

# **School of Law**

**"Regulation of Islamic Finance:  
*Analysis on Development of UK Banking Industry*"**

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## ***Chapter -1***

### **• INTRODUCTION**

Islamic Finance has been marching in its potentialities ever since its resurrection in the last three decades. It has been estimated that their worth in the current situation rounds around US\$ 500 Billion all over the world.<sup>1</sup> They also show a potential strength in their growth compared to other systems, which is shown in the last year as 30%.<sup>2</sup> The development of the industry is particularly marked with the wide range of products like commercial loans, housing finance, project funding, etc.<sup>3</sup>

Islamic Finance market is spread almost whole world and London stands second to its operations in Middle East. It is asserted that there are around two million Muslims in UK having more than 0.3 million household. Still it is asserted that the Muslims in UK are not fully provided with the services of this industry because of the deficiency of the regulatory framework in this arena, in consonance with *Shariah*.

The UK regulators have shown their positive signals to address this issue.<sup>4</sup> It is in this context that the Financial Services Authority has published a paper on “Islamic Finance in UK: Regulation and Challenges” drawing attention of the people the need of creating a

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<sup>1</sup> A. Hanif, ‘Religion and Money: Islamic Finance,’ available at  
<[http://www.religion.info/english/article\\_371.shtml](http://www.religion.info/english/article_371.shtml)>

<sup>2</sup> K. Robinson, ‘Islamic Finance is Seeing Spectacular Growth,’ International Herald Tribune, November 5, 2007.

<sup>3</sup> R Wilson, ‘Islamic Investment Products Available In The United Kingdom,’ available at  
<[http://www.islamic-banking.com/aom/ibanking/rj\\_wilson.php](http://www.islamic-banking.com/aom/ibanking/rj_wilson.php)>.

<sup>4</sup> Speech by Callum McCarthy, Chairman, FSA, in Muslim Council of Britain Islamic Finance and Trade Conference, on 13 June 2006 available at  
<[http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613\\_cm.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml)>.

legal framework which will address the problems faced in this area.<sup>5</sup> They have attempted to analyse why UK is emerging as global hub for Islamic finances. Their central issue in that aspect is to address the risk and challenges which Islamic firms in UK face in the retail and wholesale markets. It was their concern as to how to encourage the development of Islamic finance in UK.

### *1.1 Origin of Islamic Finance*

Islamic Finance as a form has originated from the ideas propounded by the Holy *Quran*, *Sunna* and *Hadith* (vows of Prophet Mohammed) and other and documents.<sup>6</sup> Generally these are known as *Shariah*, as a system of principle to be followed throughout.<sup>7</sup> The philosophy of Islam not only gives the divine rule but it encompasses the right path, which has to be followed in all aspects of life. Therefore, it was necessary that such system should provide guidelines and modes of economic activities, which is an essential part of the life.

Islamic Finance has witnessed liberal market situation and capitalism at the time of agricultural revolution.<sup>8</sup> The concept of market forces and transactions of mercantile products took place in the 8<sup>th</sup> Century at the behest of Islam traders.<sup>9</sup> Almost all the forms of economic transactions were carried out there. Muslims financed most of such trades.<sup>10</sup>

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<sup>5</sup> M. Ainley, et al, 'Islamic Finance in the UK: Regulation and Challenges' available at <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> (which is prepared on behalf of FSA herein after referred to as 'the Paper').

<sup>6</sup> H. Hourani, 'The Three Principles of Islamic Finance Explained,' available at <<http://www.iflr.com/?Page=17&ISS=16434&SID=515347>>.

<sup>7</sup> H.A. Hamoudi, 'Jurisprudential Schizophrenia: On form and Function in Islamic Finance,' (2007) 7 Chicago Journal of International Law, 605.

<sup>8</sup> M. Bonner, 'Poverty and Economics in the Qur'an,' (2005) 35 Journal of Interdisciplinary History, p.391.

<sup>9</sup> S.Y. Labiba, 'Capitalism in Medieval Islam,' 29 The Journal of Economic History, 79.

<sup>10</sup> 'Islamic Economic Jurisprudence,' available at <[http://www.wikipedia.org/wiki/Islamic\\_economics](http://www.wikipedia.org/wiki/Islamic_economics)>

The main postulate of Islam ie, to avoid poverty by equitable distribution of resources, which paved way for eradicating poverty in the 13<sup>th</sup> and 14<sup>th</sup> Century.<sup>11</sup> The system prevailed under Islam then, was to give excess of wealth to the poor as charity and without *riba* (interest).<sup>12</sup> It can also be seen that in 1758, the Quakers banned making of profit out of slave trade.<sup>13</sup>

## *1.2 Revival and Evolution*

As most of the Islamic Nations were under colonial rule, where the administrators promoted their way of economic activities, which was foreign to Islam.<sup>14</sup> The Muslim populations were forced to comply with such system. However, decolonisation took place and the countries were free to take up with their form of finance. Therefore, it is known as resurrection of Islamic Finance. The history notes that the ethos of Muslim community has shown an urge for adopting a financial system, which strictly adheres to the principles of *Shariah*.

The first move in this regard was under taken in Egypt, but without projecting its Islamic nature in order to avoid being termed as fundamentalist, which is antithetic to the then political underpinnings.<sup>15</sup> The Bank based on profit sharing and non-interest took place in 1963 and in 1967, there were several banks under the system. Nasir Social Bank of Egypt, which was established as interest free bank in 1971. Islamic Development Bank in 1974 emerged to serve the member countries based on fees profit sharing.<sup>16</sup> The later Seventies witnessed emergence of Islamic Financial institutions claiming to be following the principles of *Shariah*. It was the initiatives lead by oil countries to form Islamic

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<sup>11</sup> Supra n. 8.

<sup>12</sup> Meaning of *riba* is under confusive term by diiferent Jurists, which will be discussed in Chapter 2.

<sup>13</sup> E. Eves and Forbes, 'The Rise of Islamic Finance,' available at <<http://www.ameinfo.com/157243.html>>

<sup>14</sup> Z. Iqbal and A. Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, John Wile and Sons (2007), pp.1-2.

<sup>15</sup> 'Islamic Banking,' available at <[http://www.islamicity.com/finance/IslamicBanking\\_Evolution.htm](http://www.islamicity.com/finance/IslamicBanking_Evolution.htm)>.

<sup>16</sup> Ibid

Financial institutions, which created Dubai Islamic Bank in 1975, which was criticized for taking interest from the World Bank.<sup>17</sup> The formation of Islamic Development Bank uniting earlier bank as World Bank for the Muslims, which covered most of the Islamic nations.<sup>18</sup>

The attack on World Trade Center had put fear on the Muslim community, whether their accounts in the conventional banks would be frozen. This paved for the shift of concentration by the Muslim community to opt for Islamic Financial institutions.<sup>19</sup> However, its development was mostly marked in Europe.

### *1.3 Importance of Islamic Finance*

Islamic Finance based on the principles of *Shariah* envisages a different kind of treatment of financial affairs based on the divine will of God.<sup>20</sup> The ethos of the Islam theology for equitable distribution of the resources among the people is the basis of it. This will aid the poor in leading their life. Therefore, institutions which functions with the compliance of *Shariah* can be of great import to eradicate poverty from the world, lest from Islamic countries.<sup>21</sup> In this regard, the religious sentiments of Muslim community to follow the principles of *Shariah* can be accommodated in the financial activities. Eg., financial transactions without charging of interest being one among them, a Muslim will find it contra-principle to associate with conventional system of financial activities based on levying of interest.<sup>22</sup>

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<sup>17</sup> Supra n. 1.

<sup>18</sup> Ibid.

<sup>19</sup> J. Hume, 'Islamic Finance: Provenance and Prospects,' available at <<http://www.iflr.com/?Page=17&ISS=16434&SID=515348>>.

<sup>20</sup> There is a debate on the issue of difference of Islamic Finance with conventional one which will be discussed in Chapter 2.

<sup>21</sup> However, it depends upon the approach of the Institutions, whether they really want to help out. If they want to follow the principles in toto it is way to salvage the poor.

<sup>22</sup> M.A. El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance,' available at <<http://www.ruf.rice.edu>>.

It can also be seen that the attitude of the people to view Islamic Finance as an alternative to the conventional system. It goes to the root of the existence of finance. It is asserted that the risk factor, which is impregnated in the conventional system of financial activities, being more, an alternate system with solid base, is warranted. Due to the advancement based on Globalisation, the economy of one nation is heavily dependent on the other, for a set back in one area will affect other. Recent issue of 'sub prime' in US had shaken almost whole world. It is in this regard that the solution lies in an alternative method founded on different pattern will solve the problems.

Scholars consider that Islamic Finance is a mid-way between capitalism and communism.<sup>23</sup> The features of Islamic Finance based on the divinity of the God and equitable distribution differs from the two. Capitalism preaches for unbridled freedom of market forces, which would certainly oppress the disadvantaged. On the other hand, communism envisages a State controlled system where it interferes with all affairs of the people, which have seen its destruction in many countries.<sup>24</sup> Moreover, the menace put forth by globalisation, liberlisation and privatization in the world can be to an extent cured by Islamic Finance.

#### *1.4 Relation to UK Market*

UK financial market is recognized as the hub of Islamic Market next to its Middle East operations and has shown a shown a high growth in UK market. The London market has historically been showing willingness and very well responded to innovative methods and flexibility to novel ideas.<sup>25</sup> As expressed in the Paper itself, "London has deep and liquid

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<sup>23</sup> N.J. Nancy and R.V. Robinson, 'Islam and Economic Justice: A Third Way between Capitalism and Socialism?' available at <<http://islamicity.com>>.

<sup>24</sup> Supra n. 9.

<sup>25</sup> I Khan, 'Issues and Relevance of Islamic finance in Britain.' available at <[http://www.islamic-banking.com/aom/ibanking/ia\\_khan.php](http://www.islamic-banking.com/aom/ibanking/ia_khan.php)>.



markets and the exchanges are among the most frequently used venues for listing and trading financial instruments globally.”<sup>26</sup> It has always appreciated new services and products. Their skill and methodology have proven to be the best in maintaining a good administration and management system. Moreover, many of the Islamic jurisdictions have accepted interpretation of the English Courts treating it as authentic.

Further, the legislative policy, especially in taxation matters, being liberal and accommodative, paved developments of the Islamic Finance in UK. The unification of several regulatory bodies under one head, FSA in 1997, has also contributed in this aspect. The pre-existing condition, where conflicting policy decision and contra-views, made the system to have shortfalls in this regard. This was a welcome move for the Islamic Finance and Banking industry to grow. Even, the move of FSA in bringing about these reforms is also a progressive one.

The need of giving importance to Islamic Finance and banking industry has been recognized in early nineties itself by the authorities in UK.<sup>27</sup> They have propagated for giving a fare competition to them. As far as in 2003 itself they have agreed to the concept of Islamic Banking in London. It was a peculiarity of the system, which provides equal treatment without any discrimination.

### *1.5 Research Problem*

It is asserted that the implementation of Islamic Banking in UK and its efficient working leads to many issues. These are related to its compromise with the prevailing regulatory framework in UK. Both the system follows different pattern based on their perception of banking and related rights, duties and liabilities which consequently varies. To have a common platform for them is a Herculean task, which was under taken by FSA along

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<sup>26</sup> Supra n. 5.

<sup>27</sup> Supra n. 22.

with Bank of England. It is the central theme of this research to find out solutions to improve the working of reformatory move in this regard.

The central issue to be resolved in this study is to find out how far Islamic Finance in UK can be developed by reforming the Regulatory Framework with a legalistic approach. In analysing the question, it is necessary to answer certain questions. Such as, what is Islamic Finance, specifically banking? What is its nature and characteristics? How it is different from other systems? Why it is more concentrated in UK other than Middle East? What are the present issues/ problems faced by the Islamic Finance in UK? What are the reasons for such issues/ problems? What is the approach of the regulator in this regard? Whether any reforms are needed? How far FSA has addressed the issue? Whether the approach of FSA is in right path? How effective the proposals of FSA in curbing the problems? On getting the answers for them, the research will analyse what are the solutions to the existing issues/ problems? Thereafter, it will be asserted how effective will be the suggested solutions.

It is devised to have six chapters in this study including this chapter, which will address each question as mentioned above. Chapter 2 will deal with the genesis and postulates of Islamic Finance and Chapter 3 will detail the Islamic banking and the practices. The evolution and current trends of banking in UK is discussed in Chapter 4 and the regulators views and prospects will be analysed in Chapter 5. The problems and issues persisting reformation of Islamic banking in UK is detailed in Chapter 6 it will bring the findings and recommendations followed by the concluding remarks.

### *1.6 Methodology*

Research will be carried out on Primary and Secondary materials such as Legislations, Judgments, Literature, Reports and opinions. This will be done analytically, from one problem to other with an objective to solve the central problem ie, how far Islamic

Finance in UK can be developed reforming the Regulatory Framework and legalistic approach.

In this chapter, it is seen that the Islamic finance's origin and growth in different eras. It has also depicted the modulations of Islamic finance due to the influence of the systems prevailed in those periods. It was also discussed that the Islamic finance's resurrection was due to the demand of the Muslim people in the later years, as an alternative to conventional system of banking impregnated with preventive practices under the Islam's philosophy. Its relation to UK market was a necessary corollary to the study about the reformation of regulatory framework in UK. It has also discussed the articulated premises of the study.

## *Chapter 2*

- **Islamic Finance: Genesis and Postulates**

Islamic Finance is unique in its nature and character. When all other legal systems profess for the will of people (grunt norm theory of Kelson), the Islamic law falls on the divine will. They adhere to nothing but the advices given to Prophet, which is explained in the *Quran*.<sup>28</sup> The prerogative of the scholars or the body of experts to explain the interpretation in the light of each and every circumstance is yet another feature.

Every legal system, which interferes with the life of its subjects, will have to work on the basis of some ideologies and objectives. Similarly, in order to analyse the law governing the finance under Islamic tradition, examination of basic philosophy and prevalent legal considerations is necessary. This Chapter, therefore, attempts to find out basic legal considerations and jurisprudential values and the rhetoric used in Islamic Law. The basic question which is asked in this regard is: What is the rationale behind regulating financial activities under Islamic law?

### *2.1 Legal Philosophy of Islam*

Islam preaches only one power, the *Allah*, the God, the entire world being his donation.<sup>29</sup> All the affairs of the world are governed and undertaken at the mercy of the God. All beings are subject to him, his wish and will.<sup>30</sup> Human beings being genetically intelligent, have the right to rule, subject to the authority of the God. He has the right to utilize the facilities as provided by the God, but has to return them at the will of the God.<sup>31</sup>

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<sup>28</sup> M.B. Sadr, *Lessons in Islamic Jurisprudence*, Oxford (2003).

<sup>29</sup> H.A. Haumudi, 'Muhammad's Social Justice or Muslim Cant: Landellianism and Failures of Islamic Finance,' (2007) 40 *Cornell International Law Journal*, p56.

<sup>30</sup> I. Munawar and A. Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, John Wiley and Sons, (2006), p.203.

<sup>31</sup> A. Abdullah, 'Islamic banking,' (1987) 4 *Journal Islamic Banking and Finance*, p.3156.

It is seen that the God has created men with different qualities, some intelligent and others less, some wealthy, others not, with a mandate to help the weaker by mightier. The ultimate equality, which is the concern of most of the legal system, lies in the fact that, when capable helps the less capable, the excess and deficiency get neutralized.<sup>32</sup> It some way relates to the concept of protective discriminations followed in democracies. The difference in the perspectives of Islam with that of other systems is that the right of equality and equitable distribution of resources is the inborn right of the man where as Islam envisages that the resources are owned by the God and therefore, it should not be accumulated but equitably distributed among the people.<sup>33</sup> The concept of right based jurisprudence prevailed in other jurisdictions is seen missing in Islam. They do not consider the right of every man but only the will of the God.

It is asserted from the words of Prophet itself that the revelation aims at attaining benefits and prevents harm.<sup>34</sup> In its positive attributes, *Shariah* is ordained to facilitate the achievement of maximum benefit to all subjects. It can be seen that, *Shariah* is preaching social well being of the people in this aspect. Further, it poses a shield towards the occurrence of harm. The significance of this prohibition is in effect to achieve the previous goal i.e., benefit to the society. The peculiarity of *Shariah* is that, it heavily concentrates upon these prohibitions<sup>35</sup> rather than the positives, however, to achieve the same. Therefore, as often characterised, *Shariah*'s severe prohibitions are ordained to achieve maximum benefits, but on a large scale.<sup>36</sup>

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<sup>32</sup> I. Kartsen, 'Islam and Financial Intermediation,' IMF Staff Papers, March 29, 2007.

<sup>33</sup> Supra n. 27.

<sup>34</sup> M. Bonner, 'Poverty and Economics in the *Quran*,' (2005) 35 Journal of Interdisciplinary History, p.395.

<sup>35</sup> A. Jobst, 'The Economics of Islamic Finance and Securitisation,' (2007) 13 Journal Structured Finance, p.4.

<sup>36</sup> M.A. El-Gamel, 'A Basic Guide to Islamic Banking and Finance,' (2000) available at <<http://www.ruf.rice.edu/~elgamel>>.

In achieving this ultimatum, *Shariah* proposes certain activities as lawful and unlawful. The lawful connotes the positives and unlawful, the negatives. However, the jurisprudential inquiry of *Shariah* leads to confusion.<sup>37</sup> The Prophet himself pointed out, both the lawful and unlawful are obvious. It is easy to find out *per se* preventable and protected. It is the affairs or things that are vague as to the lawfulness are of great difficulty. Jurists and administrators will find it difficult to characterize such things, whether to treat as lawful and unlawful. Therefore, the gray area between lawful and unlawful constitutes the area of thrust for the Islamic Law.<sup>38</sup> It is obvious that the *Quran* and *Hadith*, had been extended or interpreted by *qiyas* and *ijmas* to meet this objectives. In this aspect, the significance *stare decise* and precedence will accrue which will govern the later administration. It had been a challenging task and indeed more severe, when complex set of facts and practices come, to find out a rationale principle to decide the lawfulness or legality on the basis of this theme.

## 2.2 Theories of Islamic Finance

As mentioned earlier, the quest for providing benefit leads to *Shariah* to adopt 'benefit analysis' as a basic postulate of Islamic legal theory in relation to economics.<sup>39</sup> Therefore, the central concern of Islamic law is to query for the economic substance and not the language used in the transactions.<sup>40</sup> Thereby it is leaving the Islamic contracts to its freedom. When other system tried to interfere into the obligations of contracts severely, by regulating it left and right, a lot of money were to be spent on in contesting litigation.<sup>41</sup> Islamic legal system stipulated to prohibit those that violate contract itself

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<sup>37</sup> H.A. hamoudi, 'Jurisprudential Schizophrenia: On the Form and Function in Islamic Finance,' (2007) 7 Chicago Journal of International Law, p.607.

<sup>38</sup> Ibid.

<sup>39</sup> M.A. El-Gamel, 'Incoherence of Contract- Based Islamic Financial Jurisprudence in the Age of Financial Engineering,' (2007) Rice University, p.5.

<sup>40</sup> Ibid

<sup>41</sup> S.A.A. Maududi, 'The Economic Principles of Islam' available at <<http://www.islam101.com/economy/economicsPrinciples.htm>>.

and Islamic law generally.<sup>42</sup> Even they have accepted a stipulation for advancing more liberal commercial regime in this regard.<sup>43</sup>

The corner stone of Islamic Finance lies in the protection of one's property by preventing unjust enrichment from others.<sup>44</sup> Islam, in this aspect, recognizes and protects the freedom of a man to utilize his property in lawful manner. The assets of a man can be developed in his own wishes and the State has nothing to intervene if he pays his taxes and he is within the general prohibitions. Therefore, trade being one of the most practiced forms of enhancing the assets, was promoted under Islamic jurisdictions, all times. As trade involved transactions of goods and money, *Shariah* regulated its aspects in every reach.

The authority of Islamic law lies in the fact that the revelation in the form of *Quran* or *Hadith* or its expansion via *qiyas* or *ijma* is not only the postulate of welfare measure but it is the basis of the legality in the life of Islam.<sup>45</sup> It leads one to assert that the Islamic law does not heed to public interest and heavily dependant on the assertions of divine will.<sup>46</sup> There, the law will follow blindly the mandates of the revelation and its interpretations. It constitutes one to state that the Islamic law propounds formalism.<sup>47</sup> The scope of innovation and trend setting are, therefore, not afforded to Islamic legal system from the classical era. The difficulty of acceptance of these by the Muslim community in this aspect slowed the modernization of Islamic Finance to a greater extent.<sup>48</sup> However, the present trends in its growth show a revolutionary approach in the latest scenario.

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<sup>42</sup> Supra n.36.

<sup>43</sup> Ibid.

<sup>44</sup> M. Fadel, '*Riba*, Efficiency, and Prudential Regulation: Preliminary Thoughts,' available at <[http://ssrn.com/abstract=\[1115875\].](http://ssrn.com/abstract=[1115875].)>.

<sup>45</sup> Supra n.36.

<sup>46</sup> Ibid.

<sup>47</sup> Ibid.

<sup>48</sup> Muslim will not accept any connotation, which will lower the authority of *Shariah*, as it relates to their belief itself.

### *2.3 Nature of Islamic Contract*

As the law on Islamic Finance was founded on the trades since the classical era,<sup>49</sup> the contracts were also under the consideration of Islamic Jurists. They have tried to regulate the transactions that took place under the Islamic regime. It can be seen that the *Hadith* says clearly that a Muslim should enter into contracts in consonance with *Shariah* only.<sup>50</sup> The legal principles of Islamic Contract are rooted in from the scripts of classical texts. The thread, which runs through the entire fabric of Islamic contract, is based upon the principle of economic basis that advocates for protection of benefits and prohibition of unjust enrichment. As such, like every legal system, the rationale of interfering with the freedom of contract of the people by the law is justified in observing the compliance of these principles.<sup>51</sup> Further, it also promulgate by heavily concentrating upon the prohibitions which is *per se* indigestible to Islamic ideology.

In order to comply with the setout principles, Islamic law envisages concepts like; finance based assets, working partnership and sharing of risks and reward. People under *Shariah* are allowed to do business and obtain profit under these spheres. However, they are required to share these among the family and destitute.<sup>52</sup> It is the specialty of Islamic financial jurisprudence that it vows for stipulation of aftermath of contract. Nowhere else, such conduct is formed a part of their legal compliance.<sup>53</sup> On these footings, *Shariah* envisages certain categories of contracts along with restrictions. Clarity and unambiguous nature of contracts is prominent among them. Overriding transparency is a basic postulate of Islamic contracts, which stipulates that a party to contract should know fully well,

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<sup>49</sup> S.Y. Labib, 'Capitalism in Medieval Islam,' (1969) 29 The Journal of Economic History, p. 85.

<sup>50</sup> Y.T. DeLorenzo, 'An Overview of Islamic Contracts and Principles,' presentation, available at <<http://www.yasaar.org/articles/An%20Overview%20of%20Islamic%20Contracts%20and%20Principles-ytd.ppt>>.

<sup>51</sup> S.A. Arjomand, 'The Law, Agency and Policy in Medieval Islamic Society: Development of Institutions of Learning from the Tenth to Fifteenth Century,' (1999) 41 Comparative Studies in Society and History, p.280.

<sup>52</sup> Editorial available at <[http://www.islamic-finance.com/item13\\_f.htm](http://www.islamic-finance.com/item13_f.htm)>.

<sup>53</sup> Protection of family is a part of Criminal law in India, however, it is not so in law of contracts.



what are his right and obligation unless he would be exposed to risks or harm.

The basic contracts, which prevail in Islamic transactions, are related to exchange, charity, guarantee and partnership over investment.<sup>54</sup> General concepts prevalent in other form of contracts like consensus and mutuality; majority of age and sanity are accepted by the Islamic law. *Gharar*, prevention on uncertainty is more severe in Islamic contract as it impregnates hidden motives. Unique feature of Islamic contracts lies in the prohibition on of trading in alcoholic, adult, gambling, etc, which is seriously viewed.<sup>55</sup> Islam doesn't permit a believer neither to engage himself nor invest, even remotely, in such trades.

## 2.4 Shariah Compliance

As discussed earlier, every financial transactions under Islamic finance should follow the principles put forth by *Shariah*. It follows that every enterprise, which runs under Islamic law, should also fall in line with these injunctions. As such, in order to verify the compliance of *Shariah* principles, there have to be a body of experts of repute who will observe such compliance. The Board will scrutinize the working and every transaction of such institutions. Every transactions, which bear doubtful connotation, will have to be cleared by the Board.<sup>56</sup> The decision of the Board will be issued as *fatwa*, which is binding on the institution. These *fatwas* will be scrutinized by a Superior Board under religious heads, whether to follow it or not. It will see whether the products offered by the institution are genuinely benefit oriented. Whether they are coming within the province of prohibited activities.<sup>57</sup>

From these discussions, it has been analysed the nature and the characteristics of Islamic

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<sup>54</sup> A.A. Jobst, 'Derivatives in Islamic Finance,' (2007) 15 Islamic Economic Studies.

<sup>55</sup> Supra n. 10.

<sup>56</sup> K. Rowiey, 'Islamic Finance: Basic Principles and Structures,' Fresh Fields Bruckhaus Deringer available at <<http://www.freshfields.com>>.

<sup>57</sup> Details of *Shariah* compliance under banking system will be discussed in Chapter 3.

finance. Islamic philosophy is related to the revealed law and its authority from the divine will of the God, which is unique. It is also examined the authenticity and authority of *Shariah* principles and the role of scholars and interpretation in Islamic law. The benefit analysis of Islamic finance is yet another feature which is different from that of other systems. The implication of lawful and unlawful and prohibition are also discussed. Islam's perceptions on the nature of contracts and its rigid nature of regulations is analysed. These discussions will help one to understand the footing of Islamic banking and further, rectifying the approach of FSA in reforming Islamic finance in UK.

## ***Chapter: 3***

- **Islamic Banking : Concepts and Practices**

Banks as financial institutions in an economy plays a main role in economic developments of a state. Since all economic activities are based upon the flow and movement of money, Banks being the retainer and controller, have a significant position.<sup>58</sup> Consequently, developmental activities of state are heavily dependent on the stability of Banking; and any adverse effect on the system will affect the economy as a whole. Therefore, all the systems, capitalist, socialist or Islamic have put on their emphasis in regulating the sector. The unique feature of Islamic Law based on the concept of welfare of man had trivially managed to observe with severity on the banking affairs.<sup>59</sup> It is attempted to analyse in this chapter, streams which will have Bearing on various aspects of banking under Islamic Law.

### *3.1 Concept of Islamic Banking*

In conventional system, Bank as an institution will work on the principle of buyer and lender. They will receive money from the depositor by offering a return, interest, on the productive use of money thus received.<sup>60</sup> As a lender, they will provide loans to the borrower receiving return as interest. In addition, they charge from such borrowers a fee for managerial expenses. Its profitability lies in the difference between the interest from the borrower and which is paid to the depositor and the fees for managerial expenses.<sup>61</sup> Hence, it can be seen that the earning of return, both by banks and depositors does not

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<sup>58</sup> M.N. Siddiqi, Issues in Islamic Banking: Selected Papers, The Islamic Foundation (1983).

<sup>59</sup> M. Haneef, Contemporary Islamic Thought: A Selected Comparative Analysis, Ikraq (1995).

<sup>60</sup> M. Lewis and L. Algand, Islamic Banking, Edward Elgar (2001).

<sup>61</sup> J.M. Taylor, Islamic Banking: the Feasibility of Establishing an Islamic Bank in the United States, (2003)

40 American Business Law Journal.

consider the productive use or efficiency of the money, which is deposited or lent.

Islamic banking, where religious mandates of certain prohibitions are prescribed, basically differs from this concept. For Islam, as discussed earlier, money is not a commodity in itself, but only a medium of transactions, will not and should not earn return in itself.<sup>62</sup> The philosophical thread runs through Islamic ideology stipulates that, nobody shall benefit from others sweat. Therefore, to get a permissible return or profit out of money, sharing of risk and entrepreneurship is necessitated.<sup>63</sup> So, Islamic Banks are required to observe these postulates viz., sharing of risk and equitable distribution of profit earned through legitimate investment. In this background, one's view of Islamic Banking will depict the activities of such institution to be that of an entrepreneur who is committed to social welfare. Banks under Islamic Financial System have to pool their deposits together and utilize the same for profitable use.<sup>64</sup> The profit earned thereby shall be shared among the depositors. It can be asserted that the role of an Islamic Bank is that of trustee prevailed in conventional jurisdictions. There is a duty cast on the banks to see that the amount lent by them is utilized for productive and permissive purposes and to ensure its materialisation. This is significant feature of Islamic banking compared to its counterparts in conventional system.

It is apparent on this pretext that Islamic Bank is playing a role of intermediary between the potential depositors and borrowers, providing equitable return and chance of profit making, respectively.<sup>65</sup> Since banks are 'armed' with pool of deposits and knowledge of its utilisation, hold an upper hand above the common man. Therefore, *Shariah* meticulously controls them by prohibiting material condemned practices like usury and

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<sup>62</sup> T.S. Twibill, Implimentation of the United Nations Convention on Contracts for the Sale of Goods (CISG) under *Shariah*: Will Article of (CISG) be Enforced when the Formation in Islamic Sate? (1997) 9 International Legal Perspective.

<sup>63</sup> A. Nazim, Points of Law: Middle Eastern Banking, Business Interspare Ltd., (1999).

<sup>64</sup> M.N. Siddiqi, 'Islamic Approaches to Money, Banking and Monetary Policy: A Review', in M. Ariff (ed.) Monetary and Fiscal Economics of Islam, International Centre for Research in Islamic Economics (1982).

<sup>65</sup> F. Al-Omar, M. Abdel-Haq, Islamic Banking: Theory, Practice, and Challenges, Oxford University Press (1996).

uncertainty<sup>66</sup>.

Profitability of bank lies in the two factors, viz, the capability of fund accumulation and taking of risks impregnated in lending. Former denotes the credibility of the bank as an institution, which attracts the probable depositors. Later, connotes the expertise of bank, how far they can ensure the return of lent money.<sup>67</sup> However, banks under Islamic System are not permitted to benefit out of taking such risks. Instead, Islam postulates the supplier of money for productive use must share the risk involved in its utilization.<sup>68</sup> The fairness principle advocated by *Shariah* mandates that, to obtain profit out of money the lender shall bear its intricacies evolved from its utilization, whereby he is also exposed to the risks shadowed therein. In its eventuality, if the supplier is not ready to share the risks, it should return without any increase.<sup>69</sup>

Therefore, an Islamic bank is expected to comply with these injunctions in order to do business. It is unlikely for an Islamic bank to fall in line with conventional bank, where such bank depends upon the credit worthiness of borrowers and not on the expected productivity of the projects that are financed. This is unfairness according to the Islamic religious thoughts, which is *haram*.<sup>70</sup> Islamic Bank which falls below the *Shariah* principle, which professes cooperative concern of men and care for others is illegal.<sup>71</sup> Any practice other than these are prohibited severely.

### *3.2 Concept of Riba*

Literature discussing the aspects of Islamic finance or banking cannot go without saying a word about *riba*. The central issue or concern of all financial activities carried in

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<sup>66</sup> Discussion on these possibilities are provided in the coming sections.

<sup>67</sup> H. Shirazi, *Islamic Banking*, Butterworths (1990).

<sup>68</sup> *Supra* n. 63.

<sup>69</sup> M. Iqbal and D. T. Llewellyn, *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*, Edward Elgar (2002).

<sup>70</sup> *Ibid*.

<sup>71</sup> B.A. Roberson, *Shaping the Current Islamic Reformation*, Franc Cass (2003).

Islamic system has to compromise, rather intravivus, the prohibition of *riba*.<sup>72</sup> It leads one to enquire the exact meaning and implication of *riba* as a barrier to the transactions involving money. The *Shariah* explained through *Quran* and *Hadith* explains *riba* as: “If you turn back, then you should collect your principal without inflicting or receiving injustice.”<sup>73</sup> It is obvious that the historical prohibition of *riba* is rooted to avoid injustice from the utilization of money given. In a sense, this connotes the prohibition of exploitation of poor debtor by rich and mighty creditor. The import of word “injustice” denotes two aspects viz, upon and return. Hence, a man who lends money should see that he should not get any increase or receive decrease from the money thus lent. Thereby injustice is equated to increase and decrease of money, which is lent.<sup>74</sup>

Another prominent *Hadith* speaks of the character or *riba* whereby it stipulates that every monetary transaction should be done “hand to hand and in equal quantity.”<sup>75</sup> Prohibition envisaged here is, the transactions of different quantities. *Shariah* mandates that equitable difference in the money transactions beings injustice and therefore *riba*. The difference occurred in such transactions would be an advantage for one and disadvantage for the other. It is contrary to the Islamic principle warranting undue advantage without sharing risks.<sup>76</sup> Secondly, the *Hadith* prevents deferment in the transactions. It stipulates “hand to hand” which clearly prohibits payments or return in a later stage. It is asserted that this *Hadith* takes into consideration, the loss of time value of money which losses in such deferred payments.

Conventional banking, based on interest-backed transactions, is entirely dependant on this aspect. The increase in money on return for the deferred repayment is the backbone

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<sup>72</sup> A. Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its contemporary Interpretation*, Brill (1996).

<sup>73</sup> M.S.A. Rahman, *The Meaning And Explanation Of The Glorious Qur'an*, MSA Publication Ltd. (2007).

<sup>74</sup> *Ibid.*

<sup>75</sup> G.S. Abod, Omar and A. Ghazali, *An Introduction to Islamic Finance*, Quill Publishers (1992).

<sup>76</sup> F.E. Vogel and S.L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return*, Kluwar Law International (1998).

of such banking. Whereas, this practice is severely condemned item under *Shariah* principles. There are basically three types of *riba* under Islamic Law. Firstly, the defer and increase on the principal lent. Here, the increase is charged as a time factor. It is, since the borrower enjoys the possession of money for duration for what he is obliged to return with increase, interest. In addition, a further increase on amount based on later deferment would attract the prohibitions. *Shariah* severely negatives this practice under *riba*. Secondly, prepay and reduce; where borrowers' transactions are financed over a time period. Here, the borrowers' purchases will be met by the backing of lender, where return is fixed with advancement of time and transactions; it is now permitted by some Islamic jurisdictions e.g. Islamic credit cards.<sup>77</sup>

Lending on the basis of collateral security is the third aspect of *riba*. Where assets are pledged to a third party upon whom the banks provide a lending. Here, the return is expected from the borrower who in turn receives it from such third parties. The problem faced in this regard is the credibility of the borrower, as any default will end up in selling the assets to such third party.<sup>78</sup> It will engrave the situation where the price of the asset yields less than anticipated rate. *Shariah* ruling in some parts accorded permission to these transactions while Malliks permit it only under strict conditions. However, Hanafis and Hanbalis have prohibited these practices.

### *3.3 Implications of Gharar*

Equally important to the prohibition of *riba*, the avoidance of *gharar* is also a peculiarity of Islamic Law. The literal meaning of *gharar* is, "that which has a pleasant appearance and hated essence."<sup>79</sup> There are items in the world on its appearance good but which hides in itself the menace. The concept mandates two aspects; to not to fascinate on its face value and to analyse thoroughly the implications of items on the basis of certain

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<sup>77</sup> A.V. Pock, Strategic Management in Islamic Finance, DUV (2007).

<sup>78</sup> M.A. Shaban, Islamic History: A New Interpretation, Cambridge University Press (1967).

<sup>79</sup> H. van Greuning and Z. Iqbal, Risk Analysis for Islamic Banks, World Bank Publications (2007).

assumption without which proper evaluation would lead to a probable risk.<sup>80</sup> Since such risks are often not pre-exposed, would lead to loss of the parties, which is avoidable under *Shariah*.

The Possibility of such risk being not contemplated ante-transactions; it will lead to simple uncertainty. The financial or trade activities basing on such assumptions would render a situation where, gain or loss cannot be determined.<sup>81</sup> This would further lead us to state that the undue advantage of one over other on the basis of knowledge is highly probable. Consumers being slighter position to know of the business affairs and financial institutions are experts in the business; they will always have an upper hand, which is oppressive to customers. This is in juxtaposition to the concept of fairness principle and welfare concept underlying the *Shariah*. It is asserted that the rationale of prohibition of *gharar* is to avoid the risk and uncertainty that may cause the trade including banking, trivial.

Moreover, Islam prohibits activities involving gambling or speculation.<sup>82</sup> They consider it as *haram*, prohibited by the divine revelation. It is against the objectives of Islam, which envisages to obtain earning through labour and legitimate trade.<sup>83</sup> Where *Shariah* postulates to seek return of goods or commodities in equal quantities, mere exercise of play on chance is prevented. The bearing of risk as a basis of earning profit does not contemplate risk on chance. The positive risk, which is permitted under *Shariah*, stipulates to avoid the loss, which is out of the will of the God, and not the expected loss, as is in the speculation. The probability of risk in speculation and gambling is much higher than the risk permitted under *Shariah*. As a consequence, the probable loss that may accrue in such activity will be higher and Islam wants to curb it any cost.

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<sup>80</sup> N.A. Saleh and A. Ajaj, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar, and Islamic Banking*, Graham and Trotman (1992).

<sup>81</sup> *Supra* n. 78.

<sup>82</sup> F. Rosenthal, *Gambling in Islam*, Brill (1975).

<sup>83</sup> H.M. Ramadan, *Understanding Islamic Law: From Classical to Contemporary*, Rowman Altamira (2006).



The jurisprudential aspirations underlying the prohibition of *gharar* is the protection of parties entering into financial transaction and trades.<sup>84</sup> It mandates that the contracts should be specific as to the item of sale and the consideration. The reach of this prohibition to the nomenclature of contracts is very significant. It is rooted from the idea that the parties to a transaction should be benefited for what is mutually agreed upon.<sup>85</sup> Therefore, unintended and non-sanctioned benefits that may accrue to such transactions are prevented under the concept of *gharar*. It leads to further assert that the object of the transactions should be clear. Further, economic based evaluation would consider the actual or economic impact of the transactions and not on the spirit of the languages used. Therefore, once any transaction is hit by this prohibition, it is illegal.<sup>86</sup>

One instance of prohibition of *gharar* is the trade where the object of such trade is not in existence. It mandates that the trade should not only be specific, but also in existence at the time of trade. The peculiarity of the contracts permitted by Islam is in its stipulation for conclusion. Once any trade is to be concluded, its performance should not be kept as a promise for future date.<sup>87</sup> In its entirety, *Shariah* prevents suspended conditional sale also.<sup>88</sup> If any contract promises to do on the happening of some other thing which is not expected as the object of such contracts, would render it *gharar*.

### *3.4 Tools under Islamic Banking*

The encouragement of *Shariah* based on welfare and fairness principles would lead to seek to devise financial products that will be permitted under Islamic law. Such products should pass the test of prohibitions set out under *Shariah*.<sup>89</sup> It should also satisfy a Muslim to earn his lively hood through his assets and money. He should feel that the

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<sup>84</sup> Supra n. 78.

<sup>85</sup> N.G. Bunni, The FIDIC Forms of Contract, Blackwell Publishing (2005).

<sup>86</sup> J.S. Petersen, Defining Islam for the Egyptian State: Muftis and Fatwas of the Dār Al-Iftā, Brill (1996).

<sup>87</sup> M. Iqbal and T. Khan, Financial Engineering and Islamic Contracts, Palgrave Macmillan (2005).

<sup>88</sup> Ibid.

<sup>89</sup> R.C. Effros, Current Legal Issues Affecting Central Banks, International Monetary Fund, 1992 (Vol.2).

products that are put for his use are religiously permitted. Further, such products shall be an alternative to its counter parts in conventional banking. Any demerits in its divinity and profiteering aspect render non-acceptance of Muslim and he will be forced to preach its counter parts, which is certainly against his beliefs.<sup>90</sup> In this pretext, we need to consider the tools prevailing under Islamic banking.

### ***3.4.1 Murabaha: Cost plus Sales***

When a prospective borrower has no resources enough to purchase assets, he approaches an institution, which will buy the same. There after, they will resell it to the borrower with an increase in the price for which they actually purchased.<sup>91</sup> Here, a financial institution buys some assets and sells to the borrower for an increased profit margin. The import of these transactions is that the borrower is required to pay the debt in lump sum, which is beneficial to him. As it is for the inability of the borrower to accumulate money purchase the assets he approaches them, he can very well pay off the debt from his income in due course of time.<sup>92</sup>

The two stipulations, which regulate these transactions, are; the financial institutions must own the property when it is sold to the borrower and the profit margin through increase in the price should be stipulated. Where owning of the assets before selling denotes the sharing of the risk over the property by the institutions and stipulated profit prohibits undue advantage by such institution over borrower through bargaining power. In addition, any subsequent increase in the profit margin is warranted as against the rule of *riba*.

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<sup>90</sup> M. Taher, Encyclopaedic Survey of Islamic Culture, Anmol Publications Pvt. Ltd. (1998).

<sup>91</sup> A. Al-Suwaidi, Finance of International Trade in the Gulf, Brill (1994).

<sup>92</sup> S. Jaffer, Islamic Retail banking and Finance: Global Challenges and Opportunities, Euromoney Books (2005).

### ***3.4.2 Ijarah or Leasing***

When a person intends to purchase an asset for his use, where he could not prepare financial avenue, he can approach a financial institution for purchasing the same and sell to him for duration of time by paying rent till then.<sup>93</sup> *Shariah* permits a bank to purchase assets for delivering the same to borrowers on lease, which will be terminated when he purchases it or the price is paid through a mark up over the rent to be paid in lump sum.<sup>94</sup> Here the lump sum payment of lease will include a portion of actual price and profit margin along with the compensation for the use of such assets. Legally, till the entire agreed amount is paid, the transaction is only usufruct of the assets.<sup>95</sup>

The legal implication of such transactions ensures two things. Firstly, the institution is under a duty to sell the assets on successful payment of rent as mutually agreed without any reservation.<sup>96</sup> Secondly, the borrower is under no obligation to purchase the same at the conclusion of repayment. Options are left open to him,<sup>97</sup> either to purchase it or not. Here also, the stipulation of owning the assets at the duration of lease bears a risk over the property, which is the rationale of permitting such transactions.

### ***3.4.3 Mudaraba: Profit Sharing***

The transactions under this concept are ordained to earn profit on the sharing of risks.<sup>98</sup> Where one party would provide complete finance for the projects and the other party will use its expertise and labour, in order to make profit. Usually the provider of finance is

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<sup>93</sup> R. Gleave and E. Kermeli, *Islamic Law: Theory and Practice*, I.B. Tauris (2001).

<sup>94</sup> *Supra* n. 86.

<sup>95</sup> H. Moinuddin, *The Charter of the Islamic Conference and Legal Framework of Economic Co-operation among its Member States*, Oxford University Press (1987).

<sup>96</sup> K.N. Wiedl, *Islamic Banking System: Not Conductive to the Start-up of Young, Innovative Business Firms*, Grin Verlag (2007).

<sup>97</sup> *Ibid.*

<sup>98</sup> D.J. Jonsson, *Islamic Economics and the Final Jihad*, Xulon Press (2006).

such institutions that are ruled by the principles of *Shariah*.<sup>99</sup> There will be agreement to share the profit on certain ratio, which is prefixed. However, certainty of amount of profit is not provided, still uncertain, which will be intra virus of the prohibitions.<sup>100</sup> Unique feature of these contracts is the loss that may occur shall be born by the lender of the money, even if they do not have control over the management of the funds thus provided.<sup>101</sup>

### ***3.4.4 Musharaka: Financing on Partnership***

When two parties can accumulate money to start a venture and earn their due profit, it is permitted under *Musharaka*. The profit and loss shall be shared into a proportion, which is prefixed. The underlying principle in these transactions is equitable distribution of resources. Here, unlike the above, any party can manage the affairs as agreed upon mutually.

It is discussed herein that the Islamic banking has many distinctive features than the conventional system. The main postulate is the perception of the banking is for the benefit of the customers and not the commercial gains of the banking institutions. Since monetary transactions are for the benefit sharing, the unearned return is invalid under *Shariah*. It also mandates that the money should not be kept idle for doubling but to be invested for using labour and trade for which will yield profits. The significance of risk based sharing of profit is also one among such features. The ban on interest and uncertain contracts is to check the welfare principles underlying the *Shariah*. Islam on this context presents their own tools that are practiced by Muslims. It will provide guidance to FSA in formulating reforms to regulatory frame works.

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<sup>99</sup> J.L. Ford, A. Khalil and C. Rickwood, Identifying Agency Problems in Mudarabah Contracts: An Empirical Study, University of Birmingham (1998).

<sup>100</sup> M.A. Khan, Issues in Islamic Economics, Islamic Publications (1983).

<sup>101</sup> Ibid.

## ***Chapter 4***

- **UK Banking Sector: Evolution and Trends**

The studies about financial markets and activities reveal that London stands in the top in international sphere.<sup>102</sup> It is asserted that the stability and consistent growth of UK Financial market paved many financial enterprises to prosper from the UK Market. Banking being the main sector in the financial market, the UK banking industry has shown its capability to support the development of financial market with a steady support. It is analysed that the volume of banking in UK with a growth rate of 3.1% which is above the international average.<sup>103</sup>

There are a lot of factors, both regulatory and market based, which secured the position of UK banking in its present status. Their merit lies in the fact that they have tried and achieved to equip with the current modulations at all times.<sup>104</sup> Significant in this aspect, when the international finance market has witnessed a radical change due to the advancement of technologies and consumer needs,<sup>105</sup> UK market has readily accepted and devised to imbibe such trends. It can be unequivocally asserted that one of the important facets of their innovative aspirations is the acceptance and recognition of Islamic banking.<sup>106</sup> It is examined in this Chapter, the evolution and trends of UK banking industry with specific emphasis on the modes of regulation and intricacies. It is

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<sup>102</sup> K. Hale, Challenges to the UK Banking Sector, (speech on 9.11.2004) available at <<http://www.fsa.gov.uk>>.

<sup>103</sup> D. Jordan, Bank of England Governor, Mervyn King, admits UK growth will slow and inflation will trigger new Alistair Darling letter, available at <<http://business.timesonline.co.uk/tol/business/economics/article3362931.ece>>.

<sup>104</sup> J. Tiner, The Future of Financial Regulation in Europe (speech on 25.11.2005) available at <<http://www.fsa.gov.uk>>.

<sup>105</sup> D. Sigh, Banking Regulation of UK and US Financial markets, Ashgate Publishing Ltd. (2007).

<sup>106</sup> H. Abdel-Ati, Economic life of Islam, available at <<http://www.islam101.com/economy/economicLife.htm>>.

also analysed, how far a foreign concept like Islamic banking can be accommodated in UK. Further, it is examined whether the market situations and regulatory framework will help Islamic banking to flourish in UK market.

#### *4.1 Evolution*

Banking has been traced back to 2000 BC, where primitive methods and practices were prevalent.<sup>107</sup> It was basically reduced to exchange of goods and services rather than still modern concept of money transfer. Further, bank as an institution was also not clearly visible except for money lending.<sup>108</sup> It is generally considered that banking as a business or profession had started from 11<sup>th</sup> and 12<sup>th</sup> Century.<sup>109</sup> The medium of transactions, money, which was prevalent at that time, was copper and tin coins. It is the Romans who brought silver coins in the UK for the first time. The financial transactions in that era were regulated and considered under the Roman law.<sup>110</sup>

It is in the medieval period that the banking in somewhat present-day form started in UK. It was primarily for feeding the needs of traders and merchants, whereas normal villagers were out of scene.<sup>111</sup> Like the prohibition of interest in Islam, Christian Church also, at that period, prohibited the levy of interest. However, Jews, who were banned from trading, but was not under the prohibition of Church regarding interest, had entered into the business of money lending.<sup>112</sup> History reveals that they being a business oriented community, were money keepers of the Crown. They collected revenue from them and lend it to needy people. When the Royal protection was taken away from them, they were forced to leave UK because of their high rate of interest.<sup>113</sup>

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<sup>107</sup> J. Daley, *Your Money: Its Lefe*, Longmans (1927).

<sup>108</sup> R. Fitzmaurice, *Brish Banks and Banking*, D.B. Barton Ltd (1975).

<sup>109</sup> *A History of English Clearing Banks*, British Banking History Society (2003).

<sup>110</sup> *Supra* n. 106.

<sup>111</sup> *Supra* n. 108.

<sup>112</sup> *Banking in the United Kingdome*, Wikipedia available at <<http://www.wikipedia.com>>.

<sup>113</sup> *Ibid*.

To fill up the lacuna thus felt, Italian immigrants were called. Since they dealt with gold as the basis of their transactions, they were known as goldsmiths.<sup>114</sup> It was their idea that to have financial transactions based on the gold reserve as base of stability. It was they who had introduced present day bank notes, keeping gold in custody, for the transactions.<sup>115</sup> Their notes were equal to money and transactions were held upon such notes. The problems faced there were, even now also, if loans were not repaid and holders of such notes ask for money beyond the expectations of the Banker.<sup>116</sup> It was felt to create a Central Bank or a 'Bank of Last Resort' as a remedy. It can be asserted from these that the UK financial market, particularly banking industry was at infant stage on that period.

#### *4.2 Emergence of Banking Industry*

The problem of lender of last resort was overcome by the creation of Bank of England,<sup>117</sup> which was owned in private sector and later took possession by the Government of UK and is a milestone in the development of banking and key pillar in the present day administration of monetary policy. Leaving that apart, the later developments of the society, which vovod for more financial resources and the requirement for production and trade posed at the advent of Industrial revolution, banking industry had been processed into its growth.<sup>118</sup> The emergence of joint stock companies and stock exchange based on the share market is the result of industrial revolution. It was required, accumulation of capital for productions on large scale, which was financed by the banks. In order to facilitate such requirements, the bank had adopted new techniques and methodology. The materialisation of the industrial revolution was certainly with the

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<sup>114</sup> The Role banks: A History of Banking and Clearing System, Bank Education Services (1971).

<sup>115</sup> Ibid.

<sup>116</sup> G. Whittlessey and J. Wilson, Essays in Money and Banking in Honour of R.S. sayer, Clarendon Press (1968).

<sup>117</sup> Origin and development of Bank of England is discussed in the forthcoming section.

<sup>118</sup> K. Robbins, A Bibliography of British History, 1914-1989, Oxford University Press (1996).

assistance and backing of banking sector.<sup>119</sup> The banks played an intermediary role where people with capital need only income and not risks, people with less capital but wanted to invest and people with capital but do not want investment on a long-term whereby they earned their respective returns.

On the other side, with advancement of financial instruments like bank notes, debentures, etc. even the use of currency, the bank was capable of feeding the needs of the people. In order to venture bigger business, joint stock banks were created.<sup>120</sup> These instruments helped people to have easy trading and business achievements. The regulators helped it with abolishing tax levied on such items and with regulations closely watching the affairs of the banks.<sup>121</sup> With advancements of transportation, particularly railway, banks were able to decentralise its operations through branches. This move was most favored because it facilitated the people in the rural areas too. Standard of accounting and interest rates on deposits and loans were another feature, which was developed under this regime.<sup>122</sup> The Government with its machinery was always keeping track of the industry all the times.

### *4.3 Bank of England*

In the year 1694, in order to fulfill the financial requirements of the Government, Bank of England was created. By giving loan of £1.2 million to the King for war, it sought privileges to issue notes<sup>123</sup> and the only joint stock company at the time. By 19<sup>th</sup> Century, the privilege to issue notes were only accorded to Bank of England and the rest of the banks who had such licenses had to surrender on its merger.<sup>124</sup> The Bank of England also

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<sup>119</sup> Ibid.

<sup>120</sup> Supra n. 111.

<sup>121</sup> P. Mizen and C.A.E. Goodhart, *Monetary History, Exchange Rates and Financial Markets: Essays In Honour of Charles Godhart*, Edward Elgar Publishing (2004).

<sup>122</sup> F. Capie and A. Webber, *A Monetary History of the United Kingdom, 1870-1982: Data Sources and Methods*, Routledge (2005).

<sup>123</sup> Supra n. 111.

<sup>124</sup> Until 1920, all such banks surrendered such privilege except Bank of Scotland, which is still continuing.



followed issue of notes keeping gold reserves in line with Italian money traders, but with modern conceptualisation.

Apart from these, Bank of England being the Central Bank of UK had two specific functions in assisting the Government in overseeing banking sector viz, to implement the monetary policy and to act as 'Lender of Last Resort' (LOLR) for assuring stability of the market.<sup>125</sup> In this regard, it is asserted that the Bank of England had to regulate interest on the transactions with a view to balance conflicting interests of consumers and bankers. Secondly, on a visibility of shock to the financial market, support the industry by providing loans as last resort. It is qualified to “act decisively and quickly without hesitation”<sup>126</sup> in order to avoid panics. It is important without which banking industry will be let down and the repercussions may affect the whole market and consequently, economy as such. In giving such lending, the Bank of England should ensure its steady repayment on the basis of collateral security.

In this regard, the Bank of England Act, 1998 and Memorandum of Understanding holds greater significance. It is a milestone in the banking sector of UK, where several radical changes were brought.<sup>127</sup> The era witnessed the formation of unification of regulatory authorities under single head, Financial Services Authority (FSA). The Bank of England retained its authority in fixing the interest rates in financial operations, since they are the direct players in the market. It would decide the problem faced in the payment and settlement in the sector. Primary source of FSA in deciding issues will be Bank of England. Moreover, only Bank of England asserts the question of liquidity.<sup>128</sup> Since they handle the source of money, it was prudent enough to leave it to their arena.

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<sup>125</sup> T.P. Schioppa, *Regulating Finance: Balancing Freedom and Risk*, Oxford University Press (2004).

<sup>126</sup> *Supra* n. 104.

<sup>127</sup> The reasons and the rationale of such changes are discussed in the next section.

<sup>128</sup> W. bains and M. Kosuya, *Coping with Crisis: International Financial Institutions in the Interwar Period*, Oxford University Press (2003).

#### *4.4 Modern Banking in UK*

With the advancement of time along with affairs, the system of banking also changed. When commercial and private life of men changed, the banks were the biggest supporters, by devising their products.<sup>129</sup> They had willingly supported new ventures and been a safe repository of their growing income. They fiducially kept the wealth generated and distributed its benefits both to the depositors and borrowers.

Since 1980s, banking industry underwent several structural changes. Attitude of competition within and beyond UK, which is common to entire world, had envisaged devising the system in its new react.<sup>130</sup> Significantly, the technological development particularly with information technology made the system customer friendly and paved for positive competition. The move for deregulation is another impact of the era, where, the regulators have moved back, leaving the industry to do business according to the market trends. In order to facilitate the requirements, in long run and large scale, diversifications and mergers were taken place.<sup>131</sup> The move for opening banking sector to insurance and building societies was yet another development that took place in the modern times.

#### *4.5 Financial Services and Management Act, 2000 (FSMA)*

It is the best example of UK's attitude towards the modernisation of financial market, that they have passed FSMA.<sup>132</sup> It is another milestone in the history of financial sector,

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<sup>129</sup> J. Howells and J. Hine, *Innovative Banking: Competition and the Management of Network Technology*, Routledge (1993).

<sup>130</sup> D. Chorofas and H. Steinman, *Expert Systems in Banking: A Guide for Senior Managers*, Macmillian (1991).

<sup>131</sup> D. Landau, et al, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, IMF (1997).

<sup>132</sup> *Supra* n. 104.

wherein they adopted radical changes in the views and outlooks of regulating the financial market in a new mode. Significance of FSMA is the culmination and synchronisation of various regulatory authorities into one single head, FSA. Their area of operations was extended to financial services and markets, societies that are engaged in financial business and for connected purposes<sup>133</sup>. Accordingly, entire market viz, banking, insurance, mortgage, equity, share market, etc; have come under the purview of FSA. All enterprises engaged in different financial activity underwent to the single jurisdiction of one regulator.<sup>134</sup>

The reasons attributed to have such changes in the outlook with single regulator is that the complexity of financial affairs prevalent required expert body to decide upon sensitive issues.<sup>135</sup> In addition, the trend of non-banking institutions to enter into banking sector and banks to non-banking sector rendered a mix up of affairs, which will be an obstacle for various regulators to overview. They should have expertise to take up with responsibility. Further, incorporating FSA as a private company ensured the independence from both Government and the market. They will be having constant touch with the market players and intervention of the Government is limited. It can be seen that, by incorporating such a body, the UK Government had recognised the importance of self-sustenance of market regulation. Further, the withdrawal of Government as a teacher or instructor, how to go about the affairs. It is commented that the role of FSA is to carry out responsibilities apolitically and to consider the interest of general public.<sup>136</sup> Apolitical denotes the interest of customers, entrepreneur and machinery of the Government, which ensures absolute independence and integrity.

On this background, FSA was expected to regulate on the business of depositing, investment and insurance. They were empowered to make rules for regulated and prohibited activities, authorisation and exemption, continuous supervision, enforcement

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<sup>133</sup> The Financial Services and Management Act, 2000, Preamble.

<sup>134</sup> B. Casu, et al, Introduction to Banking, Prince Hall Financial Times (2006).

<sup>135</sup> Ibid.

<sup>136</sup> D. Wame and N. Elliott, Banking Litigation, Sweet and Maxwell (2005).

powers and establishment of appeal powers.<sup>137</sup> Further, FSMA required FSA to scrutinise discretion in confined, checked and structured way to discourage abuse of power.<sup>138</sup> Further, they were accountable to the Parliament and Judiciary. FSMA also channelised the role of FSA to focus on market confidence, public awareness, protection of the consumers and reduction of financial crimes.<sup>139</sup> Wherein first two denotes the positive enthusiasm for FSA, later denotes its strict implementation. It is commented, the foremost area of FSA's concern is market confidence. Unless the market is in order, the entire affairs will not run smoothly.

#### *4.6 Role of Islamic Banking*

Since 1980s and 1990s, Bank of England permitted some banks which speak of *Shariah* compliance to deal with the Islamic financial products. They were actually, not fully comprehensive in specific terms. They were ordained to attract the Muslim believers with nomenclatures. They had the backing of conventional banking products and system and their Islamic products were only for the purpose of earning Muslim participation. In its essence, they were not comprehensive *Shariah* compliant. However, by approving Islamic Bank of Britain, FSA has signaled for fully *Shariah* compliant bank in UK. It was the role played by Lord Edward George, who applauded for implementation of Islamic banking in UK is remarkable.

It has been analysed, how banking in the present form had emerged in the UK. The changing perspectives on the concept of banking in different periods were remarkable. It can be asserted that the reason behind the development of banking in UK is its acceptance of different approaches and attitude for experimentation. The history of banking in UK reveals that they had to have acquaintance with different pattern of

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<sup>137</sup> FSMA, Section 5.

<sup>138</sup> R. Grote and T. Maruhn, *The Regulation of International Financial Markets: Perspectives for Reform*, Cambridge University Press (2006).

<sup>139</sup> FSMA, Section 2.

financial activities, which solidified their system. The role of Bank of England as a leader and back born of the UK economy is an important aspect of UK banking sector. It can also be seen that the UK banking market being vibrant and dynamic, had found its pace with the advancement of modern technology. The implementation of deregulation, free market situation, competition and mergers is a shift in that aspect. The enactment of FSMA and emergence of FSA had led the UK to be prominent globally, in this regard. It has depicted what are the present trends and views of UK banking sector, which will help to ascertain the possibility of reforming Islamic finance in UK.

## ***Chapter-5***

- **Islamic Banking vis-a-vis UK Market: Views and Approaches of Regulators**

The innovative attitude of UK financial market to imbibe any positive practices have led the emergence of Islamic banking in UK. The growing needs of comparative size of Muslim population is one of the reasons for such movement.<sup>140</sup> They have also recognised the potential of Islamic banking institutions backed by the industries of Middle East, which can develop the economy of UK itself. Further, it was also viewed as an alternative to conventional banking products, which is otherwise secured, if any stress is occurred in the commercial banking industry.<sup>141</sup> In addition, the advantage of London, unlike other capital centers, due to time zone, has also paved the development of Islamic banking in UK market. The merits of UK market is the availability of skilled laborer, expertise in financial affairs, openness in innovation, fair competition prevailed and the dynamism in the market which have helped such move possible.<sup>142</sup>

In this context, it is analysed, how far UK regulators recognised Islamic banking in UK? What are the moves for accommodation and development of Islamic Banking in UK? Particularly, whether the reformative quest reflected in the Paper is comprehensive? Whether FSA has addressed material issues for such move? What is the response to their move? Altogether, it is examined, whether FSA is in right track and to point out the missing links in such move.

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<sup>140</sup>M. Kahf, 'Islamic Banks: The Rise of a New Power Alliance of Wealth and Shariah Scholarship,' in C.M. Henry and R. Wilson (eds.), *The Politics of Islamic Finance*, Edinburg University Press (2004).

<sup>141</sup>M.T. Usmani, 'Sukuk and their Contemporary Applications,' (2003)3 IBF Review.

<sup>142</sup>C. Gondat, 'The Economics of Retail Banking: An Empirical Analysis of UK Market for Personal Current Accounts,' (2004) Spring, Bank of England Quarterly Review.

## 5.1 Concern of FSA

Ever since the inception of FSA under FSMA as a private company, there had been discussions and concerns as to the strategy of regulation. As the incorporation of such a body is an obvious shift in the perception of regulation, they had to find out what should be the role of FSA.<sup>143</sup> When FSMA had given only broad guidelines with full discretion upon the shoulders of FSA which shows a withdrawal of Government's intervention, it was a Herculean task for the FSA to find out methodology and underlying rationale.<sup>144</sup>

In their formulation, FSA have indeed adopted a method, derogating the strait jacket legal approach which preaches detailed rule based regulation. Instead, they vowed for high-level principle based administration.<sup>145</sup> It manifested to observe the result of conduct rather than being a tutor or a guide to insist for compliance of certain formal procedure. It envisages that they are concerned about the impact of the conduct of firms rather than their omissions to follow prefixed procedures.<sup>146</sup> Further, FSA intends to set out exceptions, 'the don'ts', which the firms to comply with and to leave them to their management.<sup>147</sup>

The focus of FSA is to balance the duties and restrictions on the players with the fair competition. In this regard, FSA's objective is to see harmony between the freedom of

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<sup>143</sup> S. Jaffer and J. Sohail, *Islamic Retail Banking and Finance: Global Challenges and Opportunities*, Euromoney Books (2005).

<sup>144</sup> D.W. Sapte, *Public Private Partnerships: BOT Techniques and Project Finance*, Euromoney Books (2006).

<sup>145</sup> 'Islamic Banking in the UK,' Briefing Note BN016/06, 9 March 2006 available at, <<http://www.fsa.gov.uk>>.

<sup>146</sup> 'Islamic Finance and the UK Financial Services Authority, Speech of Howard Davies, 2 March 2006 available at <<http://www.fsa.gov.uk>>.

<sup>147</sup> *The Future of Distribution in Financial Services, Speech by Stephen Bland, 4 December 2007 available at <<http://www.fsa.gov.uk>>.*

competition and the regulatory restrictions.<sup>148</sup> In order to procure fair competition, compliance of strict regulation is a barrier. It is, therefore concentrated how far enterprises can be left out of rules, allowing them to lead competition and produce good results.<sup>149</sup> Significance of this approach is the increasing level of innovations in the market.<sup>150</sup> This will ultimately result in a dynamic and liberal market in UK.

It can be seen that this shifted move is to accommodate the technical and commercial advancements. Further, it will help them to retain UK's competitiveness globally.<sup>151</sup> Therefore, for the first time, the regulator would place responsibility of fair play on the senior management of the firms. Their withdrawal from interfering in the affairs of firms would cast a duty upon the management to see the direction and movement of the firm.<sup>152</sup> It is based on the rationale that, if the players are doing fairly, market will respond fairly. If any foul play by any firm will not only impact upon them but with in the whole market, which will be crucial for all. Therefore, duty is cast upon the senior management to devise and observe the activities of each firm.<sup>153</sup>

In order to facilitate the role caste upon the FSA, they have formulated three aims. Promotion of markets in fairness and orderly manner, both in wholesale and retail business is one among them.<sup>154</sup> They set out principles of fairness and good conducts which the entrepreneurs will follow for an orderly market. The other one being,

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<sup>148</sup>FSA's Continuing Obligations Regime, Speech by Mike Knight, 21 November 2007 available at <<http://www.fsa.gov.uk>>.

<sup>149</sup> *Current regulatory Issues and Challenges for the Funds Industry*, Speech by Dan Waters, 14 November 2007 available at <<http://www.fsa.gov.uk>>

<sup>150</sup> The UK approach to regulation, Speech by Hector Sants, 7 November 2007 available at <<http://www.fsa.gov.uk>>.

<sup>151</sup> *Regulatory Challenges in a Principles-Based Environment*, Speech by Clive Briault, 8 November 2007 available at <<http://www.fsa.gov.uk>>

<sup>152</sup>Supra n. 144.

<sup>153</sup>*The Implications of Globalised Financial Markets of Regulation*, Speech by Callum McCarthy, 20 October 2007 available at <<http://www.fsa.gov.uk>>.

<sup>154</sup>*Implementing principles based regulation*, Speech by Dan Waters, 7 December 2006 available at <<http://www.fsa.gov.uk>>.



protection of consumers, particularly retail, to get a fair deal.<sup>155</sup> In this context, they have adopted an informed choice system, where the consumers can benefit from the business. The last one connotes the increasing efficiency of FSA itself, to achieve these objectives.<sup>156</sup>

The formulation of FSA to achieve their objectives has set out four key areas of concern. Here, they set out the outlook of FSA, as to how they will regulate the market functions. Their analysis will be based on the concept of 'risk based.'<sup>157</sup> The paradigm shift denotes here is, they are concerned about the impacts of conducts of the firms. They will analyse the result of the conducts, whether it has any impact on the effectiveness or whether it result in any negative connotations. It is strictly market-based evaluation. If any thing goes wrong they will look into the issue and try for its rectification as both regulator and administrator. It is asserted that the intervention of FSA in any given situation will be on the basis of evidence of any wrong, which marks the withdrawal of State intervention as practised prior to FSMA.

Secondly, they have adopted the concept of evidence-based regulator.<sup>158</sup> They intend to come with regulation only on the happening of any mischief, which will have bearing on the entire market. Since, they left the market to resolve the problems occurred therein, they will regulate only if there is evidence that the market has failed to bring solutions.<sup>159</sup> The third aim speaks about the principle-based approach, where standard of conduct expected, is put for the guidance of the firms. The last one being the scope of regulation on the basis of outcome.

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<sup>155</sup>*Financial stability analysis in the UK, Speech by Callum McCarthy, 8 November 2006 available at <<http://www.fsa.gov.uk>>.*

<sup>156</sup>*Ibid.*

<sup>157</sup>*How do we achieve regulatory convergence in practice?, Speech by Callum McCarthy, 8 December 2004 available at <<http://www.fsa.gov.uk>>.*

<sup>158</sup> FSA's regulatory approach in Europe and globally, Speech by Verena Ross, 13 September 2007 available at <<http://www.fsa.gov.uk>>.

<sup>159</sup>*Risk-based compliance for financial services, Speech by Kari Hale, 25 November 2004 available at <<http://www.fsa.gov.uk>>.*

Further, the principles on the basis of FSA's acts are also set out.<sup>160</sup> Foremost among them is the equal treatment. FSA will apply regulation universally among the firms. They don't distinguish between UK and non-UK firms. They will ensure that no special consideration is given to UK firms and special requirement from non-UK firms.<sup>161</sup> Their adoption of this principle had lead to secure the position of UK market globally significant. In addition, they have devised for stress test, where firms have to ensure that their affairs are in better off position. The rational in this move is, the better person to assess the market situation of the firms is the firm themselves, rather than the regulator. Only if they fail to find out solutions, FSA will enter into the scene.

## *5.2 Initiatives for Reforms*

Though the operations of Islamic banking started in 1980s and 1990s, it was in small scale, mostly related to housing finance. Its volume was comparatively lesser which did not satisfy the requirements of the Muslims in UK. Moreover, high standard products of investment tools that were introduced did not cater the needs of the retail customers. Due to the prevalent regulatory requirements, its cost was uncompetitive which lacked the attention of the people. Further, the products, which were basically *Shariah* compliant, did not adhere to regulatory framework of UK. As such, the consumers did not get adequate protection. This paved lesser amount of momentum for Islamic banking in UK till early 2000s.

With the advancement of commercial activities due to the change of circumstances and market situations, Islamic banking started its growth thereafter.<sup>162</sup> Emergence of various

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<sup>160</sup> The FSA's retail agenda: working with the industry, Speech by Hector Sants, 21 November 2007 available at <<http://www.fsa.gov.uk>>.

<sup>161</sup> *FSA's Continuing Obligations Regime*, Speech by Mike Knight, 21 November 2007 available at <<http://www.fsa.gov.uk>>.

<sup>162</sup> Draft Regulatory Reform (Financial Services and Markets Act 2000) Order 2007, Great Britain Parliament House of Commons Regulatory Reform Committee, Parliament Great Britain Regulatory

products and intervention of enterprises in the later 2000s have opened up door for the development of Islamic banking in UK. Improvement in the quality of the products and clarity in the transactions have added in this aspect. The initiatives of both Islamic and non-Islamic institutions in this regard are remarkable constituent in this improvement.

The regulators of UK have in 1995, acknowledged the importance of Islamic banking on an international platform.<sup>163</sup> As a part of their traditional innovation, they also vowed for its growth, keeping London as its center, which is known for its competitive attitudes. In regard with the problems raised by Islamic banking compared to its conventional counter part, they were apprehensive that it can be traced later and solutions can be achieved through market analysis. There were initiatives from the UK Government to examine and solve the problems faced by the Islamic banking in UK.<sup>164</sup> One such significant move was the abolition of stamp duty for the purchases of property by the borrower from the bank as part of mortgage transaction, in 2003.<sup>165</sup> Regulators had their intension in bringing favourable conditions for the Islamic banks to develop in UK.

### *5.3. Background of the Paper*

In furtherance to the initiatives of the regulators, they have carried out a study on the reforms of Islamic banking in UK by way of the Paper.<sup>166</sup> The Paper carves out the formulation of reformatory regulation in the affairs of Islamic banking. Their initiative is to devise a regulatory framework for Islamic banking, which will follow the principles of

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Reform Committee House of Commons, Great Britain: Parliament: House of Commons: Regulatory Reform Committee, Great Britain, Regulatory Reform Committee, House of Commons, The statutory Office (2007).

<sup>163</sup> Speech of Lord Edward George available at <<http://www.bankofengland.co.uk/publications/speeches/2003/speech193.pdf>>.

<sup>164</sup> High Level Committee 2001, Report.

<sup>165</sup> The Finance Act, 2003.

<sup>166</sup> *Supra* n.5.

*Shariah* and requirements of regulatory framework of UK.<sup>167</sup> They have discussed in the Paper, regarding the growth and development of Islamic banking together with regulative accommodation, which can be afforded to Islamic banking. The impact that the Paper gives is to curb the risks and challenges that are faced by the Islamic banking in UK. Their aim by preparing the Paper is to invite the views and opinions of the public to bring out the possible solutions to the problems they projected.<sup>168</sup>

It can be seen that they have intelligently conceived the Paper as the views of the scholars associated in preparing the Paper.<sup>169</sup> Though FSA points out that this is a premier or curtain raiser to the broader perspectives, on a reading, it reveals that they have done an exhaustive study. Further, a reading between lines reveals that they intend to make an Islamic regime, which is internationally acceptable. It is also asserted that they are committed to unify different views of schools, which are mutually disagreeable. Even though they preach for fully *Shariah* compliant products, they contemplate that its possibility is less. Therefore, they are advocating for products, which has acceptance from the Muslim community, which may not be strictly *Shariah* compliant.

#### *5.4. Concern of the Paper*

As mentioned earlier, the Paper tries to achieve *Shariah* components in the financial products, which are acceptable to the Muslims. As such, their area of concern is, how far products can be launched which is complimentary to the *Shariah* principles. One of the problems identified by the Paper is the *Shariah* arbitrage.<sup>170</sup> It is the circumstances prevailed in the Muslim world, where, due to the existence of different schools, each may view one product differently. This will be a barrier to the universal acceptance of such products by Muslim community. Further, FSA is accepting that, they are not in a position

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<sup>167</sup>Challenges for Islamic Finance, Keynote address by His Excellency Rasheed Mohammed Al Maraj, 8 July 2008 available at <<http://www.bis.org/review/r080717c.pdf>>.

<sup>168</sup> Ibid.

<sup>169</sup> Ibid.

<sup>170</sup> Ibid.

to ascertain who should be treated as official.<sup>171</sup> Equally important, to scrutinise the life cycle of the product, whether it follows the mandates from the inception till the end. It is asserted that as and when any product falls from the standard of *Shariah* compliance, the firm will be at loss due to the disfavour of Muslims. It is important to analyse the conduct of business by a firm, whether *Shariah* compliance is followed, on a large scale.

Another problem identified by FSA is the shortage of qualified scholars. It is rooted from the issue, what is the standard of qualification for a *Shariah* scholar. Due to the existence of different schools, selection of scholars who are universally acceptable is difficult. Further, the recognised scholars are usually not available in UK. Moreover, the lack of human resources having expertise in Islamic banking is another issue in UK. This is very important when the products are to be designed and calculated in a *Shariah* compliant manner. Since the accounting and analysis of business are different from conventional system, it has to be done by expert in such fashion.

The problem of jurisdiction of English Courts in connection with the question of applicability of *Shariah* law in UK has also been identified. A recent verdict of the Court,<sup>172</sup> which negated the enforcement of right based on the *Shariah* law in English jurisdiction, has been projected in this regard. It is also highlighted that the problem of acceptance of *Shariah* on the ground that, this being a non-national legislation. On this pretext, they professed for documentation in consonance with *Shariah* law. However, they point out its practicability because of the usage of English contracts terms in Islamic contracts.

It has been aptly pointed out by the paper that the Islamic banking, after revival is relatively young and the experience of pitfalls is less identified. Therefore, in order to apply it in a large scale would attract severe impacts on its failure. It is warranted in this context, a framework for minimizing the risk. The problem of risk management is also

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<sup>171</sup> Ibid.

<sup>172</sup> *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd (No.1)*, [2003] EWHC 2118; [2003] 2 All E.R. (Comm) 849.

intricate in this regard. Since all the products have to be strictly adhered to *Shariah* principles, risk management used in the conventional banking is not applicable. Further, the inexperienced use of Islamic banking, the use of conventional tools of risks management will not suit. Therefore, a conceptualization based on the given problems to formulate a risk management system is solicited. It is significant particularly because, any assistance from the conventional risk management on the basis of interest and *gharar* is not accepted in the Islamic banking. It is also to be noted that the three pillars posed by Basel 2 is also not applicable. Therefore, the equilibrium to meet the requirement of *Shariah* principles and Basel 2 is also a task for Islamic banking in UK.

Through this chapter, it is inferred that, due to the upsurge of Muslims in UK and the intension of UK authorities to keep London as the centre, they recognized Islamic banking. The articulated premises of FSA in advocating for reformation of Islamic banking in UK are for the betterment of Muslims in UK and whole world. It was remarkable on the part of FSA whereby they have promulgated for reforming Islamic banking with a new dimension. The importance of the Paper lies in the fact that, the study carried out in that aspect is some what exhaustive. They have tried to address many issues which have been on the development of Islamic banking in UK, which has bearing on the study.

## ***Chapter 6***

- **Findings, Recommendations and Conclusion**

The study has depicted various aspects of the central problems persisting the reforming of Islamic finance in UK. The nature and modalities of Islamic finance and methodology of banking are depicted in the earlier chapters. The current situation prevailing in UK banking industry and their perceptions about Islamic banking have been detailed in later parts. It was also discussed the problems identified by UK regulators regarding the acceptance and development of Islamic banking in their economy. However, on a close scrutiny of affairs, it is obvious that their perceptions are not conclusive, merely touching the formal layers of the problem. It is analysed that, unless the problems inbuilt in the Islamic banking as a whole is not seen addressed, the reforms to Islamic finance by regulatory changes will not yield good.

This chapter, being the final, will examine the outcome of the study depicting the problems and challenges in the sphere. It will also point out the genesis and modalities of such problems. Then, by way of recommendations, it will suggest the solutions for overwhelming the issues. Analysis of entire concepts and the approaches of both Islamic and English system are required in this aspect. Further, in conclusion, it is attempted to answer the central and collateral problems in the study.

### *6.1. Philosophical and Jurisprudential Connotations*

The question as to why Islamic finance's growth was in lesser pace in UK, lest in Islamic world, leads us to the core of the issue. It is unambiguous that the Islam professes a unique philosophy, which is distinct from that of other systems. Their contra-accommodative nature with other systems prohibited Muslims from developing their financial activities with other world. However, it is interesting to see that they were good in indulging in commercial and trade related activities. History denotes that their merchants were prominent in international trade in the earlier point of time.

It can be seen that, when other systems shown progress in their economic activities through new practices of financial activities, they have restricted their finance with in the clutches of religion. It is pertinent to note that, when they have given absolute freedom in commercial activities, they have restricted their financial transactions in a preventive manner. Existence of more prohibitions in this respect has lessened their growth in that sphere. It marks that their assertion of distinction between commercial and financial activities and regulatory restrictions on the latter had paved its slower progress in the later years.

In its philosophical connotations, Islamic jurisprudence revolves around revelation and its mandates. Unlike other systems, where the influence of religious ethos was minimal, Islam obeyed its principles in its entirety. Whereas other systems preached for secularist approach not only on the basis of existence of different religious thoughts also for modernizing the affairs, Islam were heavily dependant on its religious mandates. They have opposed what is prohibited by *Quran*, lest did not profess what is not permitted therein. This has lead to a situation whereby, for each and every aspect, they sought sanctions from revealed law. Instead of formulating new principles, they have tried to expand the *Quranic* versions in a given situation. Contrastingly, more than permissiveness it yielded preventions. Their jurists who were basically religious phonetics, tried to project its prohibitions in its extended form rather than reaching viable solutions with modern trends. Unless this approach is changed, any developments in Islamic finance would render unfruitful.

The difference in the basic ideology of Islam with that of others is their perception of economics in the charitable nature. When western systems adhere for development of individuals through economic activities, Islam propounded welfare of the people as a communion. Therefore, when Western system gave more freedom to contracts and financial activities, Islam gave such freedom with checks in the forms of *riaba*, *gharar*, *maisir*, etc. It has been asserted that the restrictions as envisaged by scholars



contemporarily, is not that much rigid. In ancient times, when resources and technologies being primitive, such restrictions were meant only to suffice the situations prevalent. It is in the later period only, when religious exponents expanded its application to the present situations, these problems arose. The paradox of such expansion is, when Islam preaches revealed law and prohibits human intervention in rule making, the expansion of such restrictions to current activities which were not contemplated in the those period is necessarily human interventions.

It is trite to note that the underlying philosophy of Islam is the welfare of the people, some thing farther than the concept of welfare state. Whereas, welfare state relates to the benefit of each human being on the basis of natural rights he possesses, Islam's concept of welfare is different. It says that the nature is the creation of God and all the things are owned by him. Man is merely authorized to utilize these at the will of God. The God has mandated to use the nature equitably and to provide such, to others who could not pursue it. The existence and its divine will is the deciding factor in Islamic law. The UK being a secular state, ruled by democratic philosophy rooted in the secularist ideology, the acceptance of Islamic finance is problematic. The synchronization of both the systems needs thorough analysis and compromise. The specialty of democracy is its emphasis on the will of the people and as such UK cannot deny the demand of the people in adopting policies. The problems faced in these aspects are; where a practice envisaged under the Islam is demanded to be abolished by the people and where policy to be adopted is against the philosophy of Islam. In both the cases, bringing equilibrium is tedious job. It is highly significant in adopting a regulatory framework for Islamic finance in UK banking sector.

## *6.2. Legalistic Analogy*

A jurisprudential analysis reveals that Islamic law is unique where legal considerations are different from that of other systems, lest UK. UK system is based on the parliamentary legislature, where it is regarded as the most powerful institution in the world. From time to time, it has the authority to decide upon the legal aspirations of the

people. They can pass any law without regard to any limitations. But, as far as *Shariah* is concerned, any legislature cannot go beyond the authority of *Quran*, *Hadith*, *ijma* and *fatwa*. The unquestionable authority of these texts is an embargo upon the FSA, a bi-product or agency of UK parliament, when it comes to regulate the Islamic finance.

When FSA being the sole regulator in UK in relation to financial activity, subject only to the Parliament and Judiciary, the existence of prohibition from *Shariah* will delineate its authority, which is not contemplated in creating such an institution. The regulatory independence of FSA has to be curtailed once they adopt a full-fledged Islamic finance in UK. Moreover, the propagation of *Shariah* Board and authority of *Shariah* scholars will bring obstacles to the role of FSA. Mutuality of *Shariah* Board with FSA will always create tension, if authority is not clearly demarcated. Further, any rule which FSA intends to bring or amendments to the existing rules, which is envisaged in *Shariah*, with variations, it is not permitted. The mandates of *Shariah* principles that legal reasoning is not permitted where it is covered by *Shariah*. Therefore, adoption of Islamic banking under FSA's regime will not be fruitful if they want to make modifications as above.

### *6.3. Approaches of Systems*

The adoption of Islamic finance in UK, as discussed earlier, being a synchronization of two different systems, its way of approaches should also be mutualised. The hurdle in this aspect is the formalism, which is prevailed in the *Shariah* is contradictory to English system. Islamism preaches the formal standards of conducts in imposing restrictions. On the contrary, FSMA had envisaged separating financial market from the clutches of formal rules and regulations. The difference is; when Islam advocates for the restrictions on the means to achieve ends, English system in present scenario adhere to the fulfillment of ends with fewer restrictions. They have over and above stated that they will regulate only when it is necessary and the market is left to its wisdom to rectify the shortfalls. But, the continuous scrutiny of *Shariah* board and scholars will render the situation other way round.

Further, UK system that envisages competitive markets with innovation, Islam restricts any such innovation on the basis of religious ethos. The underlying fabric of *Shariah* in the financial transactions is the attainment of maximum justice. Its relation to the welfare of the people varies with the acceptance of profit making of risk taking individuals by UK system. The point of difference is the Islam's ethos for protection of society at a larger context with that of protection of individual's economic freedom in English system. When English system preaches for uncontrolled financial activities with positive competition, Islam restrains such freedom with the objective of welfare to the people. It can be asserted that the UK system's approach is rooted to attain progress through economic innovation and Islam's apprehension is regarding the failure on taking of risks. History reveals that the restrictive attitude of Islam had lead a slower progress of Islamic states and the economic policies of UK lead its market globally prominent. Therefore, any move for reforming regulatory framework to accommodate Islamic finance in UK has to bear these fallacies in mind.

As rightly emphasized by the Paper, but poorly addressed, the problem of codification of *Shariah* law. *Shariah* rests its authority in religious texts and leave its application through fatwa whereby scholars are at liberty to interpret it. It can be seen that there is lack of codification that results in its binding nature. Without a codified law, it has been problematic for the Muslims to follow in certainty. The area which left out by the texts being open to different schools of thought made them to adopt variations in their approaches. Consequently, there is no proper system of rules, which is universally accepted. It also brought out an anarchical state of affairs where the other disfavor one view. Therefore, in Islamic law, there is no place for precedents, which binds the authorities to adopt a uniform set of principles.

Islam's view on the concept of money has very impact on their practice of financial activities. The distinction of money with that of commodity is an important facet in this respect. They subscribe no value for money and consider it only as a medium of exchange. When they have permitted profit upon the commodities, they prevented any increase on the basis of using money as commodity. English system on the contrary, does

not distinguish between money from any commodity. It is as good as goods of trade. Hence, one can buy money for money itself. Therefore, adopting Islamic finance in UK needs to compromise the concept of money, as prevalent in their system.

The practice prevailed among Islamic scholars is to find out alternatives for the conventional products. In this regard, they are viewing only expansion of existing products by devising it to meet *Shariah* compliance. The fallacy is that, in order to device that on the basis of profiteering aspect, they had to dilute the same. Every financial products should yield profit, may be on the basis of taking risk, as such any products which does not do so will fail ultimately in the market. So, such products have to consider the conventional calculation and even to accept their accounting. This will lead one Muslim to pay an excess over their financial transactions, as what his conventional counter part pays. There is absolutely no change, in addition, some times they were asked to pay even more than what conventional customer pays. It denotes the failure of Islamic finance to provide an alternative method for the benefit of a Muslim consumer. Therefore, FSA being, taken up the task of reforming Islamic finance in UK, has to accord some beneficiary schemes in this regard.

The unique feature of Islamic finance is that they base their transaction on the partnerships and risk-sharing; and the return is for such taking the risks. They avoid pure lending of money because they do not recognize money as a commodity for trade. Therefore, unlike English system, Islamic banking has to be careful in its intrinsic dangers that are in built in such transactions. The value of assets may diminish to a certain extent where Islamic banks may not be able to realize the debts on such assets. Further, *Shariah* warrants that the relationship of lender and borrower should be one in accordance with the tools of Islamic finance ie, *Mudaraba*, *Ijma*, *Musharaka* and *Istiana*. This limitation would be an obstacle for the FSA to regulate Islamic banking transactions where any new techniques are not permitted so far. The issue is aggravated when the Islamic banking is equipped with regulatory framework on such type of transactions only and implementing the standard of English system requires thorough analysis.

#### *6.4. Issue of Prohibition in Islamic Finance*

It is asserted that the main issue of regulating Islamic finance in UK is the prohibitions of *Shariah* on *riba*, *gharar*, *haram* etc. When the entire financial transactions of UK is based on interest and uncertainty with competition, any move for reforming Islamic finance will have to see it is within the contours of *Shariah*. It has been often commented that the ban on interest is the main cause for the negative growth of Islamic finance in the Islam world itself. Actually the prohibition of *riba* in the classical era was meant to prevent excess on the precious goods like gold, silver, food, etc., However, in the later period the scholars have expanded it to currency which does not relates to essential commodities. It is also asserted that since the currency or money as is prevailed now being not present in the classical period, there was no reference to *riba* on monetary transactions then. The assertion of *riba* over monetary transactions would, thus be, the imaginations of the scholars with quasi-scientific expertise.

When adopting a regulatory regime in UK, therefore, the FSA has to cop up with this problem. If they accept the prohibition of *riba*, they need to find out an alternative way to cover the situation. In this regard, taking of any bond or debentures via security is also hit by this prohibition. When such certificates or investments yield income in the form of interest, the involvement of *riba* is unavoidable. Therefore, any investment in order to secure the financial institutions under *Shariah* needs to overcome this aspect. It is for the FSA to meet the situation in regulating Islamic finance.

The prohibition of *gharar* is implicit in the financial transactions concerning insurance. The concept of uncertainty and transaction on such uncertainty necessarily pervade the business of insurance and related activities. The problem with conception of Islam related to insurance is that the cover provided to one risk which may not come. There the stipulation that the transactions which takes place on a certain factors should be in existence. It can be seen that the *hadith* relied in bringing this concept as against insurance depicts a ban on trade on the basis of fish in sea. It is asserted that, there the prohibition activities are on purely gambling or game of chance. The concept of

insurance rests in the fact that the risk which is covered will come, today or tomorrow, but it is uncertain as to when it will come. So, the concept of gharar may not attract in such circumstances, where the risk is probable. Moreover, the basis or the idea of insurance is to get back to the original position or indemnify the losses. Here, there is no excess or increase and basically it is a protection and not gain which is the basic principle of insurance. Due to this ban, Islamic entrepreneurs had to suffer a lot in their transactions.

Importantly, the prohibition on the preventive activities like liquor, adult materials, gambling had also impact over financial development of Islamic finance. Shariah does not only prohibit a Muslim from indulging in such business, instead, any transactions with firm engaged in such business itself is *haram*. Therefore, any income from such business can not be used by Islamic financial institutions in their transactions. It is imperative that modern complex and mutual business and trade activities are backed by income from such business and the adoption of Islamic banking in UK will not be fruitful and may not receive welcome by Muslims in UK.

### *6.5. Shariah Compliance*

One of the probable problems faced by FSA in regulating Islamic finance in uK is the requirement of Shariah compliance of financial products. For acceptance of Muslim community, of financial products, must test the compliance of Shariah principles. The greatest problem in this respect is the issue of universality. As often commented, lack of universally recognized Shariah practice will aggravate this problem. With countries and schools of thought, standard of shariah practice varies. Further, Islamic banking being not standardized, any move for shariah compliance is abortive. The state of affairs prevailing in Muslim countries reveals that, there is no universally accepted system and as such one school's views or pinions may not be recognized by the other. Accepting any one system will invite opposition from other side and consequently a general practice cannot be adopted by FSA.

The requirement of check of shariah compliance in the life cycle of financial products is yet another issue in this regard. Islamic finance warrants financial product be checked at every stage of its operation. This would require more intervention of regulator in the market. This approach is already negated by the UK in enacting FSMA, where they have refrained from intervening in the financial activities of the market leaving the market to find out its solutions and adopting the same.

Another issue in this aspect is the standardization of accounting system. Since Islamic finance being a recently emerged system,<sup>173</sup> which could not develop a system of accounting and book keeping, to meet the system of UK market, Islamic financial institutions will face problems. It is significant, when regulations in UK require a system of accounting and Islamic banking based on different considerations; their accounting pattern has to meet such requirement.

### *6.6. Recommendations*

In order to circumvent the problems identified by this study and probable problems which may accrue, it is recommended to adopt following factors in reforming Islamic finance in UK:

A new statute may be enacted by the UK parliament, incorporating *Shariah* principles by demarcating what is accepted and not under UK system, in consultation with *Shariah* experts. Such legislation needs to be out of the consolidation of principles which are practiced in different pattern, with consonance. Then, the legal considerations will be around that law only. It will prevent the frequent intervention of *Shariah* scholars with different views.

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<sup>173</sup> Though its presence was there at earlier period, it has grown to present state after the resurrection in last three decades, as discussed in the Introduction.

The requirement of *Shariah* Board shall be complied with a combination of scholars from all the different schools and the financial experts of UK, in order to avoid the conflict of interests. The matters for their considerations are left to them for their control and FSA needs to see only if any inadvertent things happen.

Islamic banking has to be observed as purely an alternative to conventional system which can remedy the shortfall of it. Any compromise or synchronization with these systems should be done only in exceptional cases. In addition, there is need to devise financial products based on the current trends and technology which will suffice the requirements of consumers. The problems faced by customers from the traditional products are to be analysed and new products be launched curing such defects.

There should be a change in the attitude of FSA in the aspect of discrimination; they need to accord some protective discrimination to Islamic financial institutions. They can very well do it on the ground that they being relatively new system and inexperienced in the UK market.

Ban on *gharar* and *riba* be crystallised with a view to avoid further conflicting interpretations which will impede the progress of Islamic finance in UK. It is argued that even the ban on interest be lifted in view of the complex affairs prevailed in the present market. It should also be seen that there should not be exploitation of Muslims customers by taking excessive charges which is equivalent to interest in the conventional system.

The problem of adequate human resources for the effective working of Islamic banking shall be met out by molding experts in that sphere. It is needed to provide training to persons which will ultimately provide expertise to such persons. Further, accounting and standardization of Islamic banking should be considered and a proper system be implemented on the basis of conventional system but with a view over the intricacies of the Islamic banking as well.



## 6.7. Concluding Remarks

The study has tried to analyse various aspects in bringing reformatory regulation of Islamic finance in UK. Islamic finance's origin and growth in different eras have revealed its aspirations. It has also depicted the modulations of Islamic finance due to the influence of the systems prevailed in those periods. Muslim people's vow for creating an alternative to conventional system was the reason behind the resurrection of Islamic finance in the later period when the conventional system of banking impregnated with preventive practices under the Islam's philosophy. Its relation to UK market was a necessary requirement for the study about the reformation of regulatory framework in UK. Islamic philosophy is related to the revealed law and its authority from the divine will of the God, which is unique. It is also examined the benefit analysis of Islamic finance which is different from that of other systems. The implication of lawful and unlawful and prohibition and; perceptions on the nature of contracts and its rigid nature of regulations is unique.

The Islamic banking has many distinctive features which is rooted in the perception of benefit of the customers and not the commercial gains of the banking institutions. Since monetary transactions are for the benefit sharing, the unearned return is invalid under *Shariah* and should be invested for using labour and trade for which will yield profits. The significance of risk based sharing of profit is also one among such features. The ban on interest and uncertain contracts is to check the welfare principles underlying the *Shariah* wherein certain tools which are permitted are presented.

The emergence and evolution of banking in UK and changing perspectives on the concept of banking in different periods were remarkable. Acceptance of different approaches and attitude for experimentation by the UK banking industry has lead them as global leaders. The role of Bank of England as a leader and back born of the UK economy is an important aspect of UK banking sector. It can also be seen that the UK banking market being vibrant and dynamic, had found its pace with the advancement of

modern technology. It is inferred that, due to the upsurge of Muslims in UK and the intension of UK authorities to keep London as the centre, they recognized Islamic banking. The articulated premises of FSA in advocating for reformation of Islamic banking in UK are for the betterment of Muslims in UK and whole world. It was remarkable on the part of FSA whereby they have promulgated for reforming Islamic banking with a new dimension. The importance of the Paper lies in the fact that, the study carried out in that aspect is some what exhaustive. They have tried to address many issues which have been on the development of Islamic banking in UK, which has bearing on the study.

The problems identified in Chapter six has the bearing on the issues raised in the introductory chapter. These problems set out therein are the core of the issue of reforming regulatory framework for Islamic finance in UK. The answer to the central issue regarding the feasibility of developing Islamic banking through regulatory reforms in UK is to adopt a new system wherein the needs of Muslim people, requirement of *Shariah* compliance and the regulatory framework of UK are properly balanced.

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