in 2006 while speaking at a conference in London that UK is well placed to become gateway of Islamic Finance in West. The UK is the home of about 2.0 million Muslims with about half a million of regular Muslim visitors on top of it. According to Office of National Statistics, the Muslim population in UK has increased ten times faster than rest of the society. This makes a sizeable market to cater for and UK Government is committed to provide its citizens freedom in the way they live and conduct their commercial activities as long as they are not violating the laws of the country.

The paper is structured as follows: section 2.0 provides an introduction of Islamic banking and finance and of its fundamental principles and governing rules; section 3.0 reviews developments in IBF in UK in three time periods – past, present and future; and finally section 4.0 concludes this paper.

2. Islamic Banking and Finance

What triggers curiosity in Islamic finance is the absence of interest, which is the backbone of Western or Conventional banking and financial systems. Islam prohibits interest, known as *riba*, not as law of the land but as divine orders leaving no space whatsoever to argue or put a case forward otherwise (Al-Qamar & Abdel-Haq, 1996). It is compulsory for Muslims to completely avoid *riba* in their commercial and non-commercial daily activities. It is even suggested that a shadow of interest will make a transaction haram. Apart from interest, other prohibitions include uncertainty, risk taking, ambiguity and investment in unethical and haram businesses. These prohibitions make up a wide part of activities of conventional banks. Under Islamic faith, all these prohibitions are believed to be signs of immorality and exploitation. In contrast, the Islamic banking operates on the principles of profit loss sharing and financing is done as participatory mode rather than lending mode. The Islamic banking and finance is a system designed to allow Muslims to deal with their financial affairs in accordance with their faith. The theoretical model is appealing and is carefully designed to avoid interest and other prohibition, however, implementation of the Islamic banking and financial system has not always been successful in practice (Shepherd, 1996).

The Western banking and financial system has kept Islamic financial system dormant for centuries. However, there have been a revival of interest of late. The IBF industry is growing at a staggering rate of 15% to 20% and has maintained this growth during the financial recession which made conventional banks significantly suffer and contract. The current size of industry is around $700 million with potential size estimated at around $4 trillion(FSA, 2006, Iqbal & Molyneux, 2005).

3. Islamic Banking and Finance (IBF) in UK

This section provides a review of past and present as well as an assessment of future of IBF in UK. This has been done in three sections. Section 3.1 provides an account of past of IBF in UK by focusing on developments from opening of first Islamic financial institution in early 1980s to 1999. Section 3.2 covers present of IBF in UK from year 2000 to date. The significance of breakup of past and present is surrounding around 9/11 incident, which had significance influence of Islamic finance outside the Islamic countries. Moreover, this incident resulted in the emergence of Patriotic Law in USA, which made USA unattractive for wealthy Muslim investors. Europe, particularly UK, emerged as an obvious choice. Section 3.3 addresses the issue of future of IBF in UK.

3.1 Past of IBF in UK

According to Karbhari et. al.(2004), the idea of Islamic banking was first developed in the 1950's and the first generation of Islamic investment banks were created in Egypt and Malaysia in the early 1960's. Due to the success seen in countries like Dubai; (Dubai Islamic Bank), and Bahrain; (Al-Baraka), Muslims felt there is no reason why it could not successfully be replicated in the UK. There were an estimated 369,000 Muslims in Britain in 1971, which quickly rose to 1 million Muslims at the close of the century(Salaam, 2010). These figures evidently suggest the large potential market size always existed in UK for Islamic financial services.

Both Dubai Islamic Bank and Al-Baraka that were mentioned above had originally emerged between late 1970's to 1980's, however these were based around predominately Muslim countries and this may have been a major factor to their success. Plans to develop these in the UK began to materialize, with Qatar Islamic Bank and Al Ahli Bank both hoping to push into the UK markets. This was a major breakthrough for the advent of the Islamic Banking Industry, however as it was new system, it faced many unprecedented challenges. The size and strength of the conventional western banks remained very strong and caused conflicts in the UK. Not only were they overshadowed by these large banks, but they also faced liquidity issues, something that was always going to be an issue for newcomer banks (Frings, 1982).

Kay (2004) talks about the history of Islamic banks in U.K by narrating that the first Islamic bank to operate in the United Kingdom was in the early 1980's, Al-Baraka bank. In 1982 the Al-Baraka Investment Company acquired Hargrave Securities, which at the time was licensed to accept deposits, when it was acquired by Al-Baraka the company was established as the first Islamic bank to serve high net worth Arabs who spent the summer in London. The bank offered for the first time to Muslims in the UK investment deposit facilities on a *Mudaraba* basis, the increase in demand from 1983 to 1991 of £23 million to £154 million showed that clearly the demand for Islamic banking within the UK was evident. However later the demise of the bank in 1993 would be that it just didn't provide like a conventional bank in that it provided instruments which were more investment funds based and as it was not able to compete competitively, due to its limited capacity and resources, in comparison to conventional banks demand soon died down.

Oakely (2009) also points out that the first form of Islamic banking in the UK was wholesale operations, where banks in London would provide newly established banks in the Gulf, overnight deposit facilities. This was necessary to Islamic banking as Gulf banks needed access to Shari'ah compliant liquidity management. As Islamic banks are not permitted to hold liquid assets like treasury bills, due to riba, banks in London such as the Bank of London started accepting deposits on a basis that there would be a mark up as a result of a Murabaha transaction, with a short term trade being the transaction on the London Metal Exchange. Consequently as a result non-Muslim British bankers soon became experts in Shari'ah principles learning innovative and imaginative methods of responding to Muslim client's requests.

In 1976 the Institute of Islamic Banking and Insurance was established in London's King's Cross, an area which didn't fit the Islamic finance image and later relocated in 1990 to Grosvenor Crescent in the West End, which was the sort of area which would generally be associated with wealthy individuals like those from the Gulf. In 1997 the United Bank of Kuwait entered the housing market basing it upon a Murabaha instalment structure. The benefits were not vast only that it was a ethical method of financing a house, however due to 'Stamp Duty' having to be paid twice as a result of the structure of the Murabaha instalment, which made the process uncompetitive in comparison to conventional mortgages. Later in the 2003 budget the double stamp duty was abolished in Islamic mortgages. The British government were keen to show that they were actively attempting to facilitate Muslims who had never used conventional banking as it was not Shari'ah compliant (Davies, 2002).

3.2 Present of IBF in UK

The US had an appealing banking system and naturally attracted overseas investors, including those oil-rich wealthy Muslims. Conflict between the US and Middle-East erupted in 2001 following terrorist attacks and sparked harsh widespread hostility towards the Muslim community. It led to many Muslims closing their US banking services and seeking new places to deposit their money (Taylor, 2007). The expected value of the deposits were £250bn, which has had many countries fighting to replace the US and expressed their intention to become the financial hub of Islamic finance outside Islamic countries.

The current climate in the Islamic banking proves that the UK is still able to prove itself as innovative in the products which it is continuously developing. Due to stricter laws regarding intellectual property rights the UK has now a major impact on the Islamic banking sector world-wide. Such as the Islamic Bank of Britain (IBB) being the first Islamic institution in the world to offer Murabaha treasury deposit accounts, proving that dynamic economies have innovative financial sectors. The government's role in making Islamic banking the hub for Islamic finance is crucial and in the early days the government's actions were limited but this was due to their limited knowledge of the Islamic banking sector. The consortium gained the approval of the Financial Services Authority (FSA) and opened their first branch on Edgware Road in September 2004 and had the headquarters in Birmingham calling the bank 'The Islamic Bank of Britain'. The locations of the branch and headquarters are very significant as they were placed in the two areas of the UK with the highest density of Muslim population, to achieve the exposure they required so. This increased to five branches by the end of 2005, showing that the demand for Islamic banking and finance was always there, drawing great similarities to Al-Baraka Bank in the early stages of Islamic Finance in the UK (Tarek, 2010).

Early regulations of the Islamic financial instruments were poor as compared to the standard of regulations within the conventional banking sector as the protection which was available to Islamic mortgages, was irrelevant in comparison to that of their conventional counterparts This was another reason why the early development of the Islamic banking sector was slow. Since then the government has changed regulations to make sure that protection is in place for the Islamic mortgages as well as the conventional. (Ayub, 2007; Umer, 2007)

Ayub(2007) further argues that now a days the government is helping to develop the market by making sure changes that are required to legislation and regulation to support the Islamic banking sector should be implemented, such as the Finance Acts of 2003, 2005 and 2006 as well as the abolishment of double stamp duty. These were the hurdles which restricted Murabaha, Ijarah and diminishing Musharakah.

Khan & Bhatti (2008) comment that due to the relative infancy of Islamic Banks the importance of their products must compare well to those of the conventional banks as many of the high street banks now have Islamic windows within their branches. HSBC AMANAH was one of the first conventional banks to start offering ethical banking products, Islamic financial instruments, to their customers. Many firms, like Lloyds TSB, started to see the potential of the market when double stamp duty was abolished after the 2003 Budget. Through acquisitions many banks purchased the infrastructure of other commercial banks to sell Islamic products. It took a few years but eventually many Islamic Banks from the Gulf then recognised the potential in the UK and negotiated with conventional banks to distribute their financial instruments through their branches. The products which were initially available to customers were two types of house finance options:

- Murabaha, where the customer would have to pay monthly repayments which would include a cost plus mark up for the banks profit.
- Ijara, this was the option where the bank would purchase the property, and the client would pay a monthly repayment as well as a monthly rent, the rent would be calculated according to LIBOR index which would avoid expensive re-valuations. Even thought the use of LIBOR is Riba based, it was accepted by the Shari'ah council, due to wide acceptance by the banking community, it can be debated that at the start of Islamic banking scholars would have never accepted this policy as the rules when Islamic banking was still infant were adhered to much more due to the reason why Islamic banking was needed, to lose western influences in the Gulf (Usmani, 2008).

At present the main deterring factor for Muslims, for not choosing an Islamic Mortgage is the higher costs due to high fees charged by the Shari'ah councils, however in the future as the number of suppliers of Islamic finance increase the cost of the products will decrease. Currently no Islamic financial institution of conventional bank with' Islamic windows' offer savings or investment accounts on a Mudaraba basis. This is due to the fact that there are no facilities available to match the liabilities against an Islamic mortgage asset, which are generally done by investing in Shari'ah compliant investments in the Gulf. The reason is the Gulf has heavily invested in assets within the Gulf but they are running out and other nations are being looked at to be the suppliers of the bonds to allow Islamic financial instruments, like the potential issue of a sovereign Sukuk by the UK government(Amin, 2007).

Aioanei(2007) is of the view that currently the direction of the retail banking industry is moving towards catering to high net worth individuals. The development of premier banking by numerous banks Islamic and conventional, such as IBB and HSBC AMANAH look to gain customers who can invest larger amounts of money to improve the liquidity of the Islamic banks or conventional banks and their Islamic funds. For instance the IBB approach is very well orientated as they placed their premier banking office in Mayfair, which is London's most expensive area, where the majority of home owners are extremely high earners with numerous Arab millionaires and billionaires residing during the summer. They are attempting to attract the petrodollars of Arab sheikhs so they can appeal to them to invest their money into Shari'ah compliant investments. It is evident that the banks in the UK are proving to be more innovative than the Islamic banks abroad as the IBB won first place in a global vote for their services, even beating the Abu Dhabi Islamic Bank.

A method currently being used to achieve a larger number of retail deposits from Muslims specifically is the attempt to attract administration of Masjids and Madarasahs, as these Muslims are the important figures within Muslim communities and attracting their investment will undoubtedly attract sceptical Muslims who may feel unnerved about opening their first account as many do not hold bank accounts as there was no option previously to have a Shari'ah compliant account. One dominant figure who has been attracted was the Imam at Birmingham Green Lane Mosque, which will increase deposits in the area due to the high profile of the imam and his influence.(Islamic Bank of Britain Report, 2005).

The recent rise in oil prices has meant that the Gulf region has increased in liquidity surpluses and due to the saturation of the Gulf markets themselves there has been a demand for the money to be invested in other locations and the demand for financial assets has consequently risen because of this.

Currently there are eight Sukuks, with an estimated outstanding valued of $70 billion, issued on the London Stock Exchange and this has developed since the early days due to the establishment of the London Stock Exchange as the first secondary market. The brokers are now trying to establish offices in the Gulf due to their knowledge and expertise that have been gained with their dealings with business men from the Gulf; this would allow a close relationship as well as attract other Gulf business men to bank in the UK.

3.3 Future of IBF in UK

The British Government's role in the future success of Islamic banking is significant, as it will determine if Islamic banking continues to flourishes in the UK. The current issue for the future is if the issue of the sovereign Sukuk for £2 billion will happen. This is necessary for the establishment of the UK as the hub for Islamic finance because the need for bonds to invest money for the use of Murabaha and Ijara. Currently the buffer used by the five Islamic banks in the UK is from the Islamic Development Bank, with the debt they issue. However there is uncertainty if the Sukuk will be issued but its issue would be a benefit to the Islamic banks as and the government as it needs finances to overcome huge budget deficit. Neither Labour nor the Conservatives have dismissed the idea yet (Okaley, 2009).

The current expertise within the Islamic market is limited. As most of the British bankers are still learning the principles behind the Islamic banking industry. So there is need to increase education and training to improve expertise and knowledge to develop Islamic financial instruments and the industry itself. The last few years have seen the increased number of universities offering Islamic Banking and finance courses at all levels to students and professionals.

The future of Islamic banking is based on technology, as more than half of British Muslims currently are under the age of twenty-one. By improving the technological capabilities of Islamic Banking the potential for expansion is vast, as the competitiveness will improve in relation to the increase in costs. The banks would be able to overcome costly distribution costs in providing services to Muslims all over the UK. Internet banking already being a major part of most conventional banks operations it is vital for the future of Islamic banking that Muslim customers are attracted to bank with Islamic banks as to allow the expansion of Islamic finance to all areas of the United Kingdom (Memon, 2007).

The development of Islamic banking has been huge since the early days, with no one expecting that in 2003 a consortium of Gulf banks and a British business man would purchase Aston Martin for £250 million being financed by a Murabaha transaction. This is the very first of its kind in the west and shows that the prospects of wholesale Islamic banking are a lot more prosperous than had been thought initially when Islamic finance was introduced to the UK (Kabir & Lewis, 2007).

An introduction of Takaful Insurance's product called Salaam Halal in 2008 has been failure in the following year due to insufficient capital. The model used to operate the company was Wakala, as it is a much more transparent model allowing there to be clarity in the transactions. The prospects are unclear in the UK but due to the success of Takaful in Malaysia and the Gulf may mean that the development of the products may result in them slowly being transferred to the UK. The primary benefit of developing a prosperous Takaful market may develop the Islamic mortgage market by offering combined packages for home buyers. Takaful is perceived to be an area of Islamic finance which has the most potential to expand rapidly due to the wide range of customers. It will appeal to from individuals to large corporations and with relatively small amounts of suppliers the potential to expand is great. The market is expanding at a rate which is double of that in conventional insurance companies, world-wide, however due to many religious issue surrounding Takaful its acceptance will vary from community to community, a possible method of attracting Muslims would be through attracting Imams (Davies, 2010).

Risk management is a vital part of conventional banking but there have been many problems in achieving this for the Islamic banking sector, mainly due to non acceptance by Muslim scholars. To develop this particular area the International Swap and Derivatives Association have signed a Memorandum of Understanding with International Islamic Financial Market to develop Sharia'ah compliant derivatives (Al-Omer, 2000).

Interestingly, HSBC have identified the concern of mixed funds and have specifically announced on their website that "funds held in Amanah Bank Accounts are kept separate from conventional funds and are not used to generate interest" (HSBC, 2010). This is an important step towards offering truly Shariah compliant services and is a key distinguisher from HSBC and many other conventional banks. More mainstream western banks should take a similar approach to ensure clarity and integrity, which subsequently will result in Islamic banking and finance being substantially larger.

Karbhari et al (2004) identify that in order to prosper, Islamic banking needs to resolve the regulation by the Basel Committee's minimum capital and liquidity requirement. Conventional banks hold much of their assets in fixed interest-bearing deposits and the BC estimates this to be a security and thus lower risk. On the other hand Islamic banks invest more on long-term projects and ventures. Karbhari et al (2004) are of the view that Islamic banks maintain a higher liquidity requirement with riskier assets than that of conventional banks.

Another issue threatening the growth of Islamic banking is the support from the UK public. As an alternative to interest, Islamic banks offer Mudaraba (profit/loss shared). This has significant benefits to both the individual and the bank making it fairer and reducing exploitation. However, Dar and Presley (2000) have found that it is not used in practice and instead finance with mark-up (Murabaha) or leasing based financing (Ijarah) is used. Figures showed that in 1996, only 20% of financing was based on Mudharabah. Both Murabaha and Ijarah services are similar to those found in conventional banks and eliminates the need for Islamic Banks as they offer nothing unique. The lack of demand for these products will cause Islamic banks to stop offering them and restrict their growth in the UK. Dar and Presley (2000) identify that venture capital financing is the western equivalent to Murabaha, which in fairness is also relatively unpopular in relation to personal financing.

In the past there have been issues concerning UK regulations and Islamic banking. One of the most notable was in 1993 which was the same year that Al-Baraka bank was forced to give up its banking license (Karbhari et. al. 2004). Tax regulations also affected Islamic banks and MCo's performance was affected in 1992 following amendments to the regulations (Dar and Presley 2000). There have also been concerns over the issue of Sukuk in 2008 in the UK. The lack of co-operation between the UK and Islamic Banks will ultimately make it more difficult in the future to grow and succeed. They both have responsibilities to protect the UK public and the Muslims, but with both pursuing different goals it is resulting in inconsistency and contradicting regulations, which will prevent the future success of Islamic Banking and Finance.

Despite these negative points that limit the success of Islamic banking and finance, there are lots of reasons to suggest this to become a strong, longstanding financial institute throughout the UK.

Following the 9/11 incidents, many Muslims sought new countries to deposit their money. The UK has announced its desire to be the western hub for Islamic banking and finance. UKTI (2008) predicts this market to grow at 15% per annum. Croft (2007) acknowledges that outside of Muslim countries, the UK has shown the most positive results and it would appear the UK is winning the race to be leaders in western Islamic banking. Lord Mayor of the City of London Alderman Nick Anstee announced in the a press conference the achievements made so far, with 20 Sukuk issues raising $11 billion, 22 banks, 5 fully Shariah compliant banks and institutions offering educational and training products in Islamic finance(Croft, 2007). These achievements should help cement their lead and better co-operation by the UK in offering more commercial services to the public can be expected.

Croft (2007) believes that Islamic mortgages are expected to grow at average of 47 per cent per annum to reach US$2.8 billion by 2009. In relation to insurance, David Hunt, of HSBC Amanah, stated that the volume of business HSBC Amanah sold grew 82 per cent in 2008. This is evidence that Islamic banking is not only financially large, but is also improving vastly and it is showing no signs of hesitance. However, only 4 per cent of insurance is Shariah compliant. Islamic insurance has the potential to be much more dominant in the market. In order to be successful in the future more marketing and education needs to be done. The Financial Times (2009) reports that "UK companies such as HSBC, Prudential and Aviva that operate takaful businesses elsewhere are not yet pushing their products in the UK.

4. Conclusions

It is observed that the IBF industry in U.K has accelerated rapidly within the last 10 years. The 9/11 factor, growth of Muslims population and the support from the UK government all have contributed to its current success. Although in hindsight, most of the achievements have been overshadowed by the lack of awareness by the public. Possibly the banks need to market this more or more education should be imparted to develop understanding.

Islamic banking and finance will be a strong industry in the future in the UK market, but will continue to face struggles in the process. It will always be difficult to challenge large banks such as HSBC, Lloyds TSB, Santander and NatWest. To promote Islamic banking products the Islamic financial institutions are becoming partners with western market players. The Western market environment specially U.K have turned up more conducive for Islamic banking and financial practices. The developments in Islamic banking in West have given an opportunity for these institutions to become integrated and competitive of world financial markets. The Islamic banking and finance systems in West will continue to grow in areas like Sukuk, Takaful, hedging funds, mutual funds, equity & asset management, corporate finance, wealth and asset management. These high street banks are far more accessible and popular, and all offer similar services. The main reason for the struggle is that, the Islamic bank is introducing an entirely new banking model into a country that has been built around an existing banking system that has been around for a long time. If they are able to maintain a consistent growth and momentum they will soon become a well established banking system in the UK and will continue to succeed in the long-term.

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