Islamic Financing and Investments in Britain: The Growing Potential*

Duncan Smith

I. Introduction

Talking as a practitioner, rather than as a scholar, the first general point to make is that it often appears that the theory – or to put it another way, the generalities – of Islamic finance are easy to understand but implementation is difficult to achieve. In short, there is a gap between theory and reality. Many of the reasons for the difficulties in implementation in the UK are historical. If we had here a dual banking system such as that in Malaysia, then the relevant regulations and legal context would make offering *Sharīʿah* compliant financial services a much simpler task. At present we don't have anything like this. However, we can point to positive indicators that there will be a more favourable legal and regulatory climate in the coming months and years. As most will have seen in the recent budget statement, a removal of one of the inequalities – double stamp duty on *murābaḥah* mortgages – was promised by the Chancellor. Other changes should follow to level the playing field for Islamic financial services, as was flagged a month or so ago by the Governor of the Bank of England, at the conference called by the Council of Mortgage Lenders, to discuss Islamic home finance.

It seems to me that a suitable way to take a hard-nosed look at what the future potential is for Islamic finance in Britain is to probe some key areas.

DUNCAN SMITH is the CEO of the Arab Banking Corporation-Islamic Banking (ABCIB) and Islamic Asset Management.

*Summary of a presentation given by Duncan Smith, CEO ABCIB Islamic Asset Management on 16th April, 2003, at the Markfield Institute of Higher Education, UK.

Review of Islamic Economics, Vol. 8, No. 2, 2004, pp. 83–90.

(i). First, to try to understand what the current situation is in terms of theory and practice.
(ii). Second, to move on to investigating what *Sharīʿah* compliant banking and savings products are needed and are practical.
(iii). Finally, a reprise of the context and an attempt to understand what makes the current time the best chance we have had to move this forward.

Before moving on, a second general point to bear in mind is that a lot of the material contained in this paper is being viewed from a very high altitude. Interested parties will need to dig into the detail themselves, in relation to their own specific topics of interest.

II. The Current Situation

As businessmen perhaps know better than most, it is always better to work with facts rather than guesses. The more information we have, and the better the quality of data, the better the decisions we will make. In terms of assessing the potential for Islamic banking products and services in Britain, there are two main ways of getting at what we really know about the opportunity.

There is now more factual material than ever before on ethnicity, religious affiliation and behavioural patterns which give background to the probable potential of the Islamic finance market. In business, however, it is necessary to look beyond statistics, questionnaires and polls and – if possible – test market products or use proxies for test marketing purposes. There have been a number of relevant "tests" in Islamic finance in Britain already and it is worth learning what we can from them as a practical check to the statistical data available elsewhere. Comparing what these numbers and the beta tests tell us, there are some mixed messages which come through.

III. Research Material

Let us look first at what statistical material we have on the research side. Helpfully, the 2001 census for the first time included an optional question on religion. The Office of National Statistics has been gradually releasing information over the last three months and at a headline level it indicates that there are, or were at the time of the

Census, 1,546,626 Muslims living in England and Wales with another 40,000 or so estimated to live in Scotland. This means a total of around 1.6 million in mainland Britain. As this was an optional question, around 4 million people decided not to give their religion and others more knowledgeable than the writer have estimated that adding the probable Muslim component of this might boost the total number to around 2 million Muslims in Britain. The census also tells us – and this is of particular importance to product distribution – much about the dispersion of the Muslim population plus information on ethnicity and thus language, both of which are relevant to the form and tone of any advertising or product promotion.

A specialist company based in Harrow – Webstar – has done some further, interesting work, overlaying electoral roll and other widely available information held on databases to create a more detailed, validated picture of our population. We can also, with a good degree of certainty, rely on earlier surveys and analyses such as the most informative Policy Studies Institute work "Ethnic Minorities in Britain" published seven years ago. Academics such as Elaine Kempson have investigated other financial markets within ethnic minorities – particularly relevant to the Pakistani and Bangladeshi communities – again helping to create a more rounded picture of Muslim Britain. Elsewhere, commercial enterprises have aggregated different cuts of information. Data Monitor has pulled together available data on Islamic home finance and relevant conventional parallels. KPMG and other accounting firms have done bespoke client research doing much the same thing for broader sets of products.

By overlapping related sets of information and making assumptions we can extrapolate and create for ourselves what we believe to be (relatively) precise models in terms of population, and from there begin to form theoretical conclusions on the likely requirements for personal financial products.

A word of caution here, however. None of the above measures actually measure what I have called the "adherence quotient" – the extent to which any Muslim for whatever reason – and I look at these below – may or may not opt to actually use a *Sharīʿah* compliant financial product. There have of course been smaller sample surveys at Leicester, Loughborough and elsewhere which have tried to get to grips with this point – i.e. to understand what Muslims say they *would* buy if it were available – but this is not the same as reviewing what Muslims have (and have not) bought in the way of *Sharīʿah* compliant financial products.

IV. The Practical Experience

Let us briefly review the actual experience so far in Britain.

Without pausing to recount every step, I want to look at the real and familiar practical examples we have over the past 20 years. Before I do, however, I should mention that many people will be aware that there are well-advanced plans by a Gulf-based group to open what may be called, when (if) it is authorised by the FSA, "The Islamic Bank of Britain". Others are talking about other similar plans. There was, of course, an earlier practical experiment which lasted between the early 1980s and early 1990s and which, too, had a mission to provide Britain's Muslims with Islamic banking services. The AlBaraka Group – a global Islamic Banking Network – spent some considerable time and money trying to establish a successful and broadly supported Islamic bank in Britain with branches in London and Birmingham. Ultimately – for reasons that do not need to be rehearsed here – they gave back their license to the Bank of England. AlBaraka International Bank Limited, as it was called, was unable to mobilize the levels of business from the existing Muslim potential client base. I think I am right in saying that, on a financial basis, the AlBaraka operation in the UK has been much more successful as an investment company, notwithstanding its much reduced relevance to a domestic Muslim market.

The UBK Al Manzil programmes in UK – sadly, the parallel Manzil USA program was closed four years ago – have been successful in a modest way. Technically they have shown what was possible and at between £40 and £50 million in their 'loan' book they have justified the programme's establishment financially for UBK.

Elsewhere, on the savings side, there has not been much good news. The Parsoli Equity Fund is still going (I believe) but the Flemings Oasis Fund closed for savers in the UK, notwithstanding generous seeding from the sponsor or the sponsor's supporters. Also – sadly to my mind as it presented a lone opportunity for small savers who could not risk stock market volatility – the Halal Mutual Fund has closed down. This gave a very 'smart' *Sharīʿah* compliant low risk savings fund that fitted within the European UCITs regulations and thus could be offered in the UK. Another institution motivated by a desire to spread Islamic Banking as well as generate a profit – Dar al Maal al Islami – tried for more than 10 years to get its 'Takaful UK' business going, to offer insurance and small ticket savings products in UK. In the final analysis, the company was unable to penetrate widely – doubtless, in part, to the lack of suitable investment instruments outside equities in which to hold client monies.

On the commercial side, although little is advertised, it is worth mentioning that ABC's Islamic Banking Group has done a fair few real estate developments using *Sharīᶜah* compliant financing contracts. These have been successful for investors, developers and financiers. Other banks are offering similar services.

V. Some Intial Conclusions – Comparing The Statistics To The Practical Experience

So what conclusions do we draw from combining the academic and the practical? As readers will be aware, we now know the answers to 'how many?', 'what ethnicity?' and 'where?' and are able to see a broad spread of needs and an Islamic finance market in the UK valued at several billion pounds. That, at any rate, is the theory. If it is wholly true, why then why should it be that, of the practical experiments, only the Al Manzil one can be said to have been sufficiently successful to last?

In short, the practical experience demonstrates the fact that something that proclaims itself to be 'Islamic' does not of itself attract what is an understandably cynical customer base in the UK. This leads us to ask a further question: 'what are the main reasons *why* the theoretical has not more readily translated into practical success?'

My impressions are as follows. First, beyond religion, perception matters. When we are dealing with our financial affairs we are, every one of us, conservative. We want to deal with institutions of substance that we believe will be around for years to come. We want to play safe. Beyond this, we want the right price and, importantly in this market, we want to be dealt with in the right tone. We don't see why we should pay a big premium because of our consciences and we want to be treated in a customer-friendly way. In terms of turning market opportunity into commercial viability, (the right kind of) advertising and an ability to get a message across to the centres of Muslim population are vitally important. Further, on a practical level some laws and their interpretation will need to be changed to enable tangible products to be crafted to realize the theoretical potential of the Islamic financial market in the UK.

Overwhelmingly, product providers should learn the lessons of past failures and limited successes and 'get it right'. They will need the right products at the right price delivered in a way that Muslim clients can believe really is *Sharīʿah* compliant.

VI. Which Products Are Needed?

Turning now to the types of products, which are required, the big needs are credit products to enable people to buy their own houses, cars and other capital items. There are drawbacks in introducing these services, though. In my experience the hurdles are usually legal and/or regulatory and derive from the fact that legislation has not been framed to take account of various *Sharīʿah* prescriptions and proscriptions. On the home finance side the issues to do with double or increased stamp duty and unfavourable risk adjusted capital weighting for banks are well known. Less well considered are those issues to do with custom and practice where, for example, a typical car financing contract will be structured to impose penal damages on late payers rather than as would be done under a *Sharīʿah* compliant equivalent simply to recover costs. Credit card structures – of which there are three which have received limited or full *Sharīʿah* acceptance – are similarly heavily structured. ABC's own Islamic credit card, which is offered by ABC Islamic Bank in Bahrain – and which may have a future in the UK – is the type of product, which will help as a proxy for hire purchase programmes for consumer durables for example as well as overdraft facilities. It seems clear to me on a general level that it is the significant billion pound-plus products – home finance, car finance and credit cards – that will receive the biggest share of attention and therefore development expense from the institutional providers of financial services.

In term of personal, i.e. retail investment products – including *Takāful* – there are significant hurdles to overcome. What is needed is not difficult to define. Products are needed giving ways of saving short, medium and long term, with or without tax wrappers –

pensions, ISAs and so on. Offering investment products for sale – and then taking in the money of members of the public – is rightly a very heavily regulated activity in a way that financing is not. UK investment legislation has been drawn up primarily with debt and equity securities and money market instruments in mind. Thus the type of low risk *murābaḥah* mutual funds, which are highly popular in – say – Saudi Arabia, could not be legally offered here to members of the public, even though from a risk point-of-view, they could be made to be the same level of risk as a money market fund or a bank deposit. It is not that the regulators and expensive city lawyers are unsympathetic about this seeming unfairness, it is simply that that is the way the regulations have been written. The single area where there is a broad level of acceptance from the *Sharīʿah* scholars and the regulators is in equities, where by using various screens to exclude highly leveraged companies and companies in the so called 'sin sectors', equity unit trusts or OEICs are possible. As we know, however, because of their inherent volatility, equity funds no more meet the majority of short or medium term savings needs of the Muslim communities than they do those of the population as a whole.

In the future, the new Islamic Bank – when it is authorized – will, one assumes, offer savings accounts. This will be a very important service but it should be recognized it will be very expensive to operate on a small scale.

VII. Business Finance

Turning briefly to those commercial products which are needed, import and export finance are regularly structured on an Islamic basis and, as I have mentioned, property finance is too. However, as with the retail sector, there is still a big gap between what customers wishing for *Sharīʿah* compliant solutions want and what is on offer. There is a major investment needed by someone on the tax and accounting effects of substituting Islamic facility structures for conventional ones. Also, local British based scholars will need to better understand the issues so as better to advise on solutions. If we do not have suitably qualified scholars here, we need to bring in scholars from Muslim countries who have experience in structuring products and services to advise.

VIII. Timing – What's Changed? Why Now?

So – why is this suddenly a hot topic? Why now? There are a number of reasons. First, I would say because there is a political dimension to the timing – which is now seen in social terms but which equally can be seen economically. We are all familiar with the government mantra of social inclusion but one could also take the hard-nosed approach that, by not facilitating a significant proportion of citizens (i.e. a percentage of the Muslim community) to participate in the economy, you are inhibiting growth. The ways this translates into action is, for example, through the broadening of the responsibilities of the Financial Services Authority, which has an emphasis now on the need to promote the development of suitable financial products (not just Islamic products, I should add) and to educate the public in financial matters. This is giving impetus to changing not just rules but also institutionalized perceptions. Second, increasingly we are able to borrow *Sharīʿah* compliant 'product technology' from overseas. Over the last five years there have been big advances made in retail banking services, investment products (including *Takāful*) and commercial facilities, particularly in the Malaysian and the G.C.C. countries. Third, as demonstrated by the census-related technology, product providers are now in a position to implement highly targeted strategies to 'narrowcast' rather than broadcast their product messages and thus target efficiently their consumers. Finally, of course, we have a growing market, hungry for product, which is becoming increasingly confident and assured in pressing for solutions from government.

IX. Looking Forward

Within the next year there will be five or six financial institutions with Islamic financial products in the market. Banks such as HSBC, the Islamic Bank of Britain (and ABC, perhaps) have invested heavily and will take a chance on the 'adherence quotient' of the potential client base being high for the products offered. Having reviewed the statistics, all the market entrants will be looking to see large numbers of Muslim customers rush to use their services. It will be interesting this time round to see if the practice lives up to the theory.