



Community Development Finance and Faith

Guidelines for developing Sharia Compliant Loans

August 2006



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A word from our sponsors

Barclays Bank

Barclays have supported the Ethnic Business Development Corporation in the research and production of this report through our Barclays Financial Inclusion Fund.

This fund, targeted at supporting local community finance organisations, is part of Barclays wider commitment to promoting financial inclusion. We believe enabling people and businesses to access banking and finance can really make a difference in supporting wider social inclusion and broader social and economic development and we realise that community finance has an important role to play in providing niche products and localised support to more deprived communities.

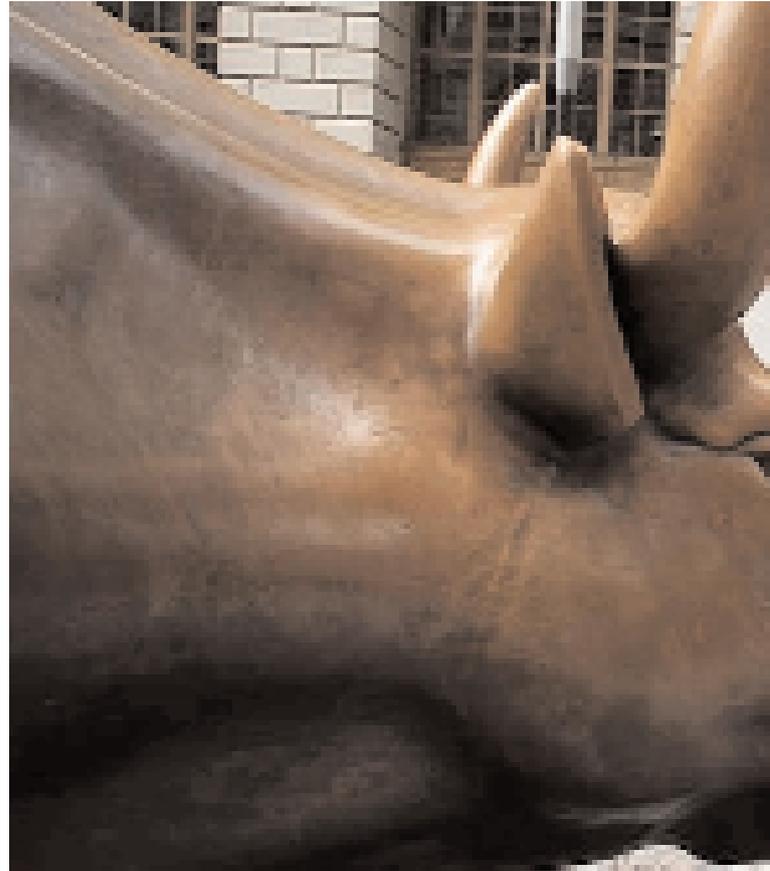
The grant we awarded to EBDC was to enable organisations to develop innovative ideas to help them reach out to new customers in need. We hope this report enables more community finance organisations to understand and work within Sharia Law to enable them to expand their products and to reach out to wider sections of society.

Foreword

The imperative to develop guidelines for Sharia compliant products within the community development finance framework derives from the incessant exclusion of people from certain faiths or cultures from mainstream financial services such as loans, mortgages, insurance and other products. As this study examines the ramifications of the impact of the Islamic faith in mainstream financial inclusion, it must not be lost on the interested observer that the issue underlining this study is that of exploring an engagement that widens participation in mainstream provision.

It must also be recognised that so far, alternative methods of accessing finance has been open to people of faith. However, the key question is whether the creation of an informal and hitherto unregulated financial services structure is helpful as a sustainable strategy and direction for BME enterprise and community development.

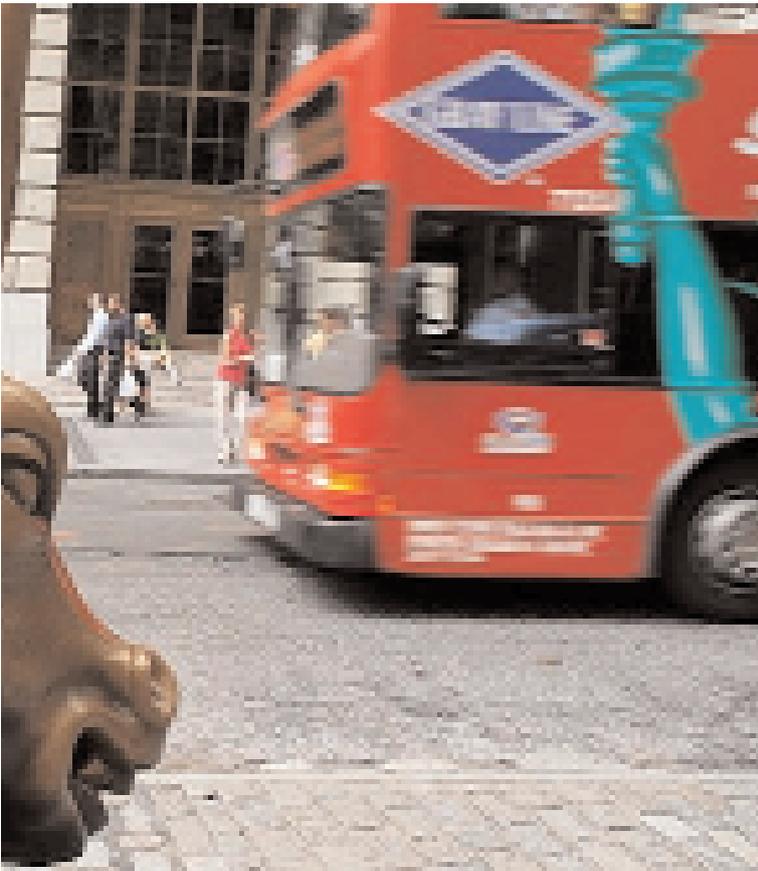
Ethnic Mutual has been assisted in this study by the collaboration of both the Ethnic Business Development Corporation (EBDC) and Equinox Consulting. This collaboration brings together two of the most resilient black led business development organisations to focus on a problem that has for some time exercised their respective constituencies. Widening participation on mainstream financial products not only augurs well for community development but also engages and extends opportunities for enterprise activities within hitherto marginalised communities by the provision of services and employment opportunities.



The increasing debate on how to galvanise social enterprise as a sustainable framework for public service delivery is also crucial to the prospects of a more financially inclusive society. Islamic faith groups and other excluded communities can take advantage of securing access to appropriate finance in order to set up robust enterprises that will provide the culturally relevant and religiously sympathetic services required by those within their communities. Services that are much needed by these communities such as provision of “*halal*” meals on wheels to Muslims in social care settings is one example that springs readily to mind.

The recent Finance Act (2005) has set the regulatory framework on the provision of Islamic finance products within mainstream and boutique banking and financial institutions in the UK. It remains to be seen how much advan-

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products both within the community development arena and the mainstream. In the event, we look forward to working within our strategic environment to develop appropriate financial and loan products for our communities. These guidelines provide a starting platform for the realisation of the objective to overhaul access to finance for hitherto excluded or marginalised communities.

These guidelines encourage Community Development Finance Institutions (CDFIs) to take full advantage of this legislative framework to deliver innovative and religiously compliant financial products for people from within their scope who may be otherwise susceptible to financial exclusion.

The implications for CDFIs is significant within the Finance Act and the impending considerations to extend Community Investment Tax Relief (CITR) benefits to individuals as capital finance providers to CDFIs. Ethnic Mutual is currently at the leading edge of these developments because our expertise straddles both CITR and Islamic Finance.

The imperative therefore to establish credible guidelines for Sharia compliant loan products within the CDFI environment is compatible with the objective to widen participation in financial

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The revival of Sharia banking within the Muslim communities is gaining acceptability in the western world. In Britain the Financial Services Authority has approved a Islamic Bank that will provide loans that are Sharia compliant.

There are several other organisations that are investigating how Sharia compliant financial products can be made available to all and not just the rich. The intention of these investigations is to ensure that some devout Muslims from socially excluded communities, who because of the religion are excluded from participating in conventional financial institutions, will have access to alternative sources of finance.

This document has been written as a guide to explain the process and principles of Sharia compliant financial instruments and how these facilities could be implemented especially by Community Development Financial Institutions set up to provide access to funding for socially excluded communities.

The document has been designed for Ethnic Mutual, a community development finance institution licensed by the FSA that seeks to provide loans to “hard to reach” socially excluded communities as a lender of last resort.

Ethnic Mutual is set up under the guidelines of the Industrial and Provident Society for community benefit and has attracted funding from the Phoenix Fund and other private charities that promote work with socially excluded communities.

The organisation was recently launched at City Hall and has also issued a call for withdrawable

shares from the general public and other high net worth persons who are interested in community finance.

Ethnic Mutual works under the ethos of ensuring that loans provided to people from disadvantaged and socially excluded communities should be appropriate to their needs and in this regard, devout Muslims should also have access to appropriate financial services.

The primary target community for Sharia compliant loans is the Muslim community who number around 1.8 million in this country, roughly 2.7% of the population.

The Muslim community are predominately from ethnic minority communities; roughly 92% of people from Pakistan and Bangladesh are Muslims. Around 13% of Indians and 20% of Africans in this country are Muslims and increasingly there is a growing Arab population and persons from previously war torn areas in Eastern Europe and central Asians who have come into this country as refugees who are also Muslim. Developing Sharia compliant financial products will enable some of these people to participate in business and have access to capital and credit facilities that are in line with their religious beliefs.

An overview of the beliefs provided below acts as a useful context.

Islam, the religion of Muslims has the same roots as the Jewish and Christian religion but is the youngest of these religions. Islam means peace with God, with oneself and all the creation of God and commitment to and guidance from God.

Muslims recognise all the prophets in the Old Testament: from Adam through Abraham,

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Jacob, David and Jonah. They also recognise John the Baptist in the New Testament and regard Jesus Christ as a special prophet.

However Muslims believe that Muhammed is the last prophet. They believe that their doctrine, worship, law and guidance for a just society, proper human conduct and equitable economic principles that are all embodied in their holy text the **Koran** and these were revealed directly to Muhhamed by the angel Gabriel. The Five Pillars of Islam are: faith and belief in the oneness of God, daily prayers, fasting for self purification, almsgiving and concern for the poor and the pilgrimage to Mecca for those who are able.

Most religions are concerned with the financial fortunes of their adherents. The wealthy are asked to care for the needy, programmes are developed to assist the needy and there is a constant search for solutions to problems that are faced by the poor. For instance, the protestant work ethic was a spur to industrialisation and in recent times, the black led churches have been at the forefront of working on initiatives to assist their congregation out of poverty. In some cases this has taken the form of setting up financial initiatives such as credit unions and pooling funds together in 'partner' schemes to assist those in business

Usury, with its connotation of exploitation of the poor by the rich has always posed a problem for most religions. Whilst Christians have accepted it as modern finance has spread in the world, devout Jews still struggle with it. Some Jews have found a way of interpreting the Old Testament texts to mean that the Jewish should not practice usury on fellow Jews. For some devout Muslims, usury still remains an

issue and they have revived medieval ways of business to deal with the issue

The Muslim religion has a particular concept of money and finance, they believe that money is a gift from God as a direct reward for entrepreneurial activity and that those who are successful must help those who are less fortunate; therefore making money by lending it to poor people is extortionate.

This view of finance is confirmed by the religious texts that prohibit **riba**, (interest) because there is no exchange of goods and services. The texts promote enterprise and risk taking as the source of wealth and encourage **zakat**, almsgiving from those that are wealthy to those that are poor.

Though the texts are uncompromising on **riba**, there are those who believe that if you invest and receive **riba**, it is legitimate to give it away as **zakat** to good causes.

In addition to the prohibition of **riba**, the sources and application of funds must be permissible or **halal**; so money that is tainted with gambling, alcohol, pornography and prostitution and any immoral activity, arms manufacturing, pork related businesses and conventional banking that accepts **riba**, cannot form the basis of any financial transaction or instrument. What this means is that some financial products are permissible whilst some are not. Venture capital funds, mortgages, lease finance funds, some insurance funds and some medium term loans are permissible, some such as private equity funds and capital protected funds are not allowed.

A variety of financial products have been developed based on the mutual principle of the

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investor and the borrower sharing the risk and working co-operatively. These instruments all promote the notion that profit from tangible enterprise is preferable to income on debt that is prohibited. The transactions are often complicated and they come with rather exotic Arabic names such as **mudharabah**- profit sharing, **musharakah** - joint venture, **wakala** - agency, **murabahah** - cost plus, **ijarah** - high purchase, **wadiah** - safe keeping, **bai' bithaman** - deferred payment, **qardhul hassan** - benevolent loan, **bai'al-inah** - sell and buy back, and **hibah** - gift. There are several more in development, some very complex so as to be able to mirror all the conventional financial instruments.

Legal and technical issues relating to these instruments are gradually being resolved. The law of the land of the contract, is not seen as inferior to Sharia law; corporation, income and capital gains tax rules are being changed to allow Sharia instruments to receive same tax treatment and the double stamp duty that apply in other modes of transactions.

The FSA expects that Islamic financial organisations will continue to operate within the rules for compliance set by the FSA so they would not attract extra scrutiny. Their products however must meet the guidelines set by the EU that ensure that the financial institutions must be sound, the customers must understand what is being offered to them, and the operators must be professional and competent.

The FSA recognises that important work has been undertaken in other countries that have

embraced Sharia banking and is confident that this work will help them their understanding of these instruments and will assist them in their supervision of institutions offering Sharia compliant products.

The Sharia concept of partnership banking, denotes partnership between investor and borrower where fees are charged for offering the products and that the investor shares a profit with the borrower. There are several mechanisms for the calculation of these fees and shares of the profit; the time value of money and the London Inter Bank Offering Rate (LIBOR) rate prevailing as well as the rental charges prevailing for the goods and services are just some of the bases for these charges.

For a loan to be Sharia compliant, a Sharia supervisory board has to be assembled to oversee the total portfolio and its performance. It is the board that endorses that the product is compliant. However the membership of the board requires respected and knowledgeable people who are experts in both western finance and the Islamic religion.

Finding such experts has always been expensive and problematic because of the dearth of the combination of skills and the frequency of their meetings.

To reduce the expense, **fatwas** that are issued on products are used as a basis for similar loans and Sharia supervisory boards could be shared amongst institutions

The process for offering Sharia compliant loans starts with the assembling of a respected and competent board who will help with the development of products, advertising the existence

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of such products, ensuring that experienced loan officers are able to appraise the applications for loans and track their repayments, and ensuring that the organisation complies with the conditions of all its regulatory bodies.

For Sharia compliance, several elements are important.

- The source of the money for investments must be **halal**
- There must be tangible products or services as the subject of the transactions
- There must be an element of risk involved in the transaction
- The products offered must not be interest bearing
- The money must not be used for purposes that are illegal or immoral
- The Sharia supervisory board must declare the loan compliant

Sharia banking is a novelty in this country at present and despite the complexities that seem inherent in products and the fact that they are seen as unconventional in western finance, they represent a legitimate way of providing finance especially to people from disadvantaged communities..

There is still little information available on how Sharia compliant instruments are implemented; but an opportunity for further investigation is important much in the same way as the concept of working capital loans have gained acceptability and success in some parts of the third world.

Though the instruments look complicated at this time, they will become popular as more people realise their availability and the useful role that they play in filling a gap in the market by providing access to funding for people from disadvantaged communities. At this point in time the pooling of resources is as important as a need for extensive work in understanding the concept and sharing it with all institutions.

Ethnic Mutual is well placed to do this because of its interest and understanding of how the concept works.

Ethnic Mutual will however endeavour to position itself as the first reference point for all who seek to work on Sharia compliant instruments and will work with all agencies to ensure that Sharia compliant loans are seen as a credible supplement to conventional instruments.

Introduction

Islamic banking has gained acceptability in the international finance and banking environment as banks in Malaysia, Bahrain and several other Muslim nations have provided regulations to guide banking under these principles.

The principles of Islamic banking are not necessarily at variance with conventional banking if a conscious effort is made to synchronise the two systems of finance and asset management.

This has been done to a significant extent in the UK by the enactment of the Finance Act 2005. This Act goes a long way to demonstrate that it is possible to achieve some convergence by the creation of a regulatory framework that allows the two concepts to run side by side.

Islamic banking had been informally accepted in Britain with the setting up in 1998 of the Ahli Bank and the licensing in 2003 of the HSBC Bank to provide Sharia compliant mortgages, it has gained formality with the recent from the FSA for the first Islamic Bank of Britain to operate full banking facilities in the UK.

Though the demand for Islamic banking has not been tested in the UK, there is already a significant client base of devout Muslims who have been denied access to finance that is appropriate, consistent and compliant to their religion.

Islamic banking has therefore become topical and there are several agencies and organisations at present who are investigating the issue of Sharia compliant loans that would meet the financial needs of people from disadvantaged communities, especially Muslims.



This document represents one such attempt to explain the process of implementing Islamic banking. The document attempts to provide guidelines that will enable an institution to consider how it can implement Islamic banking and the mechanisms needed for compliance. This is not intended to be a definitive document simply because the inner workings of developing appropriate Sharia compliant products and services will be the responsibility of the different agencies opting to provide the products.

So far, such methodologies are to a large extent commercially confidential because they are still in the state of development by smaller, alternative financial organisations.

Introduction



The development of this work therefore has been relatively difficult because of the heightened competition for information from sources that are also in the process of examining the topic. We have therefore relied very much on information that is mostly already available in the public domain; interviewing experts on the subject has revealed a difficulty to reach agreement or consensus on some material mechanisms of the religion's edicts and interpretations of context and teachings. We have however remained focused on our objectives to:

- Provide clear guidance on the rules governing development finance products and to examine the functional implications of development

finance for faith communities

- Research the theories governing religious attitudes to credit and explore ways of providing religiously acceptable credit products for people currently excluded from mainstream credit products
- Provide literature and toolkit setting out guidelines for providing certain types of credit products such as Sharia compliant loans

This document will therefore be instructive not only to the Community Development Finance but also to mainstream banking and finance sectors.

Ethnic Mutual in context

Ethnic Mutual Ltd was set up in 2004 with funding secured from the DTI Phoenix Fund. It operates as a Community Development Finance Institution and has the primary aim of providing loans as a lender of last resort to people from diverse communities who are susceptible to financial exclusion and or may be “hard to reach” by mainstream initiatives

Ethnic Mutual Ltd is registered with the Financial Services Authority (FSA) as an Industrial & Provident Society for Community Benefit. It has also secured registration as a licensed credit broker under the consumer Credit Act 1974. Trading as Ethnic Mutual, this Society is a pioneering CDFI targeting financial exclusion for the most “hard to reach” communities in London.

Ethnic Mutual has supplemented its initial funding with grants and support from other organisations such as London Rebuilding Society, Industrial Common Ownership Fund (ICOF), the CDFA, Esmee Fairbairn Foundation and Barclays Bank Plc.

Ethnic Mutual is now established within the growing network of CDFIs in London and intends to play a strategic role in providing access to finance for private and social enterprise development, focussing on marginalised or excluded communities

Within its first six months of operating, Ethnic Mutual's loan officers dealt with applications for loans totalling over £1.25 million, supported over 80 businesses and provided loans of over £250,000.00 to enterprises in London.



The organisation was recently formally launched at City Hall on 19th July 2005 and has also issued a call for withdrawable shares from the general interested public to contribute to its capital base so that it can build a sustainable organisation and make a real difference in creating opportunities for those who face financial exclusion.

For this share offer, individuals are limited to a maximum of £100.00 worth of shares, Companies or other corporate bodies to a maximum limit of £20,000.00 but there are no limits imposed on subscription from another IPS. Irrespective of the number of shares allocated, the IPS maintains a one member, one vote system that underpins its governance.

Ethnic Mutual in context



Ethnic Mutual operates as a lender of last resort, specifically focussing on the 'hard to reach' group of excluded communities (lone parents, ex-offenders, long term unemployed, refugees and asylum seekers) for whom economic development is vital if regeneration and the renewal of communities is to be realised.

Ethnic Mutual also realises that for some of these communities it is essential that the CDFIs loan assessing and processing systems are flexible enough to cater for the achievement of a social objectives oriented needs justification framework without necessarily losing the rigour that is expected from wholly commercial loan appraisal and approval systems.

The types of loan and other financial services facilities offered must be relevant to and appropriately suit the needs of the target communities served by Ethnic Mutual.

It is for this reason that the issue of developing appropriate frameworks for deploying Sharia compliant loan products is significant for the proportion of Muslim clients who may fall under Ethnic Mutual's radar.

The target Client group - Muslims in Britain

The target client group of people who are likely to benefit from any Sharia products will be prospective and existing enterprises developed by people from the Muslim community. The products may also be suitable to other communities with a proven or established aversion to interest bearing products.

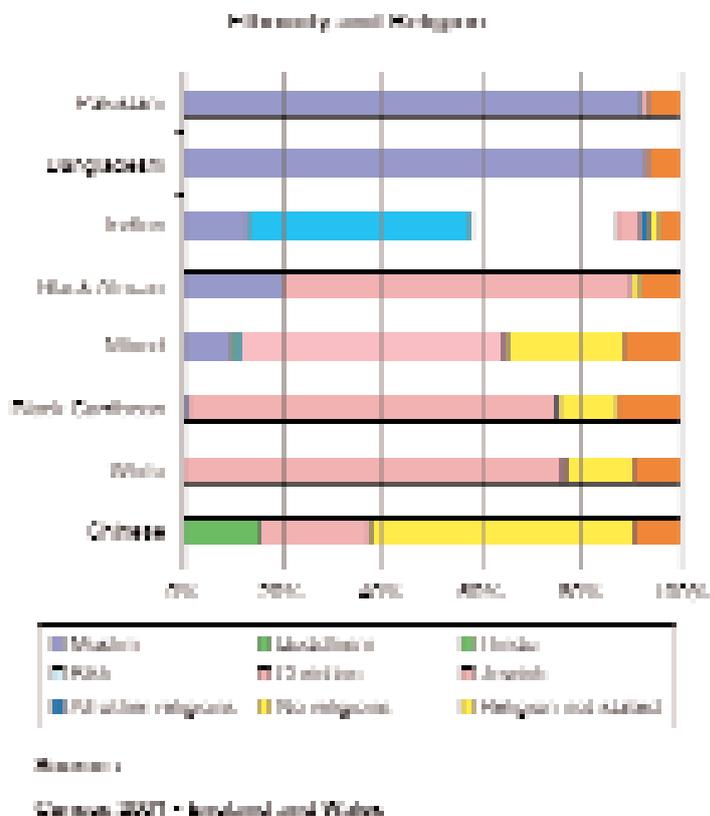
The Muslim population in Britain has been estimated at around 1.8 million people. Although Britain remains a Christian country, a significant number (30%) of the population do not classify themselves as Christians.

About 15% of the population claim that they have no religion but around 7% of the population do not state their religion.

The largest religion after Christianity is Islam with 2.7% of the Population declaring that they are Muslims.

The Muslims of Britain come from all over the world. Islam has normally been associated with people who come from Arab states in the Middle East but the large majority of Muslims who live in this country are from Asia and Africa. Roughly 92% of people from Pakistan and Bangladesh claim to be Muslim. The proportion of Indians who claim to be Muslim is around 13% and at least 20% of the African population are Muslims.

A large number of Muslims are seen as live in localities where they have suffered discrimination and racial abuse, the younger (second generation) Muslims are doing well in education and some are now choosing professional careers as opportunities open up.



There is a vibrant enterprise environment amongst the Muslim community that is recognised and highly visible. Muslims are significantly involved in the distributive and retail trades, engaged in handling products from foodstuff (specialising in ethnic foodstuffs etc) and visible in the distribution of hi-tech gadgets and electronic goods.

They are also renowned for running corner shops such as newsagents and operating various ethnic restaurants.

Muslims are involved in business and enterprise activities that are estimated to be worth upwards of around £200 billion. To attain such successes and visibility, the communities have had to develop various financial intermediaries and systems to provide them with access to appropriate and religiously compliant finance over the years.

The target Client group - Muslims in Britain

These channels are mostly unregulated and informal, and though effective, there still remain significant issues about how they continue to mobilise finance for their businesses.

For instance at the personal level there are many Muslims who are unable to purchase their homes because up until recently there were hardly any financial products available that can contemplate dispensing with the charging of interest.

Now **halal** mortgages are becoming extremely popular replacing the mobilisation and pooling of cash to buy houses outright - a commonly held view as the only avenue of raising finance available to these communities.

Not being able to own property is a drawback to accessing mainstream finance because of the relationship between freehold negotiable (real estate) assets and the types of collateral adjudged as acceptable and mainly required by banks. The lack of appropriate (religiously compliant) financial (negotiable) instruments has also always been a constraint to the majority of devout Muslims who wish to live their lives in accordance with the teachings of their religion.

The concomitant effect is the creation of an entrenched exclusion, albeit by choice on the part of Muslims, from mainstream finance and asset building. More crucially, this has not only caused a flight of capital from the UK by Muslims who have been able to generate wealth through enterprise but is also regarded as a significant factor in attracting inward investment through financial services provisions for non resident Muslims.

Moreover, as the world financial markets become more advanced, capital increasingly follows convictions (ethical, religious etc) to the extent that the UK may suffer capital flight by those who may wish to switch the abode of their wealth to more religiously sympathetic environments

For our purposes however, Sharia compliant products will be targeted at devout Muslims who may be using other less effective and sometimes informal and unregulated methods to finance their businesses. Given the significance of **Zakat**, products must also target high net worth Muslims who are interested in investing in community enterprise as a duty to help reduce poverty, by channelling funds through credible institutions.

Developing Sharia products come with problems; the process needs clerics to pronounce that specific products are Sharia compliant, and in the absence of a hierarchy within the religion, there are considerable differences in interpretation of the rules governing Islamic banking and finance.

The Muslim Religion

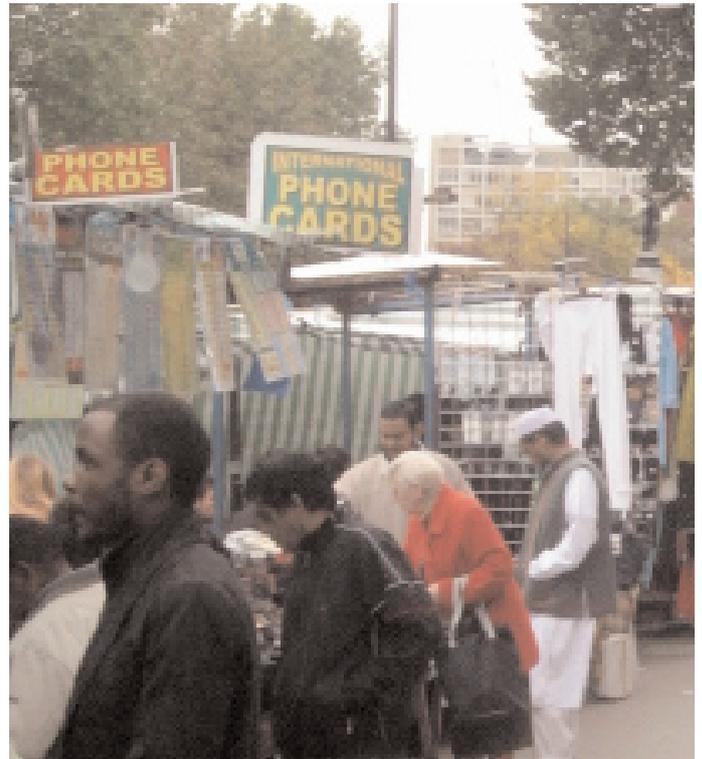
Islam, the religion of the Muslims means to achieve peace with God, peace with oneself, and peace with the creations of God through submission to God and commitment to his guidance.

There are five pillars of Islam

- IMAN. Faith or belief in the oneness of God and the finality of the Prophethood of Muhammed
- SALAH. The establishment of daily prayers that are said five times
- SAWM. Self purification through fasting from dawn to dusk during the month of Ramadan
- ZAKAH. Concern for alms giving to the needy and
- HAJJ. The pilgrimage to Mecca for those who are able.

Muslims believe in the One, Unique, Incomparable, Merciful God who is the sole Creator, Sustainer, and Cherisher of the Universe. They believe in the Angels created by Him and in the Prophets, through whom his revelations were brought to humans. They also believe in the Day of Judgement and in individual accountability for actions and in God's complete authority over destiny, good or bad, and in life after death. Their belief is summarised in the words "There is none worthy of worship except God and that Muhammed, the last prophet is the messenger of God"

Islam has the same roots as Judaism and Christianity and is the most recent of the religions. Islam recognises all the prophets as having been sent by the one true God. From Adam, Noah, Abraham, Lot, Ishmael, Isaac, Jacob, Joseph, Job, Moses, Aaron, David, Solomon,



Elias, Jonah in the Old Testament through John the Baptist and Jesus, peace be unto him, who is revered by Islam in the New Testament, to Muhammed who is regarded as the last prophet.

Muhammed was born in the year 570 CE and at the age of 40, whilst engaged in meditative retreat, started receiving the Qu'ran through the angel Gabriel and this went on for a period of 23 years.

The Qu'ran contain the exact words revealed by God, through the Angel Gabriel, to the Prophet Mohammed. These words were memorised and dictated to the followers and written down by scribes. The Qu'ran is the principal source of the Muslim faith and practice. The Qu'ran deals with all subjects pertaining to life on earth including, wisdom, doctrine, worship and law. Its theme is the relationship between God and his creatures and provides guidelines for a just society, proper human conduct and equitable economic principles.

Religion and Finance

Most religions are concerned with an ethical way of life that ensures that the people lead lives that are moral and beneficial, not only, to themselves but also to others.

The world is in essence material as well as spiritual and therefore some of the major religions provide guidance on materialistic things relating to what must be done if believers wish to enjoy life after death.

Religion has also been concerned with financial issues and the provision of pastoral care for the poor. For instance, Christianity, an established religion has been concerned with helping the poor by preaching thrift so that they are able to mobilise finance. The industrial revolution and Adam Smith's considerations on the Wealth of Nations have significant relevance on the Protestant work ethic that is based on the accumulation of capital for industrial expansion.

Privileged people, within these established religions, are exhorted to cater and care for those who are less fortunate than themselves. The concept of charity and alms giving to help people out of poverty has been a cardinal pillar to some of these religions and their precepts. Belief in religion has been used to promote a concept based on enlightened self interest where an entrepreneur has been responsible for all their workers needs, an altruistic way of getting them to produce higher output.

In more recent times, black churches in North America, that cater for a largely economically poor congregation, do not only minister about spiritual salvation but have sought ways of assisting their congregation by setting up instruments such as credit unions to help them meet their financial obligations and difficulties.

In America, several black led churches have initiatives geared towards mobilisation of funds from the congregation to invest in business.

Some of the most popular ones have been the setting up of incubators for small businesses and shopping malls to serve their local communities.

In the UK, the PHOENIX Fund has provided support for “Faith in Business” to accord access to finance to faith based enterprise activities. The issue of finance is germane to religion; religion pronounces on several issues relating to finance, on wealth, on profits and even on the payment of taxes. The issue of religion and finance is therefore not restricted to the Muslim religion. Whilst it is accepted that the Muslim religion significantly frowns on the application and effects of interest, the major religions have at one point or the other taken a view on the prospect of ‘making money on money’ as opposed to generating wealth by productive activity.

Jews have found a way around the issue of interest based on the incidence of the charge (it is acceptable to charge interest to non-Jews); Christians have also been able to live with the issues around interest by necessarily dissociating religion from economics.

For devout Muslims however, the issue of interest remains contentious because the religion (through its vociferous proponents) has so far not allowed an opt out on this practice but remains opaque as to its interpretation and application.

Muslims and Finance

The Muslim view of finance is based on a particular concept of money and its application with respect to need and the significance of investment. There is a belief that money belongs to the Almighty and is a gift to those with the necessary acumen who, through industry and commerce, are able to make profits. These people are then encouraged and expected to share their profits with others who may be less fortunate.

The concept makes a clear a distinction between profit and interest. Profit is allowed because it is regarded as an income for productive activity. On the other hand, Interest that is seen as the charge for the use of “other people's money,” is regarded as exploitative and also an unjust reward for doing nothing. It is this distinction between profit and interest that needs to be highlighted in any discussion of banking from an Islamic point of view.

Some of the principles relating to this view of finance and money include:

- Wealth should be directed in a permissible halal manner at all times - a person must invest funds in such a way as to benefit themselves, their family and their community
- A person must spend according to their income and avoid extravagance or unnecessary debt
- Funds should not be used to monopolise resource or activities
- Funds should be used in productive enterprises and not hoarded. Zakat is therefore levied as a wealth tax as a disincentive to hoarding wealth



- Money is not a commodity but a measure of value which is to be used to fulfil the needs of society
- To make money from money is forbidden - wealth can only be generated through legitimate trade and creation of assets
- A fixed return on capital is not allowed, as returns from an investment cannot be guaranteed

These are the guiding principles that most devout Muslims would wish to follow. In essence, they are the principles that together make the development of Sharia compliant financial instruments within a Western banking and finance environment more challenging. The process of development and deployment of Sharia compliant products are quite different from what obtains within conventional banking. However, the significance of the recent Finance Act 2005 is that this legislative instrument sets out the necessary legal and regulatory framework that tend towards a synchronisation of the core principles of Islamic banking with the rudiments of Western conventional financial services provision.

Sharia and Interest

Most religions provide guidance on practices that are not only permissible but also based on the principles of faith linked to ethics and morality. The charging of interest is one area that is abhorred by some of the major religions such as Judaism, Christianity and Islam.

The Islam view of interest is based on the

- **Sunnah** - the practices and traditions of the Prophet Mohammed
- **Hadith** - the sayings of the prophet and on
- **Quran** - the spiritual texts that guide the practice of Islam.

The religious texts from the Old Testament show that usury that is described as excessive interest is frowned upon and is regarded as an exploitation of poor people by the rich who have money. Some of the texts reproduced below advocate against charging of interest

We find this in Exodus 22:25 "If you lend money to one of my people among you who is needy, do not be like a moneylender; charge him no interest. This forbids interest if money is lent to people who are poorer. Several devout Jews therefore consider usury as being unjust and unlawful.

This view is confirmed in Leviticus 25:35-37

35 'If one of your countrymen becomes poor and is unable to support himself among you, help him as you would an alien or a temporary resident, so he can continue to live among you. **36** Do not take interest of any kind [a] from him, but fear your God, so that your countryman may continue to live among you. **37** You must not lend him money at interest or sell him food at a profit. The texts in **Deuteronomy 23:19 -20** states Do not charge your brother interest,

whether on money or food or anything else that may earn interest. **20** You may charge a foreigner interest, but not a brother Israelite, so that the LORD your God may bless you in everything you put your hand to in the land you are entering to possess.

The texts above however have been interpreted to mean that whilst Jewish people cannot charge interest to other Jewish people, they are allowed to charge interest to others who are not in the same religion. These texts have been used to explain why banking was attractive to many Jews who found nothing wrong with charging interest, usually exorbitant interest to others who were not Jewish.

So from medieval times, Jewish bankers have always lent money and/or provided banking services to rich Christians.

Islam, the religion however, completely forbids usury and does not provide any let out clause to anyone including taking interest from people who are not Muslim. The texts below are unequivocal.

Al-Nisa 4:160:162 We made unlawful for the Jews certain pure things which had been lawful for them before, because of the injustice which they had committed, their obstructing many people from the way of God, (4:160) their taking usury which was prohibited for them, and their consuming people's property unjustly. For the unbelievers among them, We have prepared a painful torment. (4:161) However, the learned among them (the Jews) and the faithful believe in what God has revealed to you (Muhammad) and to the others before you and those who are steadfast in prayer, pay their religious tax, and

Sharia and Interest

believe in God and the Day of Judgment.

They all will receive a great reward from Us. (4:162)

Al-Baqarah 2:275:280 Those who take unlawful interest will stand before God (on the Day of Judgment) as those who suffer from a mental imbalance because of Satan's touch; they have said that trade is just like unlawful interest. God has made trade lawful and has forbidden unlawful interest.

One who has received advice from his Lord and has stopped committing sins will be rewarded for his previous good deeds. His affairs will be in the hands of God. But one who turns back to committing sins will be of the dwellers of hell wherein he will live forever **(2:275)**. God makes unlawful interest devoid of all blessings and causes charity to increase. God does not love sinful unbelievers. **(2:276)** The righteously striving believers who are steadfast in their prayers and pay the **zakat**, will receive their reward from God. They will have no fear nor will they grieve. **(2:277)** Believers, have fear of God and give up whatever unlawful interest you still demand from others, if you are indeed true believers **(2:278)**.

If you will not give up the unlawful interest which you demand, know that you are in the state of war with God and His Messenger. But if you repent, you will have your capital without being wronged or having done wrong to others. **(2:279)** One who faces hardship in paying his debts must be given time until his financial condition improves. Would that you knew that waiving such a loan as charity would be better for you! (2:280).



Al-Imran 3:130 Believers, do not accept illegal interest in order to increase your wealth many times over. Have fear of God so that you will have everlasting happiness (3:130).

Ar-Rum 30:39 God will not allow to increase whatever illegal interest you try to receive in order to increase your wealth at the expense of people's property. Whatever amount of zakat you give to please God will be doubled (for you). (30:39)

The scriptural texts also encourage people who have made money to give to charity and provide alms for people less well off. Whilst the texts are against making money from money, they actually encourage commerce and the taking of risks so that profits will be made.

Sharia and Interest



The need for risk taking in commerce and commerce based on tangible goods and services remain at the heart of the prohibition on interest because interest is seen as making money on nothing - no goods and services are exchanged and there is little element of risk taking in the sense that you will receive your money back and interest for doing nothing.

However the issue of separation of risks into a transaction risk and a credit risk remains unresolved. There is the argument that there is a risk involved in lending money to someone who is unknown to you and that credit risk must be taken into account as an integral part of the whole transaction.

Devout Muslims have refused to compromise on this issue in the same way as the Jews and Christians have accepted that there are modern ways of doing business and the issue of the ban on interest needs to be consigned to medieval times when there was a lot of exploitation by

money lenders and loan sharks and in modern times financial institutions are so highly regulated that the abuses can be minimised. Other issues such as the time value of money (inflationary pressures) necessitate the charging of interest.

The uncompromising attitude of devout Muslims has ensured that they are not part of the property owning class and therefore have little collateral or security with which to expand their businesses.

Because interest (riba) is prohibited but risk taking and enterprise is rewarded, there has always been an urgent need for banking products that will be acceptable to devout Muslims even in a conventional western context much in the same way as halal meat is now on offer at some high street butchers.

For Ethnic Mutual, penetrating the Muslim community will meet its objective of ensuring that “hard to reach” marginalised and financially excluded communities are assisted by its interventions.

Islamic Banking Principles

Whilst the cornerstone on Islamic banking prohibits the charging of interest there are several other issues, probably equally important, that influence the choice of products.

An important issue at the centre of Islamic banking is the concept of risk taking and risk sharing. The problem about interest being unethical is that the lender will profit without exchanging goods or taking risks in a commercial endeavour. It is this concept of sharing risk between the borrower and the lender that sets Islamic banking as different from most conventional banks.

In trying to understand the concept of Islamic banking some have equated its most significant features to venture capitalists who take a stake in the businesses that they invest in. Islamic banking is more likely to be viewed as a mutual where borrowers and lenders all participate in risk sharing.

Compliance with Islamic rules of banking is gaining acceptability in the western world because it allows even conventional banks to set up financial products that are acceptable to all including non-Muslims.

In addition to the banning of interest in the conventional banking sense, Islamic rules also forbid the lending and borrowing of finance in certain transactions regarded as sinful and for some observers, some of these are also ethical issues of increasing relevance to Western societies such as:

- Gambling
- Alcohol
- Arms manufacturing
- Pornography and prostitution
- Pork related businesses
- Any immoral undertaking
- Any monies from conventional banking sources on which interest has been charged or received

There may be other transactions that may render a transaction illegal under the eyes of Islamic rules and this is why the process of Islamic banking often involves an advisory or supervisory panel.

Islamic banking is relatively new in the western world, though it has worked successfully in mainly countries such as Sudan, Iran and Pakistan who have structured their systems around Islamic banking. Others such as Saudi Arabia, Malaysia and Bahrain have allowed banking alongside conventional banking. A lot of work has therefore been done on setting up the relevant regulations to enable such a bank to operate in this country.

The important issues relating to Islamic banking is that it has now been fully accepted in the west. There are some conventional banks offering Sharia compliant products side by side conventional products and there are institutions that have been licensed in this country operating on wholly Islamic principles. How well these products work will be a test of time- their success will be of great benefit to those from communities that are currently excluded.

Permissible Products

Islamic banking has been available in this country over the past eight years. The Ahli Bank that was granted a licence in 1998 to provide Sharia compliant mortgages teamed up with the West Bromwich Building Society to do so.

The HSBC, the largest conventional bank in the UK has since 2003 been providing Sharia compliant mortgages.

In 2004 the Islamic Bank of Britain was given a licence to provide a range of products that would be available for Muslims. All these products were developed to comply with the principles of Sharia law. This would seem to suggest that there are products that lend themselves to Sharia compliance and there are products that may be problematic.

The range of products that are acceptable under Sharia are:

- Mortgages that are already approved by the FSA and have also been recognised by the government with the withdrawal of double stamp duty that had adversely affected the processing and the cost of the transaction
- Venture capital funds, probably the best suited products under Sharia because they allow the matching of investors with borrowers in an enterprise for which the investor participates in the equity. This type of fund is within the spirit of the Sharia laws because there is an element of actually risking money and using entrepreneurial acumen to make profits that can be shared by both partners i.e. the investor and the borrower.
- Lease finance funds are also permissible under Sharia because they involve a tangible product and the rent that is being charged for the hire of

the product can be calculated with an element of profit.

- Insurance Instruments are increasingly permissible under Sharia. Most of the products available have been recently developed using *ijarah* principles.
- Medium term loans are possible through an arrangement of charging a fixed fee that equates to profit on the transaction. These are easier where the loan is for a tangible asset though it is possible to accept loans that provide working capital.
- Capital protected funds that guarantee a fixed return on the capital

Some products however present problems that may be resolved with time and are at present difficult to make Sharia compliant. For example, private equity funds have been known to be problematic because of the possibility that they may be invested in companies that are already leveraged with interest payments to conventional banking institutions. It does take a period of time to fully discharge all the debt and convert these into compliant products.

Though the charging of interest has been fundamental to products such as mortgages and hire purchase agreements, there are now Sharia compliant products that have been structured around these instruments.

To be Sharia compliant the source of the funding must also to be *halal*. This requirement makes for increased complexity within conventional banking environments where the accounting systems and procedures makes it impossible to guarantee providence of the sources of funds.

Islamic Banking Products

Although there are several products currently being offered under Islamic banking, several more are being developed.

Some of the newer products are seen to be rather exotic by conventional bankers who because they see banking as a distinct business, tend to view interest as profits rather than what it actually is - a return on debt rather than a return on a tangible enterprise.

A description of some of the current products on offer is presented below.

•**Mudharabah** (Profit Sharing)

Mudharabah is an arrangement or agreement between a capital provider and an entrepreneur, whereby the entrepreneur can mobilise funds for his business activity.

Any profits made will be shared between the capital provider and the entrepreneur according to an agreed ratio, where both parties share in profits and losses. The profit-sharing continues until the loan is repaid. The bank is compensated for the time value of its money in the form of a floating-point interest rate that is pegged to the debtor's profits.

In the **Mudarabah** model, a **mudarib** or entrepreneur usually provides management expertise which is treated as a form of capital. The investor is known as the **rabb al-mal**. The share of expected future profits between the **mudarib(s)** and the investor(s) is agreed at the outset in any ratio mutually agreed to by the parties involved. The **rabb al-mal** bears all losses of invested assets (be they cash or other forms of capital). In cases where there is more than one investor losses are to be shared according to the investment share of each investor. The entrepreneur must not bear any of

the loss(es) attributable to invested capital. The entrepreneur is not allowed to take any form of remuneration other than profit-share. Technically, the entrepreneur has no recompense for his efforts unless the project is profitable; unless there is a guaranteed wage.

•**Wakalah** (Agency)

This occurs when a person appoints a representative to undertake transactions on his/their behalf, similar to a power of attorney.

•**Murabahah** (Cost Plus)

This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of interest determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e. the bank cannot charge additional interest on late payments), however the asset remains in the ownership of the bank until the loan is paid in full.

Murabahah is often referred to as 'cost-plus financing' and frequently appears as a form of trade finance based upon letters of credit. In its simplest form, this contract involves the sale of an item on a deferred basis. The item is delivered immediately and the price to be paid for the item includes a mutually agreed margin of profit payable to the seller. In this contract, the market cost price (true cost) of the item is

Islamic Banking Products

shared with the buyer at the time of concluding the sale.

According to Tarek al-Diwany (Islamic-finance.com), **Murabahah** is a form of 'trust sale' since the buyer must trust that the seller is disclosing his true costs. After discussing the true costs, a profit margin may be agreed either on a percentage of cost basis or as a fixed amount. It is very important to remember that the amount of profit earned in this transaction is not a reward for the use of the financier's money. In other words, a financier cannot take money if he/she does not perform any service other than the use of his/her money for the transaction. Such an occurrence would cause this type of deal to resemble the charging of interest. Today, **Murabahah** is used most to assist short-term trade transactions.

•**Bai' Bithaman Ajil** (Deferred Payment Sale)

This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties.

This is similar to **Murabahah**, except that the debtor makes only a single installment, on the maturity date of the loan.

•**Musharakah** (Joint Venture)

This concept is normally applied for business partnerships or joint ventures. The profits made are shared on an agreed ratio, while losses incurred will be divided based on the equity participation ratio. This concept is distinct from fixed-income investing (i.e. issuance of loans).

The **Musharakah** model is essentially a sharing model. Parties involved in a partnership arrangement contribute funds to and have the

right to exercise executive powers in that project in accordance with an agreed formula. All partners are obligated to contribute capital to the venture. These contributions can be subject to profit sharing in a ratio mutually agreeable to all the investing parties. Just as with *mudharabah*, a fixed amount of payment can not be agreed at the outset.

As with most joint ventures partners must receive regular accounting information as well as other information on business activities.

•**Ijarah Thumma Al Bai'** (Hire Purchase)

There are two contracts involved in this concept. The first contract, **Ijarah** contract (leasing/renting) and the second contract, **Bai'** contract (purchase) are undertaken one after the other.

For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed rental over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price.

In effect, the bank sells the product to the debtor, at an above market-price profit margin, in return for agreeing to receive the payment over a period of time; the profit margin is equivalent to interest earned at a fixed rate of return.

Islamic Banking Products

This type of transaction is particularly reminiscent of *contractum trinius*, a complicated legal trick used by European bankers and merchants during the Middle Ages, which involved combining three individually legal contracts in order to produce a transaction of an interest bearing loan (something that the Church made illegal).

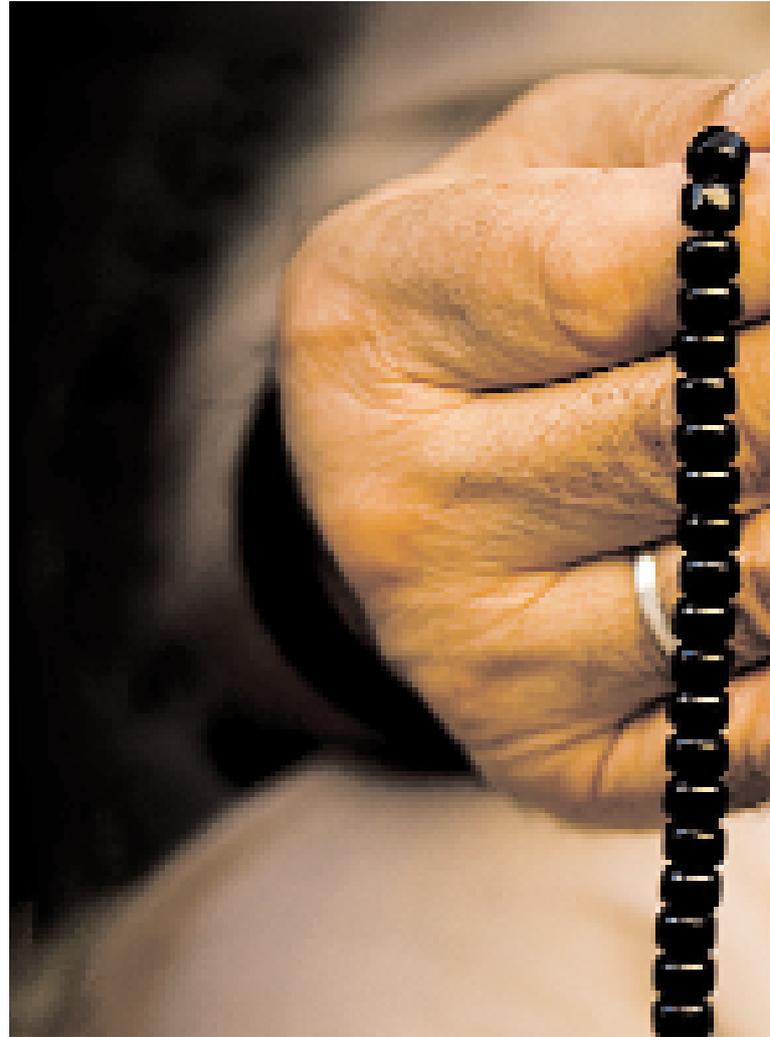
The use of leasing is represented by the ***Ijara*** contract in Islamic law. The contract represents a transaction in which a known benefit (usufruct) associated with a specified asset is sold for a payment. In the course of this sale of usufruct, ownership of the asset is not transferred - the bank maintains ownership of the asset.

The ***Ijara*** contract can be designed to return the fixed assets to the lessor at the end of the lease period, in which case the lease takes on the features of an operating lease in which the bank takes title of the asset at the end of the lease term. The other mechanism would be to allow the lessee to agree, at the outset, to buy the assets in question at the end of the lease period. The lease here takes on the nature of a hire purchase known as ***ijara wa iqtina*** (literally, lease and ownership). In simple terms, this means that the asset can be sold to the lessor at the end of the lease.

•**Wadiah** (Safekeeping)

In **Wadiah**, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it.

The depositor, at the bank's discretion, may be



rewarded with a ***hibah*** (gift) as a form of appreciation for the use of funds by the bank. In this case, the bank compensates depositors for the time-value of their money (i.e. pays interest) but refers to it as a "gift" because it does not officially guarantee payment of the gi

•**Qardhul Hassan** (Benevolent Loan)

This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this

Islamic Banking Products



to be the only type of loan that does not violate the prohibition on *riba*, since it is the one type of loan that truly does not compensate the creditor for the time value of money

•**Bai' al-Inah** (Sell and Buy Back Agreement)

The financier sells an asset to the customer on a deferred payment basis and then the asset is immediately repurchased by the financier for cash at a discount. The buying back agreement allows the bank to assume ownership over the asset in order to protect against default without explicitly charging interest in the event of late payments or insolvency.

•**Hibah** (Gift)

This is a token given voluntarily by a debtor to a creditor in return for a loan. Hibah usually arises in practice when Islamic banks voluntarily pay their customers interest on savings account balance. For instance if you have a capital protected fund as a product it will be difficult to convert that into a Sharia compliant product because whilst it might be legitimate to protect the capital, the source of which might be halal, there is a problem with guaranteeing an income on the capital. The problem relates to the fact that the issue of risk taking which should be central to any permissible transaction under Sharia is absent.

Legal and technical issues

In developing any Sharia compliant product, issues about jurisdiction under which the contract is made and the law to which the contract relates, must be considered in addition to the religious and moral issues.

Whereas English law has jurisdiction in England and therefore most contracts are discharged under English law, contracts that are Sharia compliant must, by definition, be further subjected to Sharia law which is universal and has no physical jurisdiction.

This complication means that Sharia compliant products have to state that the jurisdiction of the law of the country is subject to Sharia law. This means that whenever there is a breakdown in the contract the laws of the land is used (in precedence) for the purposes of adjudication.

There are however situations where a contract may be permissible under English law but may not be acceptable under Sharia law. In such cases the Sharia law is void and cannot be used.

This situation applies under conditions of:

- Stolen, inferior and immoral goods
- Public goods
- Religious properties and artefacts

Therefore the jurisdiction that will guide any transaction irrespective of whether Sharia compliant or not should be the law of the country in which the contract was made otherwise or another country otherwise we would have cases where defaulting contractors will look for ways of avoiding their debts by claiming a “superior” jurisdiction of Sharia.

In addition to the problems of jurisdiction in the law, there was another technical problem in the case of mortgages for example where because of the nature of the transaction double stamp duty had to be paid. Fortunately, this has been resolved by the Chancellor of the Exchequer waiving the stamp duty, on these types of transactions, in the last Budget.

Another problem relating to how profits from these transactions are taxed has been in resolved Budget 2005 by the Chancellor with the statement below:

- Corporation tax, income tax and capital gains tax rules will be changed. This will allow the Islamic equivalents of loans and deposits accounts based on ***Murabaha*** and ***Mudaraba*** contracts to receive the same tax treatment as equivalent banking products.
- The removal of multiple payments of stamp duty land tax SDLT will be made more accessible in Scotland and will cover a newly available Sharia product known as diminishing ***musharaka***. This will help house buyers to finance their purchase without taking an interest bearing mortgage

Most of these technical and legal issues will be resolved in time as more people find that the concept of Islamic banking is not exploitative but serves an important religious and cultural need.

More western economists who understand Islamic banking and more clerics who understand Western banking systems are required. There are few such people now but with time they will increase in number as more products are introduced.

Compliance

Islamic banking has to comply with regulations that are set for conventional banks in addition to the moral issues laid down by Islam.

The Financial Services Authority (FSA) is the single agency that regulates the finance sector and now accepts Islamic banking because they have worked with experts on the field to ensure that these products do not contravene the objectives they have set to:

- Maintain confidence in the financial sector
- Promote public understanding of the financial system
- Protect consumers of financial services and products and
- Reduce financial crime

So long as a bank or financial institution keeps in line with these rules there is really no problem with their being registered.

Any registered institution must meet the criteria set by the authority in relation to:

- Legal status must be clear
- Location must be under the jurisdiction of the UK
- Financial resources and capital must be adequate
- Necessary systems to manage in a prudent way must be in place.

However there are areas where Sharia banks differ from other more conventional banks and the FSA has to be satisfied that these differences do not in any way affect the soundness of the institutions. Some of these differences are:

- Different range of products; some very exotic
- Risk sharing means the depositors are also equity stakeholders so capital structure is different

- Understanding that as shareholders there is no guarantee for depositors against losses by the institution

- Multi-contractual arrangements mean that they operate as a cross between fund managers, venture capitalists and mutuals

These differences notwithstanding, there is no extra scrutiny of such institutions because they satisfy a need in the market place and there are already nationals of these countries investing and benefiting from services offered by Sharia compliant institutions elsewhere. The FSA has embraced Islamic banking as innovative and providing requisite diversity.

After much debate about jurisdiction and the law, the major issues of concern, the FSA has come to the conclusion that it is only necessary for registered institutions to satisfy the same conditions that apply to conventional institutions.

The three primary conditions in line with FSA objectives are:

- The product must meet basic EU directives to protect consumers and investors
- that shareholders and customers must understand exactly what is being offered
- Those providing the services must be wholly professional and competent in what they do

Countries such as Bahrain and Malaysia have for several years operated both conventional and Islamic banking. There are several banks who offer either wholly Sharia products or a combination of Sharia and conventional banking products. These countries have helped to advance understanding by western countries that the Sharia products, though based on strict Islamic principles, can sit side by side with

Compliance

conventional products. The FSA has a Unit that therefore continues to study developments in Islamic banking.

That the FSA has approved the operation not only of mainstream banks such as HSBC but has actually agreed for a fully Islamic bank to operate under Sharia principles resolves the issue for some community development finance institutions who want to operate under Sharia principles.

The Consumer Credit Act remains a stumbling block with regards to advertising because it states that adverts relating to financial products should clearly state the Annual Percentage Rate (APR) of the loan because that is the best mechanism for comparison with similar products offered by other organisations.

The issue here is that because a Sharia loan is offered without interest it will become problematic for any interest to be shown - this will become incompatible with the treatment of any other calculation of earnings such as fees that may legally be charged on the provision of a Sharia compliant loan even though such income cannot be considered in the strict sense as "interest" for the purposes of the Consumer Credit Act 1974.

One interpretation of the Act is that it does not apply to Sharia products because the view of the Act is that no other rate of interest apart from the APR can be advertised.

Most advertisement relating to Sharia products are fairly discreet and the intent is that instead of people just reading from pamphlets and brochures about the products they are rather encouraged to seek a discussion as to how the

product meets not only their financial but their moral needs. In some cases this is essential since one of the basis of Islamic banking is a partnership between an investor and the borrower.

In Islamic banking it has been established that because the source of the money is as important as the use to which the money will be put, proving that the source is Sharia compliant will always present a challenge to lenders. In the event, the acceptability of Sharia products as legitimate offerings for both religiously minded as well as non-religious people who want a different type of loan that will suit their specialist needs will be the challenge for delivering faith based financial products within a community development finance setting.

Sharia loans also must comply with the regulations of financial supervisory agencies such as the FSA and the Office of Fair Trading (OFT).

In addition they must comply with the internal regulatory and compliance frameworks of the Sharia boards comprising of clerics and other people who may be very hard put to reach agreement on the religious significance and interpretation of individual contracts as required by the religion.

Calculating Fees

Calculating fees and profits is probably one of the most complex issues under Islamic banking. Because interest is prohibited one is not expected to use prevailing interest rate as a proxy for any calculation. Despite this there are some organisations that use London Inter Bank Offering Rate (LIBOR) as the main basis for calculating their profit. This is the prevailing loan rate at the time of the transaction and this is capitalised over a period.

There are others who use a notion of the profit expected by the organisation and this is therefore capitalised into each loan that is provided over the period.

Invariably all lenders expect to cover all their costs relating to any loan transactions. These costs range from advertising, discussions and negotiations around packaging the loan and the cost associated with monitoring and payments.

Under the concept of Sharia a loan is seen more as an investment in a business by the lender and though it is not always practical the lender should be seen to have an involvement in the running of the affairs of the borrower. So essentially Sharia advocates for equity type investments rather than debt type investment.

Within Islamic banking environment, financial institutions operate more like a combination of venture capitalists and mutual funds. It therefore becomes increasingly ambiguous as to which accounting principles should be applied with respect to asset deployment and fiscal treatment that will make Sharia compliant products more acceptable to Western banking given the requirements of Western accounting procedures and conventions.

There are also issues relating to calculation of fees since there is a need to determine what level of fees will be acceptable and reasonable. Another issue is what happens at the end of the transaction when the lender disengages. In some of the Sharia transactions for instance, the lender retains title to the goods purchased with the borrowed funds. When all the payments have been made the title to the goods are transferred to the borrower.

The concept is new and therefore further work needs to be undertaken to ensure that the process of ascertaining the incidence of charges works within a western environment. The Finance Act 2005 provides some guidance in this area in terms of how to treat Sharia compliant products within a Western accounting framework.

Furthermore, the experience of Ethnic Mutual in advising the Treasury on some of these matters towards the synchronisation of the treatment of income arising out of Islamic finance products such as **Zukuts** to be treated as securitisations. Within such frameworks, their accounting must be treated to a certain extent in relation to the origin of “profit” rather than on the basis of the domicile of the investor. On the other hand, for income to be viewed in terms of fiscal relevance by virtue of the domicile of the capital as opposed to its source. In these circumstances, the achievement of a level playing field in terms of the fiscal aspect of Islamic banking compared to Western banking becomes achievable.

The Sharia Supervisory Board

Assembling a Sharia supervisory board can be difficult. The essential and desirable skills demand that board members need to be conversant with a combination of conventional and Islamic banking knowledge, but also aspects of religion and its significance with the provision of finance. It is essential that they are respected as academics, well versed in Islamic law and can interpret the Qu'ran.

Unfortunately the large numbers of academics who study the Qu'ran are not conversant with the world of western conventional finance and conversely the large number of people who are proficient in developing finance products are not experts in the interpretation of Qu'ranic law as it relates to Sharia.

The Sharia board must understand the issues of finance and how to translate a specific loan into an acceptable fee that will make profit for the lender. They should be familiar with the different products that are compliant and suggest ways to the lender of developing newer products. Since they oversee the total Sharia portfolio they should be able to pass comment on the direction that the institution should be taking in attracting potential clients and investors.

The Sharia board must be capable of resolving difficult and borderline cases and make rulings that will have general applicability. The Sharia board will audit the performance of the portfolio in accordance with established religious ethics. The Sharia supervisory board must work out the details of the products and how this will be implemented usually on a one on one basis.

The Sharia Board will have responsibility for:

- deciding on whether the loan is Sharia compliant
- assisting in working out the terms of payment
- working out an agreed fee structure for each loan
- providing a **fatwa** on the compliance of each loan type that can be used continuously
- working out the policy for meetings of loan panels depending on the throughput of applications
- developing a policy for making decisions on loans during periods when there are no meetings
- developing a framework for auditing the organisation and deciding on the frequency of audit
- keeping abreast with developments in the area both Islamic and conventional finance

The Sharia board will introduce a set of products and a strategy on how these products can be sold to the individuals. They will work with the loan officers and the main board of the organisation to ensure the smooth operation of the products.

Sharia supervisory boards are not only difficult to assemble but they can also be costly to manage. If there are too many people on the board, arranging meetings can be a problem.

If there are too few they may not be able to harness the wide variety of skills and experience needed to issue credible rulings on the Sharia portfolio.

The process

A process for offering Sharia compliant loans within a CDFI is provided in this section. The main board of the organisation (board of trustees) has to decide that there is a market for the provision of Sharia compliant loans and that they are willing to exploit the opportunity to provide these loans.

The board has to be willing to investigate further how the whole process of providing these services will operate

Assembling the board

The board will be responsible for:

- the development of the terms and conditions under which the Sharia loans will operate.
- setting up of a Sharia supervisory board that will decide on the compliance of each loan facility.
- Advertising the existence of Sharia compliant products
- Liaison with any investor or organisation who want to provide funding for its Sharia products
- Reviewing the performance of the Sharia loan portfolio, examining payments and establishing problem products and clients
- Ensuring that audits and reports are made to the Financial Services Authority (FSA) and annually to the Industrial Provident Society (IPS)

The board also has the responsibility of assembling the Sharia supervisory board.

The CDFI loan officers will be responsible for:

- Receiving applications from potential borrowers
- Discussing the particular needs of the borrowers in relation to amounts to be borrowed and

schedule of payments

- Undertake due diligence on borrowers status, track record and securities and collaterals
- Carry out the appraisal and develop a decision memorandum
- Attend loan panels and present applications to panel members
- Inform applicant of the decision of the loan panel
- Monitor the loan repayments and provide support to the borrower

Sourcing the funds

It is important that the source of finance that will be used for making Sharia compliant loans do not attract any interest. If they are sought from conventional banking sources and attract an interest, they are unsuitable for the purposes of Sharia.

The source should also not be from any operation that is regarded as sinful. There are already a lot of high net worth Muslims who are willing to put up their funds for use in Islamic banking operations and this is a source that is open for tapping by Ethnic Mutual.

There are already high net worth Muslim individuals who invest in the city of London; the move to diversity of products and the approval by the FSA is in part a willingness to accommodate their wishes for Sharia compliant instruments and a desire not to drive these people away to other countries offering products that they are more comfortable with.

Whilst these now invest in products that bear interest, most resolve the issue by giving away the interest they earn to just causes.

The process

Advertising the offering

Advertising the products should not contravene the standards set in the Consumer Credit Act that stipulates that an APR must be stated. Islamic banking products are not able to stipulate an APR so what is advertised is the existence of a Sharia facility and a request for interested persons to come and discuss their requirements for such a facility.

A large part of the advertising effort should be directed to potential investors in the facility as well as to potential borrowers.

Both conventional and non conventional methods of advertising must be deployed to ensure that there is maximum interest in the activities of Ethnic Mutual. The important issue that must be stressed is that the organisation intends to offer a choice to its customers and investors.



Conclusions

Sharia lending is still a novelty in this country though in some countries such as Bahrain and Saudi Arabia, where the regulatory framework has been developed, it is working well.

The FSA in England has now approved Islamic banking and licensed a fully operational Islamic bank that conducts business under Sharia principles. Other financial and non-bank institutions are also beginning to look at best ways of implementing Islamic banking. Islamic banking requires disclosure of more information to the regulatory authorities because it is new; this does not however mean that there is more scrutiny.

Most of the material and reference points on Islamic banking is not yet in the public domain since most interested organisations are protecting their sources of information. The pace of development of such products is achieving critical mass that would ensure that these products are available as a flexible alternative to conventional banking products.

Any institution that intends to implement Islamic banking must recognise however that it is a more individualistic form of banking tailored to the needs and requirements of both the investors and the borrowers and as such it offers a lot of flexibility.

This means that at present Islamic banking will be more expensive to implement and the borrowers should therefore be made aware that the facilities that will be provided will be more expensive than conventional facilities. In the event, Islamic banking is more attuned to CDFIs than mainstream banking.

Pooling of information and resources is therefore one way in which the operators of Sharia loans will be able to attest to their seriousness and credibility. Pooling of resources will also help to foster a sense of cooperation rather than competition.

New operators will be able to benefit from new insights and existing operators may be able to reduce the costs involved in Islamic banking. There is some complexity in the way the instruments are structured, this is not because the instruments are in themselves complicated. This is more because they are unfamiliar and in some cases different from conventional banking operations. Those offering Islamic banking are offering more than a deposit and current account, they are offering a multiplicity of products aimed at meeting the total financial needs of the customers.

The types of instruments however lend themselves to simplification and as they become more popular, it is undeniable that they will be better understood. The products will become more acceptable with usage and time much in the same way as *halal* meat is now acceptable on most high streets and markets.

The provision of these facilities will fill a gap in the market place and also assist people from marginalised and socially excluded communities; their existence provides an opportunity for Ethnic Mutual to broaden its frame of reference as it seeks to consolidate its position as a community development finance institution.

Recommendations

The development of these guidelines have been made possible through a grant by the Financial Inclusion Team of Barclays Bank Plc in support of the initiative by the Ethnic Business Development Corporation to undertake development work in establishing a Community Development Finance Institution targeting ethnic minorities in London as main beneficiaries.

Within this target group, Muslims make up a significant proportion of the potential client group. The crossover and acceptance of Islamic banking in the UK by regulatory authorities presents real opportunities for community development finance institutions, specifically those with an ethos of operating as mutual societies resonate with the risk sharing principles of Islamic banking.

There is no denying the fact that there is a need to undertake more extensive work on the subject. This work is necessary because of the avowed objective by CDFIs to offer Sharia compliant loans as part of their product portfolios.

The extra work will focus more on working with external partners (collaborative joint working) and other organisations who have declared an intention to offer such products (building relevant networks of stake holders).

Working with other agencies to continue the investigation will help to reduce the extra administrative overheads that this type of flexible banking demands. The collaboration should be forged more in an atmosphere of cooperation rather than competition and each partner must be willing to share information. The implications of this work will be more significant in

terms of Ethnic Mutual's singular focus on exploring the parameters for instituting Islamic banking within a community development finance framework.

Consequently, Ethnic Mutual should therefore position itself as a first reference point for people who are seeking to invest in Sharia products and who seek financial assistance under Islamic banking principles.

Ethnic Mutual must also be positioned to consolidate its influence and expert knowledge and experience of the communities and the subject matter of shari'a within the supply side by building collaborative networks with mainstream banking and financial institutions as well as other CDFIs so that a viable and credible framework for delivering shari'a compliant financial products can be deployed.

Positioning itself as a reference point for information and contact will be underpinned by an internal capacity building of Ethnic Mutual's Board, management and staff on the workings of Islamic banking and Sharia compliance. Ethnic Mutual must also investigate ways of working with other agencies in the setting up of Sharia supervisory boards that will provide credibility for the host of Sharia compliant instruments that will meet the needs of faith based clients - both private and social enterprise.