PROFIT AND RISK SHARING IN ISLAMIC FINANCE

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ABSTRACT

This paper examines the economic and financial issues surrounding the Islamic Financial Services Industry in Europe, focusing on the UK mortgage market. The paper has significance for European Financial Services generally. The European Muslim population exceeds 20 millions and according estimates potential demand for Islamic mortgages in the UK is around £20 billion. First we discuss the background of faith based economic systems and how the Islamic faith provides a framework for the economic well being of society. Second, we outline three further aspects of Islamic Financial Services Industry (a) their strategic and operational vision (b) the demographic profile of the Muslim community (c) the requirement of Shariah compliant investment. In the final part we compare Islamic and conventional mortgages developing mathematical model of Ijara mortgage. In the Islam the borrower and lender relationship is transformed into a partnership relationship through risk sharing and in particular the sharing of profit (and loss).

Introduction

Popular wisdom attributes the decline of religion to the materialistic culture of modern times, a view embedded in the understanding of religion as only spiritual in nature and completely divorced from the secular well being of an individual. Islam is seen as a particular threat to western civilization. The understanding of religion and particularly of Islam is often distorted by Western eyes (Said 1995; 2002). Every religion has played a critical role in guiding the survival of civil society and shaping economic activity. Early Christianity preached fair distribution of wealth and the reduction of the burden of debt on the poor. The main arguments against interest rates arose from the excessive burden of usury, especially in pre industrial societies where growth rates were predominantly around zero – so that the burden of debt could not absorbed by returns from productive investment. The same guidelines were provided by other faiths including Hinduism (Suzuki 2000).

Islamic banking is a growing phenomenon, which came into existence to satisfy the financial needs of devout Muslims (there are 1.6 billion Muslims in the world) who wish observe the Koranic prohibition of Riba. Many economists[1] have studied the macro-economic properties of banking institution in the framework of an isolated and ideal Islamic economy: but, in the age of integrated global financial markets, the instantaneous transformation of an entire financial sector to profit-and-loss sharing as envisaged by Sharia law is very unlikely. So what is the outlook for Islamic banking? Inevitably discussion of Islamic finance involves the concept of Riba: that is, the question of what constitutes appropriate interest rate on debt (Ahmed 1992). We study this question through an analysis of the Islamic Mortgage Market in the UK the centre of European Islamic Finance.

Khan (1986) noted that the abolition of interest-based transactions is not a subject alien to Western economic thought. Fisher (1945), Simons (1948) and Friedman (1969) have argued that the current one-sided liability, interest-based financial system can be fundamentally unstable. There are many such examples; the German hyperinflation of the 1920s, oil shock inflation's in Europe of the 1970s; and banking crises in Japan, East Asia, Russian and Argentina default and Enron bankruptcy, and so on.[2] The occurrence of crises is the result of a complex of factors emanating from over exuberance, greed, underestimation of risk, overexposure, currency failures, asset depreciation, faulty regulation, illiquidity, macroeconomic shocks and accountancy maladministration. Central Banks and International Institutions have learned to moderate the spread of such crises by relaxing liquidity, but many experts point to the limitations of such measures and to the inequity of the modern global financial and the exposure of the entire world economy to crises (Stiglitz 2003; Soros 2003). Zarqa (1983), Khan (1986), Chapra (2000), El-Gamel (2000) and Abdul Gafoor (1997). A significant outcome of an Islamic based profit and loss sharing system may be to introduce greater stability into western style financial transactions.

The Islamic economic principles of sharing risks and rewards, and joint participation in the wealth creation activity by borrower and lender, through substituting equity for debt, is a potential solution that promotes entrepreneurship and creativity in the economic cycle. Islamic principles require equity participants actively to benchmark proposed projects against moral standards in addition to financial parameters, leading to wider community participation in the wealth creation process. **In the Islamic economic model the borrower and lender relationship is transformed into a partnership through risk sharing and in particular the sharing of profit (and loss).** In the Western tradition, the lender tends to be only remotely involved in the business proposal scrutinizing the risk return trade off of the loan regardless of its social implication.

A Strategic Vision for Islamic Finance

At present the rate of slow growth in the Financial Services Industry indicates that the product portfolios and markets have reached maturity, at least for the time being. Annual financial results since 2000 of major financial groups do not match the growth rates of the previous ten years. In this context, Islamic banking offers a global opportunity for growth and profitability specifically to institutions capable of differentiating their products by developing expertise in community based banking. A strategic vision that includes Shariah compliant products and services would not only satisfy the needs of the 1.6 billion Muslims in the world but may also attract ethically motivated customers. For Muslim and ethical consumers, four key market segments can be further developed into Shariah compliant business units within European banks; global consumer banking, commercial banking, global corporate banking and global investment management.

(a) Global Consumer Banking

Product portfolios include saving plans, protection products, home financing, consumer durable financing, equity brokerage and personal pension/retirement planning products. E-commerce and intermediaries as well as traditional distribution channels support the product portfolio. Evidence suggests that consumers are willing to pay a premium for these products. For example HSBC New York within the first month of the lunch of Islamic mortgages reaches $10 million.

(b) Commercial Banking

Small and medium sized enterprises form the backbone of the world economy Muslim entrepreneurs form a part of this market. Such businesses are involved in manufacturing, trading and distribution of products and services. The banks product portfolio for this market segment includes trade finance, cash management, asset finance and bill discounting services tailored to Islamic preferences.

(c) *Global Corporate Banking*

A bank product portfolio could includes investment and underwriting services, brokerage services, asset and commodity finance, commercial insurance and foreign exchange products. Shariah compliant versions of these conventional products can be developed and distributed through existing channels. The target markets for developing these products are the firms listed on the Dow Jones Islamic Index, FTSE global Islamic index[3] Good Index and other similar indexes. Another target market is the countries that have signed up the various international agreements promoting ethical business practices. The audiences mentioned above may well pay a premium for these products and services.

(d) Global Investment Management

A bank's product portfolio for this market segment could include Shariah compliant tax efficient investment accounts, mutual funds, closed end funds, unit investment trusts, personal pension, retirement planning and medium net worth wealth management services. These investment solutions have been developed by a number of Islamic and conventional institutions for the high net worth individuals. It is important to note that historically the provision of these products to the growing medium net worth market segment has been fairly restricted.

All four areas are promising for the development of differentiated bank portfolio. In the following sections we focus on consumer banking, in particular, the UK mortgage market. We also give a brief outline of potential demand in other segment of the market in so doing we are able not only to analyze development in the mortgage market but also highlight the significant sharia compliance in the European financial Service industry. London is the centre of the Islamic financial segment.

UK Shariah Compliant Market Analysis

In 2001 investors from Middle East invested £827 million in European property market, a 225% increase over the previous year of this amount, 91% was invested in the UK. In the first 9 months of 2002 alone, Middle East investment in UK Commercial property totaled £875 million which is 15% up on the entire 2001 total. [4]

According to the International Association of Islamic Banks (IAIB), by 1998 there were 176 Islamic banks and financial institutions operating in 38 countries. These institutions had total assets of $148 billion, paid up capital of $7.3billion, and generated $1.2 billion in aggregate net profits latest year of operation. Sir Howard Davies (2003), chairman of the Financial Services Authorities in the UK said "*there was a gap in the market for retail sector Islamic banking products, which would cater to nearly two million UK Muslims*". There are approximately 2 million Muslims permanently resident in the UK (i.e. 50% of all UK ethnic minorities) with estimated saving of around £1 billion, while over half a million Muslims visited Britain in 2001, spending nearly £600 million[5]. The 5,000 richest Muslims in the UK have liquid assets of over £3.6 billion, according to wealth analysts' data monitor[6] HSBC, the UK-listed bank, which has £2 billion assets under management and three Islamic funds, is predicting growth of assets under management of up to 40 per cent for year 2002[7]. If we follow the Datamonitor (1999) research, then this indicates that out of their 1.65 million estimate, 300,000 Muslim adults in the UK have annual incomes in the range of £30000 and above (see table 1). This means that approximately 25% of all adult Muslims are excellent prospects for banking and financial products.

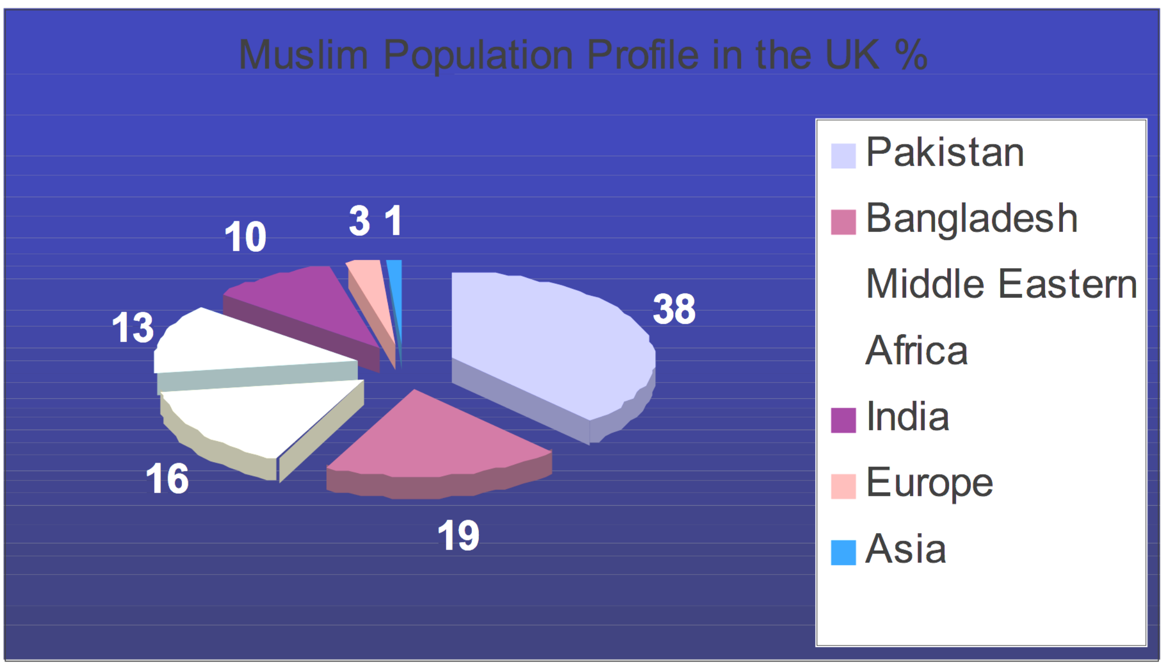
Geographic Distribution of Muslims in UK

The distribution of Muslims in the UK falls into a number of well-defined regions in the South (London, Luton and Slough), the Midlands (Birmingham and Leicester), and the Pennines

(Manchester, Lancashire, Leeds and Bradford), as well as smaller centre in Glasgow, Cardiff/Bristol and Bath. In some heavily populated areas, such as Leicester and Luton, for example, up to 20% of the population is Muslim. Indeed, Leicester is set to become the first ever Islamic City in the UK, within the next decade, as the Muslim population rises to above 50%; i.e. an ethnic majority. Much of the Muslim population is centred on the South East of England, in Slough, and in North, West and Central London. Datamonitor estimates that 8% of the population in Greater London is Muslim, amounting to approximately 725,000 persons. This means that over 40% of the Muslims in the UK live in the Greater London area.

Profile of Muslim Population

The Muslim population in the UK is predominately from the ethnic and cultural backgrounds of India (10%), Pakistan (38%), and Bangladesh (19%). Approximately 16% of UK Muslims are of Middle Eastern origin, with the remainder coming from Africa (13%), Europe (3%) and Asia (1%).



The Muslim population origin in the UK[8]. **Figure 1**

Historically the ethnic groups originating from the Indian sub-continent have shown a higher rate of population growth, as compared to other groups in the UK; a trend that is likely to be confirmed anew by the Official Census in 2001. The second and third generations of Muslims from these ethnic groups have been born British nationals. They have shown success in educational and professional achievements. The group earning £30000 or more per year basically comprises of these educated professionals. Research also indicates that these professionals are more knowledgeable of their religious and social roots. Thus, there is a natural inclination among them to align their financial decisions with the Islamic faith.

UK Mortgage Products: Potential

A salient feature of home ownership in the UK is the high proportion of homes purchased through mortgage loans. Acquiring a mortgage is one of the first financial decisions that an individual makes in order to lead an economically secure life. During 1999 British banks have written 756,000 mortgage loans, while building societies and other lenders have 426,000 mortgage loans. (Britain 2001 Year Book) none of these 1.18 million mortgage loans were designed to provide the Muslim community in the UK with a mortgage product in compliance with the injunctions of the Islamic faith.

It is estimated that the Muslim population in the UK secures 5% of total mortgages (Dar 2002). The Land Registry UK recently published that for the year 2001-2002, the average value of residential property in UK is £121,000.Taking this estimate in account, along-with the Muslim share of the existing mortgage market, the total market size for the Shariah compliant mortgages is potentially in excess of £7 billion. If only ½ of Muslims in fact abide by Sharia compliance the market is 3 billion this we recognize is a conservative estimate. The demand for the Shariah compliant mortgage by the ethically motivated consumers would also be significantly high, however due to unavailability of the relevant data it is not possible to provide an exact market size for the ethical consumer segment.

UK. Ethical Funds

Currently their exist a substantial demand or ethically following table give an outline of product providers

Fund Type	Product Providers	No. of Funds
Unit trusts, Oeics and IS As	28	41
Life Funds/SP Bonds	18	26
Pension Funds	17	28
Total Number	40	95

N.B. Some providers are in more than one category. Table 1
Funds under management = £3.3 billion (1999), Source: "Money facts", October 2000

Clearly the demand for Sharia compliant funds is partly a subset of the demand for ethically managed funds
A = the demand for ethically managed funds
B = the demand for Sharia compliance

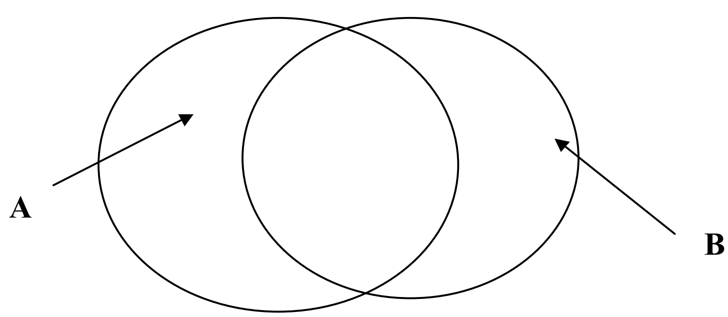


Figure 2

UK Investment Products Potential

Of the British Muslims earning above £30,000 p.a., 182,000 had savings accounts, 141,000 had ISAs, PEPS and TESSA's, 86,000 owned shares and 16,000 had purchased unit trusts (Datamonitor estimates 2000). Total ISA market was worth £48 billion in 2000, of which £28.4 billion in funds or shares and £19.6 billion in cash (9.3 million ISA plan holders); existing PEP market valued at £60 billion (5.5 million PEP plan holders). It is estimated, that out of the above figures, approximately 5% of the investment belong to British Muslims and these investors would respond favorably to funds that (a) observe the Shariah guidelines (b) UK registered (c) managed by a leading Asset Manager. It is worth noting that ISA transactions accounted for 50% of all new UK investment business; and 70% of total volume. The following table gives an age income analysis of UK Muslims

Age Bracket	Below £30k	Above £30k
18-24	244,470	56,138
25-34	154,421	61,453
35-44	194,977	95,515
45-54	149,122	55,758
55-64	108,259	22,972
65 and over	70,925	2,005
Total	**922,174**	**292,941**

Table 2: Age and Income Analysis of UK Muslims[9]

We can glean something about the existence of a European market by looking as some global figures. There are more than $100 billion of retail funds available for Shariah investment, growing by 15% p.a. and 160 Islamic financial institutions offering products/services. As well as 102 Shariah mutual funds. Currently only $2 billion are invested in Sharia funds globally, including $700 million in one Saudi Arabian fund. This compares with £3.3 billion ($4.8 billion) invested in 1995 UK ethical funds in the year 1999.

Shariah mutual fund market expected to grow by 10% p.a. globally. However a significantly higher growth rate can be achieved by providing Shariah compliant financial products to Muslim and Ethical communities resident in Europe and USA. It's difficult to estimate the exact demand for Sharia compliant mortgage due to the unavailability of market data. Taking this consideration into account, the European Market for Sharia compliance product is very substantial.

We now move to a more specific analysis of a particular market: the UK mortgage market, and a discussion of the nature of Sharia compliance since the Islamic Investment Banking Unit (IIBU) of the United Bank of Kuwait (UBK) in London has been offering Islamic house financing since 1997, we use this experience to describe the two main sharia compliant mortgage products: (a) Murabaha Based Mortgages (b) Ijara Based Mortgages.

Murabaha Based Mortgages

Briefly under the Murabaha mortgage plan (Murabaha is the Arabic for profit). The price charged to the client of IIBU is purchase price of the house, plus a profit margin (based on the appropriate rate of return to IIBU investors) and including any administrative and legal expenses which associate with the transaction. The client purchase the house from IIBU by installment over agreed period between 15 and 30 years)

<u>Murabaha Based Mortgage</u>

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

↓

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

↓

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

↓

The clients first payment to the bank is made on the day of completion and is clients initial contribution is a minimum of 20% of the purchase price. The customer agrees to pay the price in agreed upon installments.

Figure 1

	Ijara	**Murabaha**
Role of financier	Buys and then rent home to you	Buys and then sells home to you
Deed of the property	Financier	Usually you
Fixed or variable payments	Fixed or variable	Fixed
Right to sale or repayment	You keep gain after completing purchase	You keep gain after paying principal due
Refinancing	Yes	No
Share property taxes and insurance	Usually included in cost of lease	No
Sale or prepayment allowed	Yes	Yes
Allowed to make home improvements	Yes	Yes

Table 2 the similarities and differences among Ijara and Murabaha Compliant financing

The Key aspect of Sharia complaint mortgages either the Murabaha purchase plan or Ijara purchase plan is that the risk associated with home price variation is shared between the client and the bank in contract in conventional mortgage the client bare all the risk. It's this risk sharing characteristic that really distinguishes Sharia compliance in the mortgage market. The risk sharing characteristic is also at the heart of the debit on Riba; Sharia law emphasized the important of risk sharing.

Ijara Based Mortgages

In this section we summaries the nature of Ijara based mortgages in (a) and (b) we set out a simple mathematical model of Ijara Mortgages.

Under the Ijara purchase plan (which is proofing to be more popular). The distinguishing features of the Ijara based mortgages plan is that the house is under the joint ownership of the IIBU and client from the outset, (Under the Murabaha based mortgages plan, the bank owns the house up to the point of final installment). Under the Ijara based mortgages plan of the client puts up 20% of purchase price and the IIBU 80% for example the client has 20% stake in the house from the outset. The client than pays rent reassess every year by IIBU, on the estimated the market price of the house concern. The rents include a profit margin for IIBU based on (an appropriate return to banking investors). The client share in the house increases in proportion to the value of the client installment (mines, of course, the IIBUS profit margin).

(a) Diagrammatic Illustration of Ijara Based Mortgages.

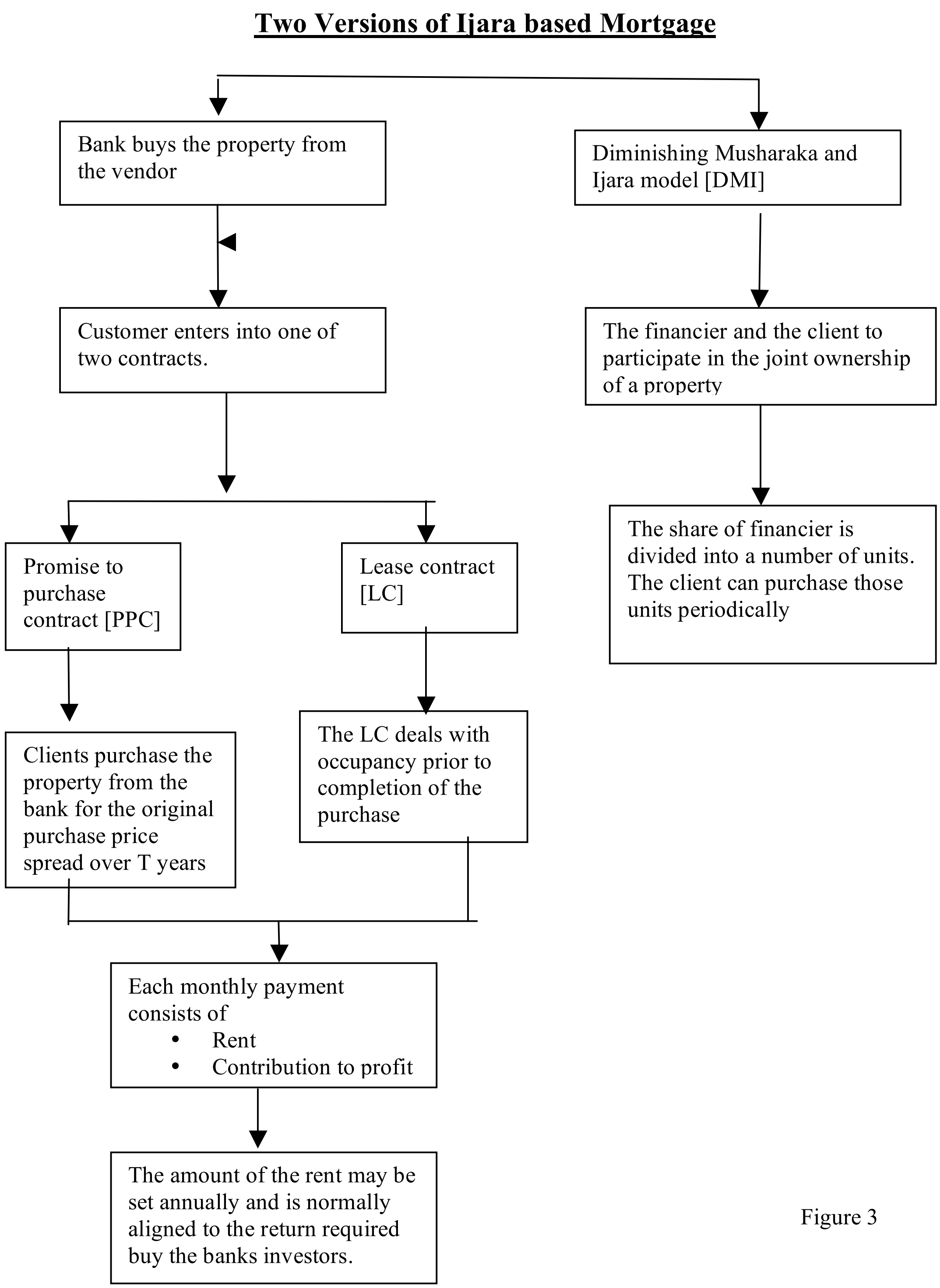


Figure 3

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(b) Mathematical formulation of Ijara Based Mortgages.

The key aspect of Ijara Based Mortgage's is risk sharing and joint ownership. Our mathematic model illustrates these aspects. We consider client share at any put in time $\mathrm{X}(t)$ and the change on the client share in the property are time $\Delta\mathrm{X}(t)$.

The clients share $\mathrm{X}(t)$ is summarized by the following expression:

$$\mathrm{X}(t) = \frac{\text{Deposit at time } t_0 + \text{Sum of the rental payments from } t_0 \text{ on wards}}{\text{Original house price} + [\text{Current house price} - \text{Original house price}]}$$

This can be written as:

$$\mathrm{X}\,(t) = \frac{CD + \sum_{t=t_0}^{T} rent(t)}{[H(t_0) + M] + [H(t) - H(t_0)]} \qquad (1)$$

The rent is calculated as follow:

$$\text{Rent }(t) = \text{wage index } +2\% = \sum_{t=t_0}^{T} \mathrm{Re}\,nt(t)$$

The risk sharing element is summarized by the following:

Risk share = $[H(t) - H(t_0)]$ Mark up = M (bank administration fees and related costs)

The increase in the client share is summarized by:

$$\Delta\mathrm{X}(t) = \frac{\sum_{t=t_0}^{T} rent(t)}{[H(t_0) + M] + [H(t) - H(t_0)]} \text{ The increase on the Client share} \qquad (2)$$

Table 3 summarizes the different between Islamic and Conventional Mortgages

A Comparison between Islamic and Conventional Mortgage.

Conventional Mortgage	**Islamic Mortgage**
The lender advances funds to the borrower and charges [interest] for the use of their money.	Based on trade [Murabaha] and leasing [Ijara], Islamic mortgages are Interest free.
Credit references, sources of income to be able to retune the loan before 65 birthdays.	Credit references, sources of income to be able to retune the loan before retirement age.
Most of the lender has no lower limit to the property value.	Minimum property value £50,000.
Up to 125% of the property value.	Up to 85% of the property value
Life insurance and building are mandatory in most cases.	There is no compulsory life and building insurance is required.
Lender never owns the property.	The bank puts itself in the position of owner of the property. Higher risks.
Payment term up to 40 years.	Murabaha up to 15 years minimum 5 years Ijara up to 25 years minimum 7.5 years
Income Multiples Up to 5 times primary annual income sole applicant.	Murabaha 2.5 times primary annual income Ijara 3 times primary annual income sole applicant
Arrangement fee usually up to £500.	Arrangement fee of 0.75% of the property value less the first payment.

Table 3

Problems in Provision of Islamic House Financing In the UK

Discussions have been taking place with the Bank of England and the financial services authority (FSA) on these issues and Khan (2002) was confident that they will be resolved in time so that HSBC (Amanah Finance) could begin offering Islamic financial products in year 2003. This has happened. The regulatory authorities have already approved Islamic mortgages in the US. Khan believes that Islamic finance potentially has appeal for the mainstream as well as Muslim consumers because of its ethical basis: "Islam teaches us that money should be channeled toward the 'real' economy, the production of real goods and services and not the 'financial' economy such as hedge funds and derivatives," he argues, "It keeps us in touch with the real economy and away from speculation"[10].

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

i. Under current regulations on lease agreements, the product has to be 100% risk weighted. In other words, HSBC (Amanah Finance says, *it has to set aside the full amount of the property to cover the full value of the house in case the buyer cannot afford to pay the rent, whereas a conventional mortgage has a risk weighting of only 50%*[11].

ii. Unlike a conventional mortgage, the proposed product would require two sets of solicitors. Islamic institutions would also want an exemption from a second set of solicitors.

iii. The inability to obtain financial assistance from the state in cases of financial hardship.

Conclusion

Islamic principles are concerned with issues of fairness and justice rather than efficiency narrowly defined. These principles focus on the necessity of sharing risk in a fair and stable society, and upon problems of exploitation in markets where power is asymmetric this is the real Riba (usury) issue.

Our case analyses shows that the principles differences between Islamic and conventional housing finance is that the former is equity based and the latter is debit based. In an Islamic mortgage situation both the bank and the client share ownership [equity] and therefore share the risk of equity ownership. In conventional banking the client owns all the equity and the banks loan to the client is secured on the value of the property.

Putting aside the penetrating comment by Ahmed (1992), “It’s not clear to whom we are cheating…” about hypocrisy in the current practice of Islamic banks, let us deal with the realm of the ideal. Consider an ideal situation in which Islamic principles of interest were adhered to by a substantial proportion of the world financial system. What they have in common is a prohibition of usury, or excessive interest rates. Could such an idealized system conceivably survive as a foundation of banking in a hypercompetitive global financial environment? Pure logic would dictate that this is not possible in a profit-maximizing world: that is if *excessive* includes interest rates that reflect high risk situations or situations of capital shortage: both of which would require high interest rates that might be considered usurious. We remarked at the beginning of the paper on the recurrent crises in the financial sector. Maladministration, deception and ethical behavior lie at the root of many of these problems. Enron and WorldCom are just two examples. The Islamic approach emanates from a foundation set of ethical principles. So discussion of Islamic finance in connection with global financial practices introduces an ethical dimension that is welcome. Also as Khan (2002) points out an Islamic system of finance might create a more stable world financial market.

NOTE

[1] Khan 1995, Ahmed 1992, Umer Chapra.M 2000 and Abdul Gafoor. A.L.M 1997.
[2] The Economist December 31st 1999
[3] The FTSE Global Islamic Index is calculated by FTSE in association with The International Investor
[4] Islamic Conference Group. Defining Islamic real estate investment 2003 UK
[5] Birmingham Post Birmingham (UK); Sep 21, 2002 John Duckers.
[6] Nicholas Stephens Data monitor
[7] Financial Times; London; Feb 25, 2002. Mawson James.
[8] Special report: Muslim Britain: A map of Muslim Britain. The Guardian; Manchester (UK); June 17, 2002.
[9] Datamonitor, Policy Studies Institute, Labors Force Survey (1999)
[10] Mark Tran Monday May 27, 2002; Guardian
[11] Mark Tran Monday May 27, 2002; Guardian

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