

Islamic House Financing in the United Kingdom: Problems, Challenges and Prospects*

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Abstract: This paper overviews Islamic financial market in the United Kingdom with a special reference to home financing – a phenomenon that has recently attracted quite a lot of attention in the country. It also provides an account of attitude of Muslims in the United Kingdom towards Islamic finance, indicating that although there is great enthusiasm towards Islamic banking and finance, it has so far failed to culminate into effective demand for Islamic financial services, including Islamic mortgages. Of the two home financing products, Manzil Ijara and Manzil Murabaha home purchase plans offered by the UBK, there is virtually no demand for the latter owing to the negative image that *murābahah* carries in an ordinary Muslim's mind. The paper argues that Islamic finance can only become a mainstream phenomenon if grassroots level awareness of Islamic finance is created in the country. In this respect, the role of providers of Islamic financial services cannot be over-emphasised.

I. Introduction

The vast majority of work on Islamic finance over the past three decades has been in developing a theoretical basis for an Islamic economic system. Much excellent work has been done on this, almost exclusively in Muslim countries. It is only in the last decade that academics in Europe and elsewhere have involved themselves in the debate. The universities of Loughborough and Durham offer masters degree programmes in Islamic economics, banking and finance, and other institutions of higher learning contemplate following suit. Specialised institutions like the Islamic Foundation of Leicester and

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Institute of Islamic Banking and Insurance in London have for some time been engaged in research and publishing in this field. An international conference on Islamic economics and banking was organized at Loughborough University in the year 2000, which attracted a lot of media attention. The Bank of England has right from the beginning been aware of developments in Islamic banking but it is for the first time that a fully fledged conference with an exclusive theme of Islamic banking is being organized by the Centre for Central Banking Studies at the Bank of England. This in itself is a testimony to the fact that Islamic finance is now assuming mainstream relevance in the United Kingdom.

Since the early days of Al-Baraka Bank (1982-93) Islamic finance in the UK has grown considerably. Apart from a number of Islamic investment funds (registered as offshore companies), about ten banks in the country offer Islamic financial services. Among them United Bank of Kuwait is the only institution offering Islamic house financing, called Manzil Murabaha Plan and Manzil Ijara Plan. Previously, the now-defunct Al-Baraka Bank offered an Islamically permissible mortgage but that ceased to exist with the closure of the bank in 1993. However, some other financial institutions may soon start offering Islamic mortgage products, the recently established Charity Bank Limited being one of them.

This paper contends that Islamic finance in the UK has developed into an elitist phenomenon without much grassroots level appeal. Arguably, the Muslim population in the UK has shown strong *desire* for Islamic banking and finance, but it is not a simple matter to infer from that an *effective demand* for any Islamic financial product. That is not to say that there is no such demand in the UK rather that there is a need to study the structure of demand for Islamic finance in the UK at a grassroots level. Many have argued that there are about two million Muslims in the UK, who have a strong demand for Islamic finance. Our approach at Loughborough University is rather pragmatic and, hence, quite different from that of many other researchers in this field. We recognize that not all Muslims act according to Islamic *Shari'ah*, and many of those who do may not make up an effective demand for Islamic financial products. Our research at Loughborough University attempts to explain the attitude of Muslim community – both individuals and households – in the UK

towards Islamic finance. It attempts to explore how Muslims are reacting to and using Islamic finance, what their level of understanding is, and what needs to be done to educate them as to what constitutes acceptable behaviour in relation to their monetary matters, according to Islamic *Sharī'ah*.

In the next section, this paper discusses different models of Islamic mortgage and their use in the UK and elsewhere. Section 3 lists major problems faced by providers of Islamic house financing. Section 4 discusses some of the challenges faced by Islamic finance in the UK before we conclude.

II. Islamic models of house financing.

This section discusses Islamic house financing models based on *murābahah* (trade financing) and *ijārah* (leasing).

2.1. *Murābahah*-based Mortgage

A *murābahah* contract implies a profitable sale and in essence amounts to a deferred payment sale, and hence may serve as an instalment sale contract for property. Of all Islamic approaches to the question of leveraged or investor-funded home acquisition, this method is the most consistent with conventional real estate processes.

2.1.1. The principle

- (i) Typically, a customer wishing to purchase a property requests the bank to purchase it to sell it to him at cost plus a declared profit.
- (ii) The bank purchases the required property directly and sells it on the basis of a fixed mark-up profit.
- (iii) The customer agrees to pay the price in agreed upon easy instalments.

The *murābahah* mortgage in practice combines *murābahah* contract with *bai' mu'ajjal* (credit sale or sale on a deferred payment basis). A strength is that the customer may deduct the payments over the base cost of the property as interest for tax purposes. A significant weakness is that the practice has a poor perception among many Muslims relating either to abuse in some cases,¹ or an inability to distinguish from a conventional loan of money secured by a note and a mortgage.

There are two variants of *murābahah* mortgage:

- (i) Simple *murābahah*; and
- (ii) *Murābahah* with agency sale.

In the simple *murābahah* mortgage, the financier (bank) buys the house from the market (vendor) and obtains the title before selling it to the customer. In the *murābahah* with an agency incorporated in the transaction, the bank appoints the customer as his agent to buy the property on the bank's behalf. Effectively, the Customer acquires the ownership title without the Bank coming into the chain. This latter practice is also referred to as synthetic *murābahah* and frowned upon by most Islamic scholars.

2.2. *Ijārah*-based Mortgage

There are two slightly different models of mortgage based on the *ijārah* contract:

- (i) *Ijārah wa Iqtinā'*^c (lease-to-own) model; and
- (ii) Diminishing *Mushārahah* and *ijārah* model

2.2.1. *Ijārah wa Iqtinā'* [IWI] model

Party A (the bank) buys the property from the vendor, or in case of re-financing, Party B (the customer) and enters into two contracts:

- (i) Promise to purchase contract (PPC); and
- (ii) Lease contract (LC).

Under the PPC, the customer undertakes to purchase the property from the bank for the original purchase price spread over a certain time period (up to 25 years). The LC deals with occupancy prior to completion of the purchase. Payments are made to the bank monthly; the amount of each payment comprising both rent under the terms of the LC and payments under the PPC. The amount of the rent may be set annually and is normally aligned to the return required by the bank's investors, making the overall monthly payments comparable with amounts paid under standard variable rate interest mortgages.

The bank, being owner, provides building insurance. Unlike a conventional, interest-based mortgage wherein the lender advances

funds to the borrower and charges (interest) for the use of money, the *ijārah* mortgage is not a mortgage, or a loan, in the strict sense. The concept of interest-free housing (or property) finance is still unknown in the West, thus the term 'mortgage' is used here in the sense of collateral and as having the title of the property in the names of those who provide the funds. The *ijārah* mortgage is thus a *Sharīah*-compatible way for the bank to provide finance by using the subject of the financing, the property. The bank buys the property and the ownership is registered in its name. The bank then leases the property to the customer who pays a monthly rent together with a payment towards purchasing the property from the bank. The bank agrees to sell the property to the customer for the original purchase cost giving the customer full benefit of any rise in property prices. Thus, there is no increase in the price of the property between the bank and the customer, even though the value of the property may appreciate over time.

Although the price of the property is fixed between the bank and the customer for the duration of the contract, the monthly payments are reviewed annually to change the rent, upward or downward, depending upon economic conditions and the payments already made. The monthly payments allow the customer to build equity in the property.² The annual review of the rent reflects changes in equity shares.

If the customer decides to sell the property before it is fully paid off, the bank and the customer split the sale proceeds based on the percentage owned by each side. The same is true in case of default.

2.2.2. Diminishing *mushārah* and *ijārah* (DMI) model

A combination of diminishing *mushārah* and *ijārah* may form the basis of property finance in an Islamic way. This concept requires the financier and the client to participate in the joint ownership of a property. The share of the financier is further divided into a number of units. The client is then able to purchase those units one by one periodically so that the equity held by the bank reduces progressively over time. Eventually, the financier has zero equity and ceases to be a partner.

The principle is quite similar to the IWI model with the difference that both the bank and the customer enter into a partnership at the

start of the contract. It is based on the idea of Shared Equity Rental (SER) and is analogous to a business partnership in which several partners may pool their money.

Suppose a seven-person group raises £70,000 (£10,000 each). If, after one year, one of them wants to withdraw, he is entitled to one-seventh of the value of the business (in this case the net worth at the end of the first year). The same applies to housing.

Assume that a person is a first-time buyer of a house. Suppose the fair market value of the house is £50,000 and that it is shared by five equal partners, each possessing 10 shares of £1,000 each. The distribution of rent in this case can be understood by using a simple model that involves five shareholders each investing £10,000, who decide to rent the house to one of their partners. The rent is determined by the fair market rental value of the house, which may be assumed to be £500 per month or £6,000 per year, while taxes and maintenance come to £1,000 per year. This will leave £5,000 (i.e., £6,000-£1,000) to be divided among the holders of the 50 shares. In other words it will produce an income of £100 per share. However, the tenant also holds one-fifth of the equity in the property; thus this is deducted from £5,000 and the remaining £4,000 is distributed among the holders of 40 shares.

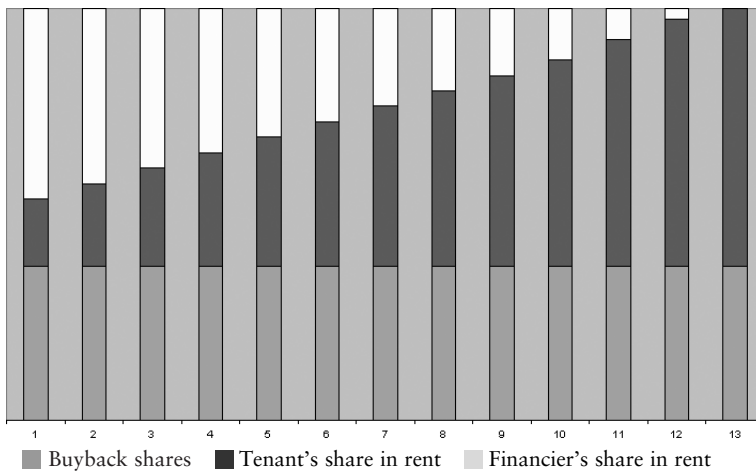


Figure 1: Distribution of rent and ownership under an *ijārah* mortgage: Example 1, Table 1 (see appendix)

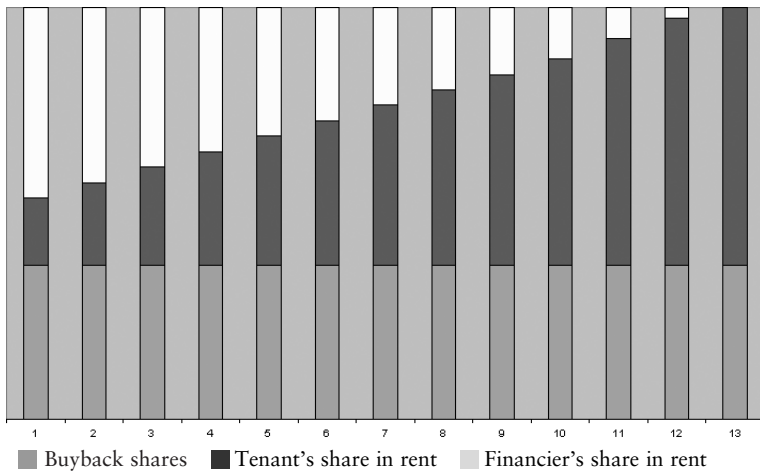


Figure 2: Distribution of rent and ownership under an *ijārah* mortgage: Example 2, Table 2 (see appendix)

If the person continues to pay rent only, he would never own the house. Therefore, he is allowed to buy back the shares of his partners to increase his equity and eventually buy the property. At the time of the purchase, the price of each share was assumed to be £1,000. It may be assumed that the price remains unchanged throughout the first year. If, after the end of the first year, the tenant is required to buy back three additional shares at £3,000 and adds to this sum the investors' share of the yearly rental (£4,000), this gives a total of £7,000 which is the basis for determining the rent for the second year: £583 per month (£7,000/12).

In order to account for the appreciation in property value, it may be assumed that, by the next year, the value will rise by 10 percent. The house is then worth £55,000 in year 2, and the price of each share is £1,100. This appreciation changes the rental as well, which, say, increases by 10 percent to £6,300 per year. Out of this £1,100 (also up 10 percent) are deducted as miscellaneous expenses, giving the net rental of £5,200 per year, an income of £104 per share. During this period, the tenant's shareholding has risen to 13 shares, which means his equity is 13/50 and his earnings are £1,352 [i.e., £104 x 13]. This leaves £3,848 to be shared among the remaining four investors, who hold 37 shares.³

Thus, in the second year, if the tenant wants to buy three more shares at the current price of £1,100 per share, he will have to add £3,300 to the rent and the total year's rent will be £8,600 with a monthly rent of £717. Under this formula, a person would own the house in 14 years, allowing a 10 percent annual increase in property value. The additional payments that the buyer has to make (£217 per month in the second year) result in five to six percent average increase in the monthly rental, which is quite reasonable. However, the increase (or decrease), can be based on the policy of tenancy boards or market trends.

This arrangement, however, proves to be quite costly and consequently may put off even religiously-motivated customers. A slightly different but detailed example of the DMI model, therefore, is illustrated in Table 1. It does not take into account the changes in property value (like the IWI model) and the rent does not alter throughout the period of the contract, which is assumed to be 13 to 15 years. The rent, £500 a month, reflects the fair market rental of an average property worth £50,000. The example shows that a customer may take 13 years to repay their mortgage, although the contract may be extended to 15 years to cater for some non-payments during the contract. The cost of borrowing for £40,000 (£28,300) for a period of 13 years is on the higher side when compared with an interest-based (interest-only) mortgage.⁴ Monthly payments are also cessive. Starting with £500 a month in the first year, they go up to £667 a month in the second year, eventually dropping down to £433 a month in the last year. If the mortgage is paid fully, the customer pays £28,300 as rent to the lender. This results in a rate of return of about 10% for an investment of £40,000 for 13 years. (For further details about the examples see Table 1 and Table 2 in the appendix)

Increasing the length of the contract from 13 years to 20 years reduces the monthly instalments (see Figure 3), but it is not of much help as it increases the cost of the borrowing quite a lot (from £28,300 for a period of 13 years to £42,000 for 20 years).

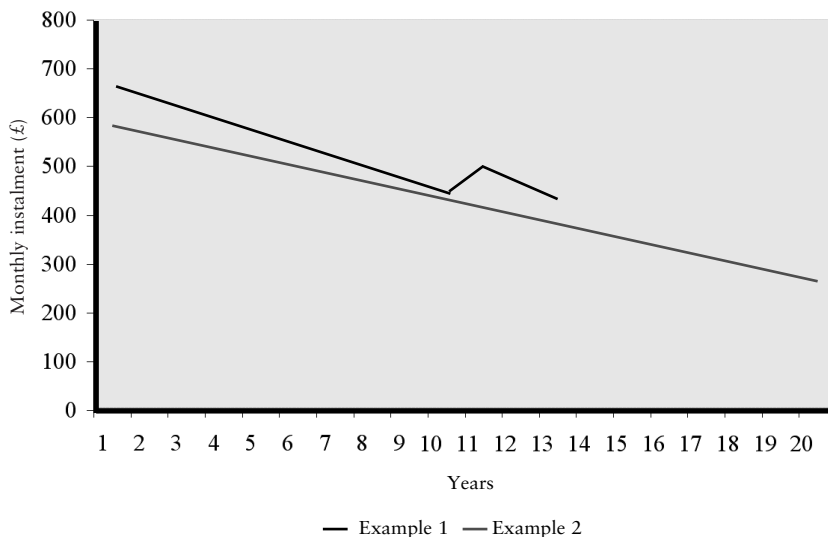


Figure 3: Comparison of monthly instalments for 13 and 20 year *ijārah* Mortgages (Examples 1 and 2)

2.3. The Practice of Islamic House Financing in the UK

Former Al-Baraka Bank in London (now an investment company) provided long-term Islamic mortgages to its clients between 1988 and 1991. The operations were similar to the DMI model whereby Al-Baraka and its client would sign a contract to purchase the house jointly, the ownership share being determined by the financial contribution of each of the parties. Al-Baraka would expect a fixed pre-determined profit for the period of the mortgage, the client making either monthly or quarterly repayments over a 10 to 20 year period, which covered the advance plus profit share. There was some debate if the profit share could be calculated in relation to the market rental value of the property, but this was rejected as frequent revaluation of the property would be expensive and administratively complicated. Furthermore, given the fluctuating prices in the London property market, there would be considerable risk for the bank.

2.3.1. The United Bank of Kuwait experience

The Islamic Investment Banking Unit (IIBU) of the United Bank of Kuwait (UBK) in London has been offering Islamic house financing

since January 1999. iHilal (UK) Limited has recently started marketing this product on behalf of the UBK. The products, named as Manzil Murabaha Home Purchase Plan and Manzil Ijara Home Purchase Plan, allow Muslims to replace existing conventional mortgage finance or buy a new property in an Islamic way.

2.3.1.1. Manzil Murabaha Home Purchase Plan

The Murabaha Plan is based on the principle of ‘trading’, or buying and selling goods at a profit. IIBU contracts with the vendor and pays the deposit required when the contracts are exchanged. The sale price from IIBU to the end buyer [the client] is the price paid by IIBU to the vendor, plus the return IIBU pays its investors, plus administrative expenses and a profit margin. The property, after sale to the buyer, is registered in the buyer’s name and the buyer repays IIBU fixed monthly instalments. The key features are:

- (i) The client chooses a property and agrees the price with the vendor.
- (ii) IIBU then contracts to buy the property from the vendor and sells it to the client at a higher price.
- (iii) The client pays the higher price by equal instalments over a term of up to 15 years.
- (iv) Following completion of the purchase the property is registered in the client’s name and IIBU holds security over it in the form of a legal charge (mortgage).
- (v) The monthly instalments are fixed and do not alter throughout the payment term.

As the property is transferred twice (once from the vendor to IIBU and then from IIBU to the client), it is required to pay the stamp duty twice. But this problem in practice is overcome by structuring the transaction so as the sale from vendor to financier to customer is by way of ‘sub sale’. Stamp duty in this case is applied to the transaction involving the higher price only.

2.3.1.2. Manzil Ijara Home Plan

The Ijara Plan is based on the IWI model. The key features are:

- (i) The client chooses a property and agrees the price.

- (ii) IIBU buys the property and agrees to sell it to the client for the same price spread over a term of up to 25 years.
- (iii) During this time, the client pays rent to IIBU for living in the property that IIBU owns.
- (iv) The rent is assessed annually and is adjusted to reflect the payments the client has made to IIBU.

To replace an existing conventional mortgage the procedure is the same except that:

- (i) IIBU buys the property from the client at its current value.
- (ii) The client agrees to buy the property from IIBU at this price.
- (iii) The client's first payment to IIBU is the difference between the current value and the amount of the current mortgage.

2.3.1.3. The two plans compared

Before we compare the two plans, it will be useful to look at Islamic mortgages against conventional mortgages available in the UK. Table 3 compares conventional and Islamic mortgages; Table 4 compares the two plans.

Table 3. Conventional and Islamic Mortgage Compared

Conventional Mortgage	Islamic Mortgage
The lender advances funds to borrower who pays interest on the mortgages loan.	Based on trade (<i>murābahah</i>) and leasing (<i>ijārah</i>), Islamic mortgages are interest-free.
Anyone with a stable source of income and able to return the loan and interest before the age of 65 is eligible to apply.	Anyone with a stable source of income and able to pay the purchase price before the retirement age is eligible to apply.
In general there is no lower limit to the property value.	The chosen property must be valued at £50,000 or more.
There are many products offering 100% financing.	The Customer has to pay at least 20% of the property's value as a down payment.
In most cases life insurance and building insurance are mandatory.	There is no compulsory life insurance although building insurance is required.

Table 4. The Murabaha and Ijara Plans Compared

	The Murabaha Plan	The Ijara Plan
Can this plan be used to refinance an existing conventional mortgage?	No. <i>Shar'ah</i> guidance is that <i>Murābahah</i> is not suitable for this purpose.	Yes. This plan allows to payoff an existing interest based mortgage. In addition for suitable cases it may be possible to include the cost of the stamp duty and legal fees in the Ijara plan.
How does the lender earn profit?	With the Murabaha plan profit is achieved by increasing the purchase price of the property.	The Ijara plan is not a mortgage but is based on a lease with a promise to buy. Monthly payments include a lease payment (rent) and an on-account payment towards the cost of buying home. The amount of the lease payment is reviewed annually and includes the lender's profit.
How is the increase in price calculated?	The amount charged depends on several factors including the value of the property and the term of the contract. Before a customer makes a commitment to proceed, the bank gives them an indication of the expected monthly payment and total price.	There is no increase in the price of the property between the bank and the customer. Although the value of the property may change over time, the purchase price of the home is fixed at the outset. And the customer gets the full benefit of any rise in the value of the property.
Do the monthly payments vary?	No, the monthly payments towards buying the home stay the same throughout the term of agreement.	The monthly payments are priced for 12-month periods, from April to April. Every April, the rent is reviewed and it is likely that the monthly payment may change, either up or down, depending upon economic factors.
What is the maximum payment term?	15 years	25 years
How much help can one have towards buying the house?	This depends on one's earnings. Normally this plan allows 2.5 times annual income in case of a sole applicant. For joint applicants it allows 2.5 times the higher income plus 1 times the lower income or 2 times joint income.	This plan normally allows 3 times annual income in case of a sole applicant. For joint applicants it usually allows 3 times the higher income plus 1 times the lower income or 2.5 times joint income.

2.4. Islamic House Financing Elsewhere

2.4.1. Islamic Co-operative Housing Corporation, Canada

Islamic Co-operative Housing Corporation Limited (Toronto, Canada), ICHC, uses the IWI model and runs the scheme as follows:

- (i) A prospective homebuyer must become a member of the ICHC (currently the membership fee being \$75 [Canadian]).
- (ii) The members must buy at least six shares of \$100 each, annually, to keep their membership active.
- (iii) In order to qualify, the members need shares equal to 10% of outstanding mortgage balance (in case of re-mortgaging) in the ICHC for at least six months.
- (iv) New homebuyers must have shares equivalent to at least 20% of the first \$100,000 of the house price and 40% of the difference between \$100,000 and the actual price up to \$200,000. The minimum required shares must be with the ICHC for at least six months.
- (v) On occupancy, the member pays a mutually agreed monthly rent to the ICHC in proportion to their ownership in the house.
- (vi) The rent is reduced from the following month in the proportion of additional shares the member buys at any time during the year.
- (vii) In case of sale or transfer of the house, any gain or loss realized in the value of the property is divided as follows:⁵
 - a. 90% to the member and 10% to the ICHC if the member has already acquired more than 50% shares; and
 - b. 80% to the member and 20 percent to the ICHC if the member has acquired 50% or less shares.
- (viii) The ownership is transferred to the member when they have accumulated shares equivalent to the cost of the house *plus* one [1] Class 'G' Preferred Share.⁶

Shares may be sold or transferred at any time to any member of the ICHC. The purchase of shares is an investment in the ICHC, which in effect is very secure since legal title of the property remains with the ICHC until all of the required shares are accumulated by the homebuyers/members. Thus, the members may keep their savings

with the ICHC instead of in a bank while waiting for their turn to occupy the house. The members are entitled to dividends on their shares before occupying the property.

2.4.2. Ameen Housing Co-operative of California

Ameen Housing Co-operative of California Inc. (AHC) uses a variant of the IWI model. Here is a summary of how the scheme runs:

(i) A prospective homebuyer must become a member of the Islamic Society of North America (ISNA) before applying to AHC for membership, annual membership being \$100.

(ii) Members have to buy at least \$1,000 worth of shares in AHC every year. Those who qualify first are allowed to buy first.

(iii) In order to qualify, the prospective buyers need shares equal to 20% of the funding required from AHC (if it happens to be less than or equal to \$100,000), and 30% if the required funding is more than \$100,000 and up to \$300,000.

(iv) The member must have bought the required shares at least six months before applying for funding.

(v) The member selects a house of their choice, which is jointly owned by the AHC and the member but the title is kept with the AHC until all the equity is bought by the member.

(vi) The member pays monthly rent to AHC until AHC's investment (including any appreciation in the value of the property) is completely paid off.

(vii) A portion of the rent goes to AHC's revenue pool and a portion goes to the member-owner's principal. Amounts are proportionate to the AHC's and the member's investments.

(viii) Based on the market conditions, rent is adjusted upwards or downwards annually.

(ix) As a result of a transfer/sale of a housing unit, any gain or loss realized, after deducting the cost of authorized major improvements and extensions and certain legal expenses, is divided as follows:

- a. 80% to the member and 20% to the AHC if at the time of the transfer member had accumulated shares equivalent to more than 50% of the cost of the property; and
- b. 70% to the member and 30% to the AHC otherwise.

- (x) To complete the ownership of the house, the member will have to accumulate shares equivalent to the cost of the property *plus* one [1] Class 'G' Preferred Share (as in case of ICHC).
- (xi) If a member wants to transfer/sell their property within one year from the date of the acquisition by AHC, they will be required to pay a penalty of \$5,000.
- (xii) Starting from the calendar year, beginning after 12 months from the date of acquisition of the property, the member will have to buy \$5,000 worth of shares or 10% of the cost of the property, whichever is less, every year.
- (xiii) After occupancy, members are normally not allowed to sell or transfer any of their shares.

It may be seen that the AHC scheme is quite similar to the ICHC, with some changes to make the product congruent with the Californian state laws that govern mortgage lending. This is a good example of how one Islamic product developed in one country can be used in another by making some changes to conform to local laws.

2.4.3. MSI Housing Fund, Houston

MSI Housing Fund, Houston, Texas applies the DMI model in its SHARE (Shared Home Appreciation in Rent and Equity) scheme, which functions like this:

- (i) MSI Housing Fund purchases a house of the customer's choice in a partnership with the customer.
- (ii) The prospective homeowner provides at least 20% of the purchase price and Housing Fund provides the remaining 80%.
- (iii) The home is purchased with the title document showing Housing Fund as the co-owner instead of mortgage-holder.
- (iv) The customer, called a resident owner, pays fair market value monthly rent proportionate to Housing Fund's ownership. In addition, the resident owner can choose to buy-out Housing Fund's ownership in a period ranging from five to fifteen years depending on their budget.
- (v) The additional payment, which reduces Housing Fund's ownership every month, is added to monthly rent to arrive at total

monthly payment. As a result, more of the monthly payment is applied towards the purchase of ownership each month.

(vi) Unlike a conventional mortgage, Housing Fund shares the cost of insurance and property taxes consistent with its status as co-owner.

(vii) In the event that a house has to be sold, with mutual agreement prior to complete buyout of Housing Fund's equity, sale proceeds are divided between the resident owner and Housing Fund according to their proportionate ownership. This is unlike a conventional mortgage where the balance must be paid off before homeowner gets anything.

2.4.4. LARIBA Financing

American Finance House's (AFH) LARIBA financing is similar to the MSI practice. Salient features are given in the following:

(i) AFH purchases a house of the customer's choice as a co-partner.

(ii) The customer owns title to the property with AFH holding a first-position lien.

(iii) The customer occupies the property and pays rent to AFH. The rent is determined by a 'marking the item to the market' principle developed by AFH. AFH and the customer call around to find monthly rental of a similar property to agree on a monthly rental.

(iv) The customer agrees to buy back AFH's portion over a period of time (usually 7 to 10 years). It is called Repayment of Capital (R-of-C, pronounced ROFSEE) to AFH.

(v) Return on Capital (R-on-C, pronounced RONSEE) is calculated based on a declining equity model based on the property's economic value (utility). This value is measured by the property's lease value as explained above.

(vi) The financing agreement consists of two parts: the first is a loan agreement in which the client returns the capital to AFH (R-on-C); the second is a lease agreement based on an agreed lease rate, calculated based on the declining equity stipulated by the R-of-C pay back agreement.

(vii) Based on the agreements detailed above, a promissory note is drawn. It details the monthly payments representing the R-of-C

portion and the R-on-C (lease) portion. To comply with the US regulatory requirements and the US banking system rules, the monthly payment streams are plugged into a traditional amortization programme to calculate an implied interest rate. This allows LARIBA to satisfy the 'Truth-In-Lending' and 'Full and Complete Disclosure of Implied Interest Rate' laws as required by the US banking and lending requirements. The models, and agreements used for all transactions, are exclusively developed by AFH to provide services for the clients seeking Islamic financing products.

2.5. Differences between the Practice of IWI and DMI Models

There is no real difference between the IWI and the DMI models, both being based on the principle of *ijārah*. Nonetheless, the following points are worth mentioning.

- (i) The IWI model runs in line with the structure of a co-operative. Although the DMI could also be used for establishing a co-operative; in practice it has not been so used.
- (ii) The financier (a bank or a co-operative) and the customer enter into joint ownership in both the IWI and the DMI. However, the legal title of the property remains with the financier in case of the IWI, while it is shared by the financier and the customer in the DMI arrangement.

III. Problems in Provision of Islamic House Financing in the UK

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) The inability to use either *ijārah* or *murābahah* to assist with house purchases under the various public sector home ownership initiatives.
- (ii) The additional stamp duty burden when finance is provided following the principles of either *ijārah* or *murābahah*.
- (iii) The adverse regulatory capital weighting treatment for the financier when house financing is provided through *ijārah*.
- (iv) The inability to obtain financial assistance from the state in cases of financial hardship.

All these and many others are genuine problems that Islamic finance faces in this country. This paper, however, does not focus on these. Instead, it attempts to emphasize that almost all suppliers of Islamic financial services in the UK have failed to estimate true demand for Islamic finance in the country. At Loughborough University, we have conducted a series of surveys among Muslim households, businesses and voluntary organizations to get an idea of the extent of demand for Islamic financial services in the UK. This paper summarizes four of these surveys conducted between 1991 and 2001. An overwhelming response of the correspondents was a rather emphatic rejection of interest. But it is important not to create a one-to-one match between the avowed rejection of interest and demand for Islamic finance, as rejection of interest does not automatically mean demand for Islamic finance. This is so because it appears that only some of those Muslims who already use financial services would convert to Islamic financial services were they made available to them.⁷ Moreover, a large number of Muslims would convert to Islamic finance if and only if it offered at least the same benefits as conventional finance. Very few strongly religiously motivated Muslims are expected to convert to Islamic finance even though they have to pay extra for the use of Islamic financial services.

Therefore, for a better understanding of demand for Islamic financial services, it is important to look closely at the of the Muslim population in the UK. In this regard, countries of origin, financial standing, saving behaviour, level of education, etc. are important. This may help to understand the difference between 'desire' and 'demand' for Islamic finance. At Loughborough, we have conducted some exploratory studies to capture the effect of these variables on the demand for Islamic finance, but there remains a need for an in-depth study. Without such a study, the true extent of demand for Islamic financial services will be a guess at best, and it may prove fatal for ambitious suppliers of Islamic financial services in this country to base their investment decisions on this crude estimate of demand.

A recent survey of Muslim voluntary organizations in the UK revealed that there is a potential demand for Islamic mortgage among such organizations provided that an appropriate marketing strategy is followed. As mentioned earlier, the Charity Bank is about to launch a couple of Islamic mortgage products for Muslim charitable

organizations after further investigation into the structure of demand for Islamic finance by such organizations.

Apart from the above mentioned demand side problem, there are some supply side problems with Islamic house financing in the UK. Both *murābahah* and *ijārah* plans offered by the UBK are quite inflexible. While the inflexibility is understandable in light of the recent advent of these products, one should not ignore a structural problem with *ijārah*-based mortgage.

In many cases, the average Muslim in this country still sends money 'back home'. The view that second and third generation Muslims in the UK are sophisticated savers or investors is not justified. In a sense, the Muslim population in the UK can never acquire the status of second and third generation while there is a constant influx of spouses from the countries of origin. No doubt a vast majority of Muslims do invest in property, but that does not necessarily imply demand for Islamic house financing. In fact, like any other rational investor in property, the Muslim investor enjoys the differential between rental rate and the rate of interest paid to the bank/building society. The *ijārah*-based mortgage tends to reduce the differential between rent and monthly re-payments to the bank/building society. This is a major cause of the lack of popularity of the *ijārah* plan offered by the UBK.

IV. Challenges and Prospects

The prospects are bright if demand for Islamic financial services is properly investigated and suitable marketing strategies are accordingly adopted. So far the emphasis has been on providing Islamic financial services to Muslims living in greater London. While it is true that the bulk of the Muslim population is concentrated in London, the more settled and relatively less mobile Muslims live in the Midlands and the north of England. The future of Islamic house financing very much hinges on the development of an Islamic mortgage for the ordinary (relatively less well off) Muslims living in the inner cities. The joint document by a number of organizations providing Islamic financial services in the UK (referred to above) proposes a number of amendments in the existing laws to enable the suppliers of Islamic financial services to assist Muslims acquire home

ownership using public sector housing schemes. Nevertheless, a lot of work needs to be done in this direction.

We propose that the existing *ijārah*-based mortgage should be changed as follows to make it more attractive:

(i) The rent should be determined as a fraction of the appreciation in the value of the property rather than with reference to the market rental.

This is in contrast with the existing practice of the IWI and DMI models. In the IWI examples of ICHC (Canada) and AHC (USA), the rent is agreed mutually with an implicit reference to the market rental. MSI (USA) and LARIBA (USA), based on the DMI model, refer to the fair market value to determine the monthly rental payments. The early British experimentation by Al-Baraka, a variant of the DMI model, did not refer to the market rental at all as it was perceived as costly and time consuming and perhaps too risky for the bank, given the volatile rental market of London. IIBU's Manzil Ijara Plan refers to the fair market rental but adjusts the payments so as to make them comparable with those of a conventional mortgage of equivalent value. Close scrutiny of the Lease Contract used by IIBU reflects that, in fact, the bank takes into account LIBOR as an opportunity cost of the capital when calculating rent of the leased property.⁸ In practice, the monthly payments, however, are much higher than in the case of conventional mortgage.

Benefit: The market rental value makes the monthly rental payments rather high. The determination of rent as, say one-third of the annual appreciation of the property value will ensure that the total monthly instalments (purchase of shares plus monthly rental) are comparable with conventional mortgage payments.⁹

(ii) Value per share (VPS) of the property should be determined as the investor's (i.e bank's) share in the property divided by the *total* number of shares.

Benefit: This is suggested to ensure that the customer does not pay more than the purchase price of the property at the start of the contract.

(iii) In the event of sale of the property before the expiry of the contract, the capital gain should be shared between the bank and the customer in accordance with the proportion of their respective

equities. However, if the customer wants to come out of the contract within two years of the start of the contract, no capital gains should go to the customer.

(iv) Insurance costs should be paid by the bank, as in the Manzil Ijara Plan of IIBU, which may eventually be passed on to the buyers of *ijārah* bonds, if the property is to be securitized and shares to be sold to outside investors.

An example of such a product with payment schedule is given in Table 5 in the appendix section. Figure 4 compares the payment schedule of the proposed product with the two examples already provided in Tables 1 and 2.

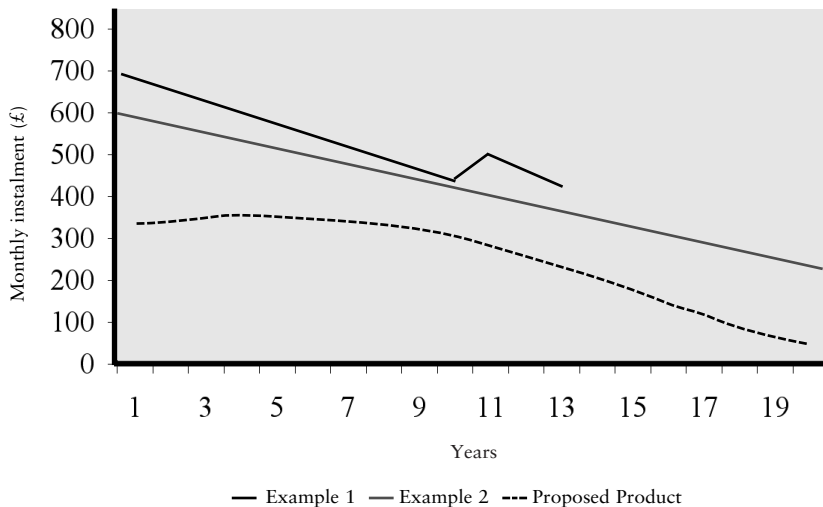


Figure 4: Comparison of the Proposed Product with the Example 1 and Example 2

One can expect that demand for such a product should be much higher than the existing Islamic house financing products, particularly Manzil Murabaha and Manzil Ijara Plans. Securitization of *ijārah* (as discussed below) should make it an attractive mode of investment for Muslim charities interested in helping other Muslim charities and, at the same time, earning some halal return on their excess liquidity. The Charity Bank Limited should be interested in such a programme as it will raise its profile as an institution friendly to ethnic minorities and different faith groups.

Appendices:

Table 1: Hypothetical example of an *Ijārah* mortgage:

Year	No. of shares owned by the tenant partner	No. of shares owned by other partners	Annual SER	Misc. Exp.	Net annual SER	Monthly instalment	SER per share	Tenant partner's share in SER	Other partner's share in SER	Return on investors' equity [%]
0	10	40	6,000	1,000	5,000	500	100	1,000	4,000	10
1	11+12=13	37	6,000	1,000	5,000	500+167 =667	100	1,300	3,700	9.5
2	14+2=16	34	6,000	1,000	5,000	500+142 =642	100	1,600	3,400	9.4
3	17+2=19	31	6,000	1,000	5,000	500+117 =617	100	1,900	3,100	9.4
4	20+2=22	28	6,000	1,000	5,000	500+92 =592	100	2,200	2,800	9.3
5	24+1=25	25	6,000	1,000	5,000	500+67 =567	100	2,500	2,500	9.6
6	27+1=28	22	6,000	1,000	5,000	500+42 =542	100	2,800	2,200	9.6
7	30+1=31	19	6,000	1,000	5,000	500+17 =517	100	3,100	1,900	9.5
8	34	16	6,000	1,000	5,000	500-8 =492	100	3,400	1,600	10
9	37	13	6,000	1,000	5,000	500-33 =467	100	3,700	1,300	10
10	40	10	6,000	1,000	5,000	500-58 =442	100	4,000	1,000	10
11	44	6	6,000	1,000	5,000	500	100	4,400	600	10
12	48	2	6,000	1,000	5,000	500-33 =467	100	4,800	200	10
13	50	0	6,000	1,000	5,000	500-67 =433	100	5,000	0	-
									=28,300	

Assumptions:

- (i) Changes in property value are not taken into account
- (ii) Rent does not alter throughout the period of the contract
- (iii) The contract period is 13 to 15 years

Table 2: Hypothetical example of an Ijara mortgage:

Year	No. of shares owned by the tenant partner	No. of shares owned by other partners	Annual SER	Misc. Exp.	Net annual SER	Monthly instalment	SER per share	Tenant partner's share in SER	Other partner's share in SER	Return on investors' equity [%]
0	10	40	6,000	1,000	5,000	500	100	1,000	4,000	10
1	11+1=12	38	6,000	1,000	5,000	500+84=584	100	1,200	3,800	9.7
2	13+1=14	36	6,000	1,000	5,000	500+67=567	100	1,400	3,600	9.7
3	15+1=16	34	6,000	1,000	5,000	500+50=550	100	1,600	3,400	9.7
4	17+1=18	32	6,000	1,000	5,000	500+34=534	100	1,800	3,200	9.7
5	19+1=20	30	6,000	1,000	5,000	500+17=517	100	2,000	3,000	9.7
6	22	28	6,000	1,000	5,000	500+0=500	100	2,200	2,800	10
7	24	26	6,000	1,000	5,000	500-17=483	100	2,400	2,600	10
8	26	24	6,000	1,000	5,000	500-34=466	100	2,600	2,400	10
9	28	22	6,000	1,000	5,000	500-50=450	100	2,800	2,200	10
10	30	20	6,000	1,000	5,000	500-67=433	100	3,000	2,000	10
11	32	18	6,000	1,000	5,000	500-84=416	100	3,200	1,800	10
12	34	16	6,000	1,000	5,000	500-100=400	100	3,400	1,600	10
13	36	14	6,000	1,000	5,000	500-117=383	100	3,600	1,400	10
14	38	12	6,000	1,000	5,000	500-134=366	100	3,800	1,200	10
15	40	10	6,000	1,000	5,000	500-150=350	100	4,000	1,000	10
16	42	8	6,000	1,000	5,000	500-167=333	100	4,200	800	10
17	44	6	6,000	1,000	5,000	500-183=317	100	4,400	600	10
18	46	4	6,000	1,000	5,000	500-200=300	100	4,600	400	10
19	48	2	6,000	1,000	5,000	500-217=283	100	4,800	200	10
20	50	0	6,000	1,000	5,000	500-233=267	100	5,000	0	-

Assumptions:

- (i) Changes in property value are not taken into account;
- (ii) Rent does not alter throughout the period of the contract;
- (iii) The contract period is 20 years

Table 5: Hypothetical example of functioning of a the proposed *Ijārah*-based mortgage:

Year	Gross property value	Investor's share in property	Value per share	Annual payment of debt	Monthly instalment of debt	Customer's equity	Investor's equity	Customer's equity [%]	Investor's equity [%]	Annual rent	Monthly rent	Total monthly instalment
0	50000			1000		10000	40000	0.2	0.8			
1	55000	44000	880	2640	220	12640	37360	0.3	0.7	1333	111	331
2	60500	45206	904	2712	226	15352	34648	0.3	0.7	1370	114	340
3	66550	46116	922	2767	231	18119	31881	0.4	0.6	1397	116	347
4	73205	46677	934	2801	233	20920	29080	0.4	0.6	1414	118	351
5	80526	46834	937	2810	234	23730	26270	0.5	0.5	1419	118	352
6	88578	46539	931	2792	233	26522	23478	0.5	0.5	1410	118	350
7	97436	45751	915	2745	229	29267	20733	0.6	0.4	1386	116	344
8	107179	44442	889	2667	222	31934	18066	0.6	0.4	1347	112	334
9	117897	42599	852	2556	213	34490	15510	0.7	0.3	1291	108	321
10	129687	40229	805	2414	201	36904	13096	0.7	0.3	1219	102	303
11	142656	37366	747	2242	187	39146	10854	0.8	0.2	1132	94	281
12	156921	34066	681	2044	170	41189	8811	0.8	0.2	1032	86	256
13	172614	30416	608	1825	152	43014	6986	0.9	0.1	922	77	229
14	189875	26528	531	1592	133	44606	5394	0.9	0.1	804	67	200
15	208862	22532	451	1352	113	45958	4042	0.9	0.1	683	57	170
16	229749	18573	371	1114	93	47072	2928	0.9	0.1	563	47	140
17	252724	14798	296	888	74	47960	2040	1.0	0.0	448	37	111
18	277996	11341	227	680	57	48641	1359	1.0	0.0	344	29	85
19	305795	8313	166	499	42	49139	861	1.0	0.0	252	21	63
20	336375	5789	116	347	29	49487	513	1.0	0.0	175	15	44
						= 39487						= 59430

Assumptions:

- (i) Changes in property value are taken into account the property is assumed to grow in value by 10% per annum
- (ii) Rent is determined as one third of the appreciation in the value of the property
- (iii) The contract period is 20 years

NOTES

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1. In Pakistan, for example, *murābahah*-based mark-up financing is now banned after initial misuse by banks.
2. It must be noted that the legal ownership of the property remains with the Bank, which is transferred to the Customer only at the end of the contract when the full price is paid off.
3. This arrangement is quite benevolent on part of the fund providers. Although the tenant partner completes their ownership of the additional three shares only at the end of the second year, they start getting share in SER on the basis of the ownership of 13 shares right from start of the second year.
4. Flexible mortgage (interest only) of £40,000 with Alliance & Leicester, for example, costs about £130 a month in interest payments. Total interest payment for 15 years is roughly about £24,000. Flexible mortgage (interest plus capital) of the same amount with the same bank costs about £310 a month.
5. The capital gain or loss may be shared after making adjustment for authorised improvements, expansions and certain legal expenses incurred by the member.
6. The cost of a Class 'G' Preferred Share is determined by the Executive Board of the ICHC as 10% of the difference between the present fair market value of the house and the actual cost. The difference is calculated after due allowance to the authorised major improvements and expansions, and certain legal expenses.
7. For example, this may mean nothing as regards demand for Islamic finance if all the correspondents who reject interest happen to be those who have never used financial services anyway.
8. Although reference to LIBOR as an opportunity cost of the capital employed is acceptable by Islamic scholars, this is looked down upon by most of the religiously motivated users of Islamic financial services.
9. Alliance and Leicester's Flexible Mortgage [interest plus capital] of £40,000 costs about £310 a month (in the first year) compared with £331 per month for the proposed house financing.