ISLAMIC BANKING AND ISLAMIC FINANCIAL PRODUCTS: COMPARATIVE STUDY OF UK, US AND MALAYSIA

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ABSTRACT

The thesis represents comparative study of Islamic banking and Islamic financial products in UK, US and Malaysia. The aim of thesis is firs to examine what are the major problems on a way of development of Islamic finances in UK, US and Malaysia. Secondly, to propose possible solutions to identified problems.

Basic principles of functioning of Islamic financial products are derived from Koran and Sunnah, primary sources of Islamic law. Main distinctive features of Islamic financial system are prohibition of interest-riba, and prohibition of excessive risk-gharar. First chapter of thesis will examine how interest free financial system functions. Second chapter will show problems emerging with practice of Islamic finances in secular states, particularly in UK and US and in state with mixed banking system- Malaysia. Third chapter will look at Islamic finances as a part of religious freedom, right to free exercise.

Islamic banking and Islamic financial products faced many serious problems on a way of their integration into Western financial market. However, there is a strong demand for Shari'a compliant financial transactions and this is the main reason why Islamic financial products managed to emerge and establish. As long as there is a demand states will take all necessary steps to accommodate Islamic financial products in their financial markets.

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INTRODUCTION

Islamic banking and Islamic financial products are very special phenomenon. They are regulated by Koran. In other words Islamic finances are based on religious doctrine. The question is how financial system based on prohibition of interest can survive in financial market where interest is the main economical incentive. Hence, we face the question whether Islamic banking and Islamic finances can be practiced in secular states and whether Islamic finances can develop and be competitive with traditional ones and what are the major problems on their way of development.

I decided to undertake the research on Islamic banking and Islamic financial products for several reasons. First of all Islamic banking in past few years experience a significant growth and spread from Islamic world to western countries. Secondly, Islamic banking and Islamic finances belong to the field of finances that has not yet been profoundly researched. Thirdly, lack of information on functioning of Islamic finances cause a lot of prejudice against them , for example Islamic banks are often seen as an institutions that are used by terrorist organizations for the purposes of money laundering. Fourthly, comparative study on Islamic banking and financial institutions can reveal problems of Islamic finances in realm of their practice. Finally, so far Islamic finances were viewed from the financial and economical perspectives, I would like to show that Islamic finances is not only different financial system but also right of every Muslim to freedom of exercise.

Islamic banking is relatively new development. The issue of Islamic finance and banking started to emerge at the end of 60ties. Because of rapid development and wide spread of Islamic banks they became the integral part of world's financial system. First Islamic bank was created in Egypt in 1963 which was later on closed for political reasons; however this experiment was an important start for the building of big industry of Islamic financing. Today there are 300 Islamic financial institutions in 75 countries of the world. Total amount of assets

are estimated to be 300 billion USD and by 2010 the growth rate will exceed 18%[1]. These numbers are clear indicator of popularity and viability of Islamic financial institutions. Not only they have high development rate but also there is pattern of incorporation of some aspects of Islamic financial system by non Islamic instructions in non Muslim countries like UK and US.

Basic concepts of Islamic banking are derived from Koran and Sunnah. Koran, the Islamic wholly book is major source of Islamic legal and religious theory. It is distinguished from the other wholly books, by the coexistence of religious doctrines with purely practical aspects of life, such as marriage, commerce etc. Only Koran itself contains approximately five hundred provisions regarding trade, commerce and contracts. Sunnah, the description of life, of Prophet, became second important source in the category, called "divine law". It illustrates how the Koranic verses were applied in practice by the Prophet. Both Koran and Sunnah as sources of "divine law" remained unchangeable with time, the other key source of Islamic law is fiqh, which is human understanding of "divine law". In order to have the status of "divine law", fiqh decisions have to be approved by all Islamic scholars of the time. This form of consensus is called ijma. The other part of fiqh is qiyas, which means analogical reasoning, namely making parallels and links of particular issue with already existing decision. These are the main guidelines for the Islamic financial and banking institutions, rulings on financial operations, forms of contracts and general provisions on the certain types of deals are derived from them. As "divine law" prescribes, all financial transactions must be in accordance with rules of Islamic Law.

Islamic law recognizes the principle of time value of the money, however it does not treat the money it does not treat the money as commodity. Koran encourages investments, holding money is unacceptable, money cannot be used for used for buying more money, they have to

[1] T.Karasik, F.Wehrey, S.Strom, "Islamic Finances in a Global Context: Opportunities and Challenges", Chicago Journal of International Law, 2007

go through certain stages, and they have to be used for purchasing goods and services. In other words: Shari'a recognizes time value of money for trade operations but not for loans[2].

The main distinctive feature of Islamic banks is that they must serve a god. Therefore not only the financial transactions, but institution and the stuff must be in accordance with Islamic Law. Every Islamic bank has a committee, which carries a task to supervise that all operations are carried on in accordance with Islamic law, mostly these committees have wide discretion towards all financial activities of the bank, their decisions are binding, they power reaches up to the prohibition of certain types of deals if they are considered to be against Islamic rules. The bank itself has to have an appearance of sacred place and all employees must lead they work and their life in accordance with Muslim religion.

My research on Islamic banking and financial products was mainly based on three books. For the second and third chapter of thesis I used articles, information available on official web sites of banks and financial institutions and cases. In started my research on Islamic finances from the book by Vogel F. E., Hayes S.L., published in 1999 called " Islamic law and finance : religion, risk and return". The book represents very detailed study of Islamic financial products. It gives very detailed description of Islamic financial products, complicated structures of their functioning, innovations related to these products and problems related to their application. As I already noted book undertakes very detailed study therefore it is difficult to understand for reader who is not familiar with finances. Another book that describes Islamic financial products was published in 2005, written by M. Obaidullah, "Islamic Financial Services". The book is written in simple language and can serve as introduction to study of Islamic financial products. What is very interesting about the book is that together with description of financial products it gives examples of transactions, problems related to them and examples of practice of banks. The other book was published in Russian in 2004 and is a joint work of several authors: A.J. Jhuravlev, M. Kemper, R.I.

[2] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.27

Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, called “Islamic Finances in Modern World: Economical and Legal Aspects”. Book is divided in 6 chapters written by different authors, it starts with general overview of Islamic economy and ends with Islamic accounting models. It goes through Islamic financial transactions, principles of functioning of Islamic banks and gives examples of Islamic banking and financial products in different jurisdiction among others in Malaysian and UK. Very interesting is the chapter on Islamic Insurance, with detailed overview of insurance practices and problems related to Islamic insurance schemes.

The materials used for second chapter are mostly articles of different authors. One part of articles was concentrated on Islamic banking and Islamic financial products in particular jurisdictions. The other part concerned financial institutions that are major provider of capital for Shari’a compliant transactions. Third chapter is mainly composed with study of the case law. It is concentrated on cases on religious freedom and also includes reports on issues of freedom of religious in UK and Malaysia.

My thesis will try to give basic guidelines on functioning of Islamic Banks and Islamic financial products. I will not try to undertake detailed study of structure of Islamic banks and Islamic financial products. I will not go into details of Islamic religious doctrine or try to figure out historical and economical incentives behind Islamic prohibitions in a field of finances. I will address problematic aspects of functioning of Islamic financial products, show how they are resolved in different jurisdictions, to what extent they are compatible with modern practices of traditional financial institutions and trace the trends of their future development. I will also approach Islamic banking from the new, so far unexamined angle, namely from the point of view of human rights instruments, particularly with the right to free exercise.

First chapter starts with prohibited types of transactions. Islamic law prohibits certain types of contracts, the major prohibition triggers interest, riba, it derives from Islamic concept that

money cannot be made out of money, therefore no interest can be charged without involvement of labor. Another kind of prohibition is gharar, transactions which involve high level of risk and uncertainty. These two prohibitions are central to understanding of functioning of Islamic financial system. Next section of first chapter describes Islamic financial transactions: mudaraba, musharaka, murabaha, ijara, sukuk and takaful. The reason why I choose mudaraba and musharaka form of contracts, is that they are oldest and most Shari'a compliant types of transactions. Mudaraba and Ijara transactions are most commonly practiced by Islamic financial institutions nowadays. Sukuk is Islamic bond, thought it is relatively new development on a market of Islamic financial products; there is increasingly high demand on this innovation. Takaful is the most popular type of Islamic insurance. In third section of first chapter which serves as conclusions to the chapter I will sum up existing problems with corresponding forms of contracts. Section will not go into deep analyze of problems of Islamic forms of contracts, it will only highlight the major issues related to particular types of transaction. The aim of first chapter is to discuss Islamic forms of transactions, major prohibitions, so that reader has general idea how Islamic financial system functions and how it is different from conventional one.

The third chapter is based on comparative study of Islamic banking in different jurisdictions. First section of this chapter illustrates to what extent Islamic banking can exist in systems where Islamic law is not governing law of the state and what kind of problems Islamic banks might encounter on the way of their development in those countries. From the common law countries I choose UK and US. Choice of UK is justified because many Islamic banks have their head offices or branch offices based in London, moreover many UK based companies like HSBC group started to offer mortgages based on Islamic regulations, what's more interesting majority of clients are not Muslims. As to the US, it is interesting because recently there have been numerous problems with existence of Islamic institutions, not only general suspect exists after terrorist attacks of September 11 but also CIA is closely monitoring

activities of Islamic financial institutions. Second section of second chapter will discuss development of Islamic banking and financial products in a country with mixed banking system. The country of my choice was Malaysia. Malaysia is interesting for numerous reasons, first of all it is considered to be the Mecca of Islamic financing, secondly in Malaysia "different legal systems coexist there, i.e. the common law inherited from the British colonial period, the Shari'a, and the indigenous unwritten law in the provinces of Sabah and Sarawak"[3]. Finally although Malaysia is country with majority of Muslim population large numbers of clients of Islamic banks are not Muslims but ethnic Chinese. The chapter will end with the summary of problems that Islamic banks face in the countries of above mentioned jurisdictions and with summary of possible solution of the problems also provided at the end of each section.

The last chapter of the thesis will look at Islamic banking from the Human Rights point of view. Islamic banks are not only the new type of financial institutions but also they trigger the right of every Muslim to exercise religion according to Koranic rules in all spheres of activities including finances. Every Muslim in the country where he lives, whether he is in majority on minority has the right to freely conduct his business according to his believes, in the institutions where he chooses. Therefore the third chapter will look at Islamic finances from the religious freedom angle and will try to figure out to what extent Islamic finances as part of right of free exercise will be protect in UK, US and Malaysia.

Comparative study of Islamic banking and Islamic financial products revealed many problematic aspects of practice of Islamic finances in given jurisdictions. It is essential to identify problematic issues before suggesting most suitable solutions. At first sight it is difficult to imagine how interest free financial product, based on religious doctrines of fairness and justice could function and be competitive, especially in established financial markets dominated by private interests and big financial institutions, oriented only to profit.

[3] S. Messmann, "Islamic banking and finance- Transplantable models from Malaysia to EU?"

My research has shown that not only it is possible for Islamic banking and financial products to establish in western financial markets but to achieve significant growth. It is not to say that development of Islamic products was smooth process, it went through different stages even in Islamic countries and it is not yet finished in secular states. At this stage, we can already trace very promising pattern such as legislative changes in UK and completion of sukuk transaction in US. But there are still problems that remained unsolved. For example in UK although Islamic bank has already been established, there are difficulties with application of Shari'a principles by the civil courts. In US situation is complicated because of the federal system, Islamic financial products and Islamic banking has to comply with federal law and laws of the state, situation is more complicated by the fact that there is no uniform form of financial institution that would be able to provide all sorts of Islamic financial products. Even in Malaysia where Shari'a is the governing religion there are numerous problems that have to be solved, such as compatibility of takaful structure with Shari'a principles. This thesis provided deeper analyze of problematic aspects in practice of Islamic financial transactions and suggests possible solutions. It also helps to look at Islamic banking and financial products as a part of religious conduct which is part of free exercise right of every Muslim.

I don't claim universal application of solution that I suggested. I am not trying to say that these solutions are directly transplantable to other jurisdictions outside the scope of my research. However, I do suggest that they are applicable to UK, US and Malaysia. More research has to be done in other countries where issues concerning Islamic banking and financial products are about to emerge. It is clear that global spread of Islamic finances is only a question of time; hence eventually every country will face similar problems that were experienced by UK, US and Malaysia. Therefore, it is important to be familiar with experience of these three jurisdictions to know how to prevent and solve the problems with Islamic banking and Islamic financial products.

CHAPTER I – BASIC FEATURES OF ISLAMIC FINANCE

1. Prohibited Types of Transactions

Islamic financial model is based on mix of religious and legal norms. Finances are inseparable part of general religious doctrine and contain notion of responsibility in front of Allah. Financial transactions are not based on pure profit for individual but rather on social and moral incentives. Koran calls for equal distribution of wealth and seeks to benefit community as whole. It tries to prevent accumulation of wealth in hands of several individuals and obliges reach to give away for charity[4]. Financial transactions should not be based only on economical incentives but first of all on principles of justice and fairness.

Basic principles of financial transaction are derived from Koran and Sunnah and they are built on prohibition of riba and gharar. Islamic scholars offer many economical reasons to advance Islamic financial system over traditional one these are arguments outside social justice. In this chapter I am not going to look at economical or religious arguments, I will not try to advance Islamic financial system; I will just show how it functions.

1.1. Riba

Riba, usually translated as 'increase' is referred as prohibition of usury or interest. Prohibition of riba comes from Koran further developed in Sunnah. It is to say that prohibition of interest is derived from primary sources of Islamic Law. There is consensus among opinions of all Islamic scholars and opinions of courts in Muslim states when it comes to imposition of ban on interest. Riba is not only prohibited type of activity but it is a great sin. Several verses of Koran are dedicated to riba:

[4] C. Wu, "Islamic Banking: Signs of Sustainable Growth" , Minnesota Journal of International Law, 2007

"O you, who have believed, do not consume interest, doubled and multiplied, but fear God that you may be successful. And fear the Fire, which has been prepared for the disbelievers."[5]

This Koranic passage refers to riba as sin another verse claims that one who takes riba rejects the faith:

"That they took [riba], though they were forbidden; men's substance wrongfully-
We have prepared for those, among them who reject faith a grievous punishment"[6]

Sunnah goes on and gives more detailed application of concept of riba. According to Sunnah it is the sinful to pay the interest, to receive interest or to be a witness of such transaction:

"From Jabir: The Prophet, may peace be on him, cursed the receiver and the payer of interest,
The one who records it and the two witnesses to the transaction and said:
'They are all alike (in guilt)' "[7]

Prohibition of interest is not unique for Islam. Interest was already prohibited as early as by Code of Hammurabi; Judaism condemned charging interest from another Jew[8]. Greek philosophers such as Aristotle and Plato also condemned charging of interest. Bible contains several passages that deal with prohibition of interest. In 1215 the Fourth Lateran Council banned practice of charging interest for Christians but allowed for Jews. Catholics were against changing interest until 19th century[9].

Islam up to date preserved very strong ban on interest. It is not to say that Islam prohibits commercial activities such as trade. But according to Islam profit should be eared through activities that involve labor and certain level of risk. If lender does not participate in return of his capital or does not bear a risk of loss, he has no right to share a profit. In other words riba represents profit that is predetermined or profit that is not earned[10].

[5] J. al-Din Zarabozo , "Interest and its Role in Economy and Life", 2007, available at: http://www.islamreligion.com/articles/538/, cites Koran 3:130-131, last visited in September 21st , 2007

[6] M.J. Taylor , "Islamic Banking- the Feasibility of Establishing an Islamic Bank in the United States", American Business Law Journal, 2003

[7] E. R.A.E. Ali "Riba and its Prohibition in Islam", International Islamic University Malaysia, available at: http://www.cert.com.my/cert/pdf/riba_drengku.pdf , cites in footnote 30, Muslim , "Kitab al Masqat, also in Tirmazi and Musnad Ahmad; translation by M. Umer Chapra, op .cit. p 236 , last visited November 8th 2007

[8] S. Messmann, "Islamic Banking and Finance- Transplantable Models from Malaysia to the EU?"

[9] J. al-Din Zarabozo , "Interest and its Role in Economy and Life", 2007, available at: http://www.islamreligion.com/articles/538/, last visited in September 21st , 2007

[10] M.J. Taylor , "Islamic Banking- the Feasibility of Establishing an Islamic Bank in the United States", American Business Law Journal, 2003

Islam does not make distinctions and applies riba to all types of financial transactions. Riba is considered when it comes to trade or just exchange of goods and when it comes to debt relation such as lending. Application of principle of riba in trade basically comes down to the prohibition of trade that is not based on honest conditions and fair exchange. Money in Islam do not have independent value they are just the subject of exchange, hence conditions of exchange would be applicable to money as well. Basically, if exchange is to be permissible under prohibition of riba it should meet two conditions. Exchange should be made hand to hand and exchanged good should be in equal quantities[11]. In other words riba prohibits excess in quantity of exchange and delay in performance of transaction[12].When it comes to lending, taking interesting for lending goes against basic principles of Shari'a. Simply giving a loan is rather charitable activity from the Islamic standpoint and person or institution who gives a loan should not expect any income either fixed either undetermined. Profit cannot be guaranteed despite the outcome of transaction. Since giving a loan does not imply any work lender loses right to participate in process of sharing risk and profit. Even though a person or institution still bears a risk of loss but he not participate in return of capital, according to Shari'a it is rather gambling then business transaction.

It is not to say that by prohibition of interest Islam denies time value of money but is does not allow treating interest as securitization from inflation. As Pakistan Federal Shari'at Court noted in its decision, once borrower is not protected from deflation then lender should not be protected from inflation[13]. As to the time value of money, Shari'a applies different religious and economic consideration but when it comes to loan it is considered to be rather charitable

[11] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[12] J. Schacht, "An Introduction to Islamic Law", Oxford University Press, 1982, p.145

[13] S. Messmann, "Islamic Banking and Finance- Transplantable Models from Malaysia to the EU?", cites decision of Pakistan Federal Shari'at Court

donation then simple exchange. By giving a loan Muslim helps the one who is in need and expects to be rewarded in future by Allah[14].

Riba, in other words prohibition of interest or usury is central to the functioning of Islamic financial system based on fairness and justice. Usury contradicts to the Islamic notion of loan; Muslim cannot expect to gain reward for making donation. Interest as such is banned if it is not eared by participating in business activities which involves profit and loss sharing.

1.2 Gharar

Gharar means uncertainty or risk. Prohibition of gharar can be traced to sources of Shari'a, Koran and Sunnah. It is not to say that risk is banned by Islam, on the contrary Shari'a compliant transaction must contain certain level of risk but risk cannot be excessive. As to uncertainty, it is seen as prohibition of fraud. Gharar does not have a single definition, it is broad concept. Contrary to riba, gharar is not absolute and there is no consensus among Islamic scholars over scopes of application and there are exceptions from gharar.

To make a clear picture of transactions which can be held null and void in terms of prohibition of gharar, it is necessary to classify them and provide examples. Consequently if transaction is to be legally binding next four conditions must be met[15]:

First of all level of risk in terms of transaction cannot be excessive. In terms of transactions there are several factors that can influence level of risk. One of the factors is inadequacy of information due to intention of one of the parties to deceive the other contracting party or unavailability of complete information. Shari'a makes it clear that obligations undertaken by

[14] R. Saadallah, "Concept of Time in Islamic Economics", Islamic Economic Studies, Vol.2 No.1 1415H (1994), available at: http://www.failaka.com/Library/Articles/Concept%20of%20Time%20in%20Islam%201994.pdf , last visited November 3rd 2007

[15] Classification used by M.H. Kamali, in the article "Uncertainty and Risk-Taking (Gharar) in Islamic Law", Law Journal, Vol: 07, No: 02, International Islamic University Malaysia, Kuala Lumpur, Malaysia, 1998, available at: http://lawinislam.com/article.php?id=7, last visited November 3rd 2007

parties of contract must be clear especially object of the contract should be determined[16]. Examples of this kind of transactions are: sale of subject without detailed specification of content, sale without precise determination of price such as indication of a "current market price", sale of the goods on a ship which will sank, even if both parties are fully informed of forthcoming disaster this transaction will be annulled since the real subject of contact is not the sale but other transaction which is not reflected by the contract[17]. The other examples of excessive risk are transactions where contracting party have no actual possession of subject of contract, cannot deliver it or when delivery is held to be impractical. Such as selling a fish in the sea or setting it free after it is caught[18].

Second condition of validity of contacts in terms of gharar is that contract has to reflect over each subject of transaction. In other words it is forbidden to combine several transactions in one contract, to create so called commutative contracts[19].

Third condition is that subject of the contract cannot be at risk or uncertainty. The best example was pre-Islamic practice of selling unborn animals.

Finally fourth condition can be said to constitute exception from prohibition gharar. Risk even if it excessive would be held permissible if there is a need to conduct transaction or if there is a long practice of such transaction where parties are aware of possible harm and there is no damage from transaction or where benefit is bigger then possible harm. For example in farm when goats of several inhabitants are united into one flock to produce a cheese and then profit of is proportionally distributed. Of course it is impossible to precisely calculate share of each inhabitant in terms of productivity of his goats but keeping collective flock has positive

[16] J. Schacht, "An Introduction to Islamic Law", Oxford University Press, 1982, p.146

[17] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.16

[18] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[19] M.H. Kamali, in the article "Uncertainty and Risk-Taking (Gharar) in Islamic Law", Law Journal, Vol: 07, No: 02, International Islamic University Malaysia, Kuala Lumpur, Malaysia, 1998, available at: http://lawinislam.com/article.php?id=7, last visited November 3rd 2007

financial effect[20]. Therefore collective benefit of practice is bigger then damage for individual. This fits also in general idea of Islam of advancing interest of society.

As we could see concept of gharar is quite broad and depends on many factors. Unarguably it is one of the basic principles of Islamic finances but it is not as strict as prohibition of riba. Additionally, gharar is very much dependant on factor of time, since what was considered to be risky or uncertain transaction few years ago can be much safer and secured in terms of modern developments. Apparently, this is the main reason why scope of application of gharar has not yet been established.

2. Forms of Islamic Financial Transactions

2.1. Mudaraba

a) General Concept of Mudaraba

Islamic financial transaction called mudaraba is referred as profit sharing transaction. Mudaraba has long historical traditions. It was practiced in Mecca before Islam, Prophet Mohammad himself was using mudaraba when he was a merchant and afterwards legalized it as one of the permitted types of transactions[21].

In the mudaraba transaction one party so called rabb-al-mal provides capital and other party named mudarib manages transaction, in other words does actual work. The profit from contract as well as duration of the contract is determined by agreement between parties. Hence, profit is shared only after termination of contract. In case of losses only rabb-al-mal is subjected to material losses, according to Islam waste of time and energy by mudarib are

[20] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.18
[21] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p. 50

equal to losses suffered by other party[22]. Mudarib has no obligation to compensate financial losses of rabb-al-mal unless they were resulted by his negligence or deliberate action. Before signing agreement rabb-al-mal has right to formulate any conditions he finds appropriate but once contract is signed it cannot be subject to changes. Under standard conditions of mudaraba contracts rabb-al-mal would not interfere into implementation of the contract at any stage of the transaction. After mudaraba contract is signed it cannot be subjected to modifications, any changes that contacting parties would like to make will lead to singing of a new contract. Here must be notated that contracting parties are free to terminate contract at any stage, in this case accounting procedures will be carried out. Finally mudarib has rights to contribute to transaction his own financial resources[23].

b) Mudaraba Transactions Practiced by Islamic Banks

Mudaraba contracts are widely practiced by Islamic banks. First case is when bank acts as mudarib when it manages deposits of clients. In other words, customer invests in bank and receives a share of bank's profit. It is worth to note here that when customer invests in Islamic bank he does not have predetermined profit, but since usually deposit is guaranteed there is no risk of loss[24]. Islamic banks formulate its nominal by current and saving accounts. Availability of financial recourses when bank acts as a mudarib depends on the type of accounts held by depositors. When client holds saving account this practically means he can withdraws his money at any time, what contradicts mudaraba contract but it is one of the types of deposits offered by banks. Typical incentives offered by Islamic banks to holders of deposit accounts are in form of gifts, such practice is at discretion of the bank and would not be secured by contract. The other alternative would be time deposits, which is basically applicable when bank serves as mudarib and falls within the meaning of profit-and loss sharing arrangements. Time deposits can be opened for unlimited or limited investment

[22] F. E. Vogel, S.L. Hayes, "Islamic Law and Finance: Religion, Risk and Return", Kluwer Law International, 1998, p.194

[23] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p. 51

[24] K. Vicor, "Between God and Sultan", Hurst & Company, London,2005, p.329

period. In deposits for unlimited period duration of contract is not specified and contract is automatically renewable unless client terminates it with three month prior notice. In this type of deposit client cannot increase the sum of deposit or withdraw any amount from deposit. When deposit is opened for limited period, duration of contract is subject to agreement between bank and client[25]. What is worth to notice here when banks acts as mudarib in this type of contract, profit is calculated not after termination of contract but at the end of accounting period. Time deposits are managed as Mutual Investment Deposits and Special Investment Deposits. When client opens Special Investment Deposits, bank can invest in the projects that are specifically chosen or approved by depositor. Client participates in profit and loss sharing procedures when profit is preliminary determined[26]. However this type of deposit is not always available for clients as it requires having minimum available capital to invest in specific project. On the other hand Special Investment Deposit is most compatible with essence of mudaraba contract. Under Mutual Investment Deposit, capital of the client participates in financial transaction in a joint basis with capital of other clients or capital of the bank. Profit of the client is not fixed to specific transaction but calculated at the end of bank's fiscal year[27].

Second option practice by Islamic banks is when banks act as providers of the capital. When bank is rabb-al mal contract may be formed as restricted or unrestricted mudaraba[28]. Restricted mudaraba is when bank invest is specific projects, whereas when bank provides unrestricted mudaraba banks gives capital which can be invested at discretion of mudarib.

c) Two-Tier Mudaraba

Islamic bank can act as middleman; this type of transaction is called two-tier mudaraba. In this cases bank acquires capital from depositors and acts as mudarib. Bank undertakes

[25] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[26] C. Segrado, "Case Study: "Islamic Microfinance and Socially Responsible Investments", University of Torino, 2005, available at: http://www.gdrc.org/icm/islamic-microfinance.pdf, last visited October 12th 2007.

[27] Ibid

[28] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

responsibility to manage deposit but does not guarantee profit. Simultaneously, bank acts as rabb-all-mal by investing these deposits into different types of Shari'a compliant financial transaction, which does not necessary have the form of mudaraba transaction[29].

*2.2 Musha**raka***

a) General Concept of Musharaka

Musharaka, together with mudaraba constitutes, profit and loss sharing type of financial transaction. Musharaka is structured in a way that envisages long term partnership of the contracting sides. It is equity based partnership where two or more parties form joint venture for the purposes of contract. Each of parties contributes capital and both parties can participate in management of project. Profit from the venture is shared between parties according to preliminary agreed ratio. When all partners participate in management, in other words when partners act as agents of each other, then profit is usually distributed equally among them. But under Musharaka agreement it is possible to delegate more powers to one or more partners, hence to authorize partner to manage business, then profit of so called "sleeping partner", who provides only capital but does not participate in management cannot be more then ration of his investment[30].

b) Permanent and Diminishing Musharaka

Musharaka is very flexible model of financial transaction and can be applied to various types of contracts, such as housing or even letter of credit. Musharaka can be two types: with permanent and diminishing partnership. Most frequently used for mortgage transactions is musharaka with diminishing partnership; this transaction is practiced by Lariba in US. The scheme is the following: a client selects a house he wants to buy and applies to financial

[29] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p. 51

[30] S. Al-Harran, " Musharakah Financing Model ", 2003, available at: http://www.islamic-world.net/economics/musharakah.htm, last visited November 12th 2007

institution for financing. Clint pays his share; let's assume 30% of the price of house as down payment and the other 70% is paid by the financial institution. Further, financial institution determines rental value of the house (usually fair rental value is determined by rental prices of similar houses in neighborhood), which cannot be subject to changes as long as agreement lasts. Once rental price is determined, client will pay 70% of the price (the amount of financial contribution of bank); agree upon period of financing and afterwards financial institution will determine additional amount of money that client will have to pay to become a full owner. By making additional payments above the rent clients reduces shares of financial institution and increases his shares until he buys out all shares owned by financial institution[31]. At the same time the title of the house is registered on clients name from the very beginning, financial institution only holds the title deeds and registers a charge to safeguard its interests[32].

Musharaka with permanent partnership is when all partners of joint venture have proportion of shares and profit that remains unchanged during existence of venture[33]. The letter of credit based on permanent musharaka transaction is following: costumer negotiates conditions of financing, places his deposit in bank, which constitute his share of price of goods he is going to purchase, banks adds its own share and issues LC to the customer. Once costumer receives goods he disposes them according to agreement with bank and shares a profit with bank[34].

c) Obligations and Liability

Obligations of customer towards bank under musharaka contract are secured by goods or property. If musharaka contract is structured in a way that customer makes down payment of a price of goods, bank cannot increase selling price of goods in case on delay in payments. On the one hand bank has to take into consideration whether customer had serious reasons to

[31] H.G. Rammal, "Financing Though Musharaka: Principles and Application", available at: http://www.westga.edu/~bquest/2004/musharaka.htm, last visited in September 18th 2007

[32] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[33] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.61

[34] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

excuse delay in payment on the other hand in absence of such excuse, as a penalty bank cannot claim compensation for delay but can oblige customer to make contribution to the charity[35].

As to liability, in musharaka transaction all partners are equally liable for losses. The losses of the venture must be divided between them exactly in accordance with the ratio of capital invested by each partner[36].

d) Termination of Contract

Musharaka contract can be terminated at discretion of one of the parties, with prior notice. If one of the partners wants to terminate the contract that does not mean that other partners cannot continue business. In this case partner who wants to terminate musharaka has right to sell his shares, at the same time partners of the venture have rights to buy his shares. But if one of the partners wants to terminate the contract and at the same time close the business the following rules are applied. If assets of venture are in a form of cash then they will be distributed among partners in pro rata basis. If assets of musharaka are in any other form they may as well be distributed among partners in a form they exist or they can be sold and money will be distributed[37]. Form of distribution of assets is subject of agreement among partners.

2.3. Murabaha

a) General Concept of Murabaha

Murabaha, otherwise referred as sale with mark up, represents financial transaction which compromises financing and trade, here financing is a part of trade transaction and financial

[35] H.G. Rammal, "Financing Though Musharaka: Principles and Application", available at: http://www.westga.edu/~bquest/2004/musharaka.htm, last visited in September 18th 2007

[36] M.T. Usmani, "Musharakah", an online publication by: accountancy.com.pk, , available at: http://www.accountancy.com.pk/docs/islam_musharakah.pdf , last visited November 12th 2007

[37] M.T. Usmani, "Musharakah", an online publication by: accountancy.com.pk, , available at: http://www.accountancy.com.pk/docs/islam_musharakah.pdf , last visited November 12th 2007

institution receives not the interest but profit[38]. Murabaha is not profit and loss sharing transaction; it is cost-plus-profit contract where financial institution acts not as a partner but rather as an intermediary[39]. In murabaha transaction, customer asks bank to buy a goods and when bank obtains goods to sell them to customer. Customer specifies type goods he wants bank to buy, it is also possible to indicate a seller, and price of goods is known to the customer and must be specified, then customer makes a promise to buy specified goods from bank. In other words to be valid murabaha contract must specify the goods, price of goods, goods must be obtained first by bank from third party and once bank receive a title of goods, hence takes on risks connected with ownership of goods, bank can sell a goods to the customer on cost plus profit basis. Profit is determined by lump some or by mutually agreed ration which is added to the price of goods[40]. Bank may reduce risks connected with murabaha transaction by appointing customer to acts as an agent and purchase goods from a seller in a name of bank. In this case bank avoids the situation when there is mistake in determination of goods and avoids costs connected with delivery of goods[41]. It is import to stress two aspects of transaction, first is that bank can reduce the risks connected with murabaha transaction but complete elimination of all risks would make transaction Shari'a incompliant. Second aspect is that preliminary determination of profit is not considered to be an interest because bank receives not only profit but is also subjected to the risks connected with ownership of goods such as risk or damage or risk that customer will refuse to buy these goods from bank.

b) Forms of Payment

Under murabaha contract, customer has two options to pay for goods; either customer will makes instant payment to the bank upon delivery of goods or he pay on a basis of deferred

[38] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.63

[39] S. Al-Harran, " Musharakah Financing Model ", 2003, available at: http://www.islamic-world.net/economics/musharakah.htm, last visited November 12th 2007

[40] M.T. Usmani, "Murabahah", an online publication by: accountancy.com.pk, , available at: http://www.accountancy.com.pk/docs/islam_murabahah.pdf, last visited November 12th 2007

[41] F. E. Vogel, S.L. Hayes, "Islamic Law and Finance: Religion, Risk and Return", Kluwer Law International, 1998, p.141

installments according to preliminary agreed schedule. In both cases price of the goods will be higher then price paid by bank. Since bank becomes the owner then it has right to charge higher price, this kind of practice would be compliant to Shari'a because in this case it involves trade of commodities not trade of money. At the same time the longer is the period scheduled for the customer to make deferred payment the higher would be the price of goods.

c) Rescheduling of Payment

Construction of murabaha allows for extension of schedule for installments but bank cannot charge additional amount of money. The logic behind this prohibition is that once goods are sold to the customer under murabaha agreement, he becomes the owner and has obligation to pay the bank price of the goods. Therefore, additional amount of money cannot be charged for the goods that do not belong to the bank any more[42]. This is very much in compliance with whole notion of murabaha agreement where subject of negotiations is not profit but the price and once the price is determined it cannot be changed.

d) Enforcement of Promise

Promise of the customer to buy the goods which bank buys to sell them later to the customer, constitutes a separate contract but is an important part of murabaha transaction. Murabaha contract comes into force when bank becomes the owner of goods, because due to the prohibition of gharar bank cannot sell the goods it does not actually possess. Therefore, promise is the only guarantee that murabaha transaction will take place. Bank should be guaranteed that customer will actually buy goods, especially when murabaha contract is made on specific kind of goods. Since, promise is unilateral contract made by customer; it raises a question of enforceability. On the other hand nature of promise is such that it causes bank to undertake costs[43]. Consequently, promise made by the customer will be enforceable through courts and could serve as guarantee that murabaha contract will take place. Such enforcement

[42] M.T. Usmani, "Murabahah", an online publication by: accountancy.com.pk, , available at: http://www.accountancy.com.pk/docs/islam_murabahah.pdf, last visited November 12th 2007

[43] M.T. Usmani, "Murabahah", an online publication by: accountancy.com.pk, , available at: http://www.accountancy.com.pk/docs/islam_murabahah.pdf, last visited November 12th 2007

mechanism applied to the promise is very important because otherwise bank can face the situation when it is left with specific type of goods that is not only difficult to sell on secondary market but also sell on cost plus make up price.

2.4 Ijara

a) General Concept of Ijara

Ijara transaction is Islamic equivalent of lease contract. In Ijara transaction Islamic financial institution buys equipment or property selected by customer and afterwards leases it to the customer on preliminary fixed rate. Subject of the transaction must be precisely specified. Most commonly subject of Ijara contract is property or expensive equipment. Formally the owner of the subject of transaction remains financial institution, customer has right to use it, hence transaction is secured by ownership[44].

b) Types of Ijara transaction

Ijara can take a form of operating or full-payout financial lease. In operating lease bank or financial institution receives back subject of lease when lease is terminated. In the full-payout lease subject of lease eventually becomes a property of lessee once cost of the property or equipment is fully covered[45]. Under both constructions of Ijara, bank has the option to appoint a customer as an agent, in case when bank does not want to deal with vendor, but here must be noted that customer will only start paying a rent for the equipment and takes on other responsibilities as lessee, once equipment is delivered[46]. Even when ijara agreement is structured as operating lease it is still possible that customer will eventually become an owner of equipment. Usually this is the case when lease contract deals with specific equipment

[44] S. Al-Harran, " Musharakah Financing Model ", 2003, available at: http://www.islamic-world.net/economics/musharakah.htm, last visited November 12th 2007

[45] F. E. Vogel, S.L. Hayes, "Islamic Law and Finance: Religion, Risk and Return", Kluwer Law International, 1998, p.190

[46] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

which is difficult to sell when lease contract is terminated, then bank may simply gave an equipment to the lessee as a gift[47]. In this case, contract of the transfer of property as a gift will be drawn up separately because of prohibition of gharar. As to the full-payout lease, for example if bank leases computer equipment worth 4,000 USD to internet provider with annual amount of lease 800 USD for term of lease of 6 years and working like of equipment is 8 years, customer after termination of lease period buys equipment for depreciated value of equipment at the date of termination of lease agreement. However, lease agreement may also provide for such an option when customer can purchase a property before the termination of lease period[48].

c) Ijara wa-iqtina and co-ijara

Islamic also provides special kind of ijara contract which ends up with purchase of the equipment, so called Ijara wa-iqtina. Under this contract, lessee pays the established amount of lease and additionally sum which is designated to buy equipment. With increase of sum designated to buy equipment amount of rent decreases and client gradually becomes an owner of the equipment[49]. Co-ijara is relatively new innovation designed to such types of ijara transactions that involves a very significant amount of capital. If financial institution lacks recourses to purchase equipment for the purposes of lease agreement, then it can form partnership with other financial institutions which would provide their share of capital to purchase equipment. Such partnership is formed on the basis of mudaraba or musharaka agreement and is usually called master ijara agreement. Rent paid by lessee is distributed among co-lesser according to their shares in the lease equipment. Additionally, financial institution which is lead-lesser can charge fee for management from other co-lessors. Fee is deduced from rent before distribution[50].

[47] Ibid
[48] F. E. Vogel, S.L. Hayes, "Islamic Law and Finance: Religion, Risk and Return", Kluwer Law International, 1998, p.190
[49] Ibid , p. 144
[50] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

d) Risk of Damage and Termination of Contract

Major distinction of ijara from conventional lease is that lesser bears a certain degree of risk connected to the ownership of subject of lease. It is not to say that lessee is not liable for damages, lessee will be held liable for damages occurred during usage of equipment. At the same time, lesser may insure equipment and include price of insurance in the rent[51]. In order to be Shari'a compliant transaction has to involve certain level of risk factor therefore lesser cannot delegate all risks to the lessee.

2.5 Sukuk

a) General Concept of Sukuk

Sukuk is most popular recent development on market of Islamic financial products. Sukuk are asset-backed securities that follow Islamic rules on financial transaction and comply with Shari'a prohibitions[52]. Sukuk may be formed directly this type of sukuk is called Islamic bonds or through securitization of assets. Islamic bonds are not based on concrete assets, they are issued and only after funds are raised, these funds are invested in specific projects; income is later distributed to holders of bonds. As to asset securitization, it starts with identification of assets of the company that needs to raise funds through securitization[53]. Sukuk are structured as debt securities, with predetermined return based most frequently on Ijara transactions but sometimes used with other types of Islamic financial transactions as well (for example sukuk al-murabaha, sukuk al-salam). Sukuk based on asset securitization is structured as equity

[51] F. E. Vogel, S.L. Hayes, "Islamic Law and Finance: Religion, Risk and Return", Kluwer Law International, 1998, p.144
[52] A.H. Abdel-Khaleq, "New Horizons for Securities: Emerging Trends in Sukuk Offerings", Chicago Journal of International Law, 2007
[53] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

securities[54], with application of mudaraba and musharaka transactions; hence they work on profit and loss sharing system[55].

b) Securitization of Assets

Sukuk may be created through asset securitization. First company identifies assets in its possession that are capable to generate income. Then special purpose vehicle (SPV) is created as mudaraba partnership and assets are sold from company to SPV. SPV issues securities against assets that were transferred from company. Assets are sold to investors and SPV pays their price to the company. Company buys assets back on deferred payment; SPV pays back the investors and takes percentage of paid amount for the services that it conducted as a mudarib[56]. Asset securitization is rather rarely conducted transaction because so far it was impossible to obtain ratings on Islamic financial products from authoritative international companies[57]. Therefore, it is difficult evaluate assets and identify their possible income, which makes it difficult to conduct securitization.

c) Debt Structured Securities

Sukuk are most commonly structured as debt securities and ijara is the most suitable from Shari'a standpoint, type of transaction to issue these bonds. Hence, if company needs to create funds for specific investments, it raises funds through SPV (Mudaraba), funds raised are invested into ijara transaction and only as next step SPV issues assets that are leased to the company. Rentals obtained by SPV from company are later distributed to the holders of debt securities[58]. Important advantage of debt securities, structured under Ijara transaction,

[54] Structure used in the article of M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[55] R. Klarmann, "Construction and Lease Financing in Islamic Project Finance", Journal of International Banking Law and Regulation, 2004

[56] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[57] M.J.T. McMillen, "Contractual Enforceability Issues: Sukuk and Capital Markets Development", Chicago Journal of International Law, Winter 2007

[58] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

otherwise called sukuk al-ijara, is that they have liquidity on secondary market[59].The other important issue is certain level of profit predictability. Once ijara rental are fixed, it is possible to ascertain the profit of sukuk al-ijara.

d) Sukuk- Recent Developments

First sukuk were issued by governments of Islamic countries, today the sukuk market is dominated by corporate sukuk. Malaysia is one of the leaders in sukuk market. In 2002 Malaysian government issued trust certificates worth 600 million USD, which were due in 2007. Sukuk were issued to develop land parcels and raise funds for construction[60]. It is much more problematic for sukuk to establish in non-Islamic jurisdiction, there should be high level of involvement of governmental organizations and government sponsored entities to prepare appropriate legislative framework. For example in US, government sponsored entities such as Freddie Mac (the Federal Home Loan Mortgage Association), Fannie Mae (the Federal National Market Association) and Sallie Mae (the Student Loan Market Association) took an active part in development of secondary market, which fostered development of adequate regulatory frameworks[61]. As to corporate sukuk, in 2006 Dubai Ports World announced offering of 3.5 billion sukuk, in the same year Malaysian company Jimah Energy Venture announced offering of 1.27 billion sukuk[62]. Taking into consideration that sukuk is very recent invention it has reached incredible level of development. Some market researchers estimate that today demand on sukuk already exceeded supply. It can be said that sukuk is most popular Islamic financial product which has already concurred Western Market.

2.6. Takaful

[59] R. Klarmann, "Construction and Lease Financing in Islamic Project Finance", Journal of International Banking Law and Regulation, 2004

[60] A.A.Tariq , " Managing Financial Risks of Sukuk Structures", dissertation submitted in partial fulfillment of the requirements for the degree of Masters of Science at Loughborough University, UK, 2004, available at: http://www.sbp.org.pk/departments/ibd/sukuk-risks.pdf, last visited November 17th 2007

[61] A.H. Abdel-Khaleq, "New Horizons for Securities: Emerging Trends in Sukuk Offerings", Chicago Journal of International Law, 2007

[62] Ibid

a) General Concept of Takaful

Takaful is insurance scheme based on Shari'a and involves trust and cooperation of parties united by common interest and financial recourses. Takaful scheme consists of owners of insurance, so called policyholders and takaful operator which manages insurance business on behalf of policyholders. Policyholders are group of participants, who contribute certain amount of capital to fund managed by takaful operator which serves as security in case of damages carried by policyholders. Takaful operators get paid for services either by receiving shares from returns of fund either by receiving agency fee[63]. The main task of takaful operator is to organize insurance scheme, to make sure that all participants pay their share of contribution to the fund and that they receive compensation in case of damages. The major difficulty in the organization of the takaful scheme would be accuracy of information on every takaful contract. To eliminate gharar it is necessary that all information is gathered and risks are reduced to minimum level[64]. Consequently the main differences between takaful and traditional insurance may be summed up as follows: takaful is based on Shari'a and laws that govern takaful transactions have to be compliant with Shari'a principles and prohibitions, funds created for the purposes of takaful have to be invested in Shari'a compliant transactions and finally takaful is not aimed to generate profit, it is rather created as protective mechanism, though there is still an element of profit, but it is made not out of insurance schemes but out of investments.

b) Types of Takaful Transactions

Takaful transaction can be divided into two models, the one that does not generate profit and the other that presupposes making profit from takaful transactions. Takaful model that does not bring any surplus in form of profit is called tabarru. According to this model policyholders make contribution to the special fund which is usually managed by policyholders themselves. Contributions to the fund have form of donations and basically policyholders loose their rights

[63] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[64] V.M. Arefeev, "Takaful and Re-Takaful", 2006, available at: http://www.rv.oslo.ru/adm/181/takaful.pdf, last visited November 16th 2007

towards these contributions. They are only used to compensate damages envisaged in agreement between parties of transaction[65].

The other takaful model which is designed in a manner to generate profit can be structured as mudaraba or wakala takaful. As in traditional mudaraba transaction so in takaful based on mudaraba one party provides capital and other party manages this capital. According to this structure of takaful, policyholders are capital provides, they organize special funds, shareholder's fund separate from policyholder's fund and takaful operator is mudarib (manager of capital). Policyholder's fund is used for takaful operations, costs that are related to operating of this fund are charged from shareholder's fund. Profits and losses are calculated respectively to the funds. Profit earned from policyholder's is shared on a basis of preliminary agreement between policyholders and takaful operators as it is done in mudaraba transactions, losses are charged from policyholder's fund[66]. If any of the policyholders already received compensation for damages envisaged by insurances he usually losses his share in a profit from takaful operations. Profit is mostly calculated at the end of takaful contract period[67].

In takaful transaction based on wakala structure, takaful operator is not a partner but just the agent of policyholders. As in case of takaful based on mudaraba model two separate funds are kept, shareholder's and policyholder's fund. However, in this case all expenditures are carried on by policyholder's fund, as takaful operator here acts only as an agent. Profit is shared only between policyholders; takaful operator receives either specified amount or percentage of gross profit[68]. In general, basic difference between mudaraba and wakala based model of takaful is that in case of wakala model takaful operator is not responsible for losses and does not have right to claim share in profit from conducted financial operations.

c) Re-takaful

[65] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.181

[66] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

[67] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.183

[68] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

Re-takaful is Islamic equivalent of reinsurance. In situation when takaful operators lack sufficient resources to manage increasing load of takaful operations, they refer to reinsurance. Under re-takaful arrangements, takaful companies delegate part of their transactions to reinsurance companies[69]. Additionally, enrolment of re-takaful companies helps to develop and spread takaful business.

3. Contemporary Problems with Islamic Financial Products

Despite the rapid growth of Islamic finances in last decade there are still number of problems related to application of Islamic financial models in practice. Some of these problems are related to the practice of Islamic financing in non-Islamic jurisdiction and with lack of sufficient information over Islamic financial products or issues related to adjustments of system to the new type of financing. However, it is not to say that Islamic financial products in Islamic countries do not face difficulties, it is often deficiency of the system, lack of consensus over certain key issues among Islamic scholars or just minor temporary questions that always rise on a way of forming of a new financial market.

In this chapter I gave an overview of Islamic financial products and Islamic prohibitions that are applicable to every financial transaction. In this section I will point out what are the problems relevant to each type of financial transaction and their practice. I will discuss the problems as they are seen by modern scholars and faced by Islamic financial products practically in all countries around the world.

3.1 Mudaraba

[69] V.M. Arefeev, "Takaful and Re-Takaful", 2006, available at: http://www.rv.oslo.ru/adm/181/takaful.pdf, last visited November 16th 2007

There are two major problems with mudaraba transaction and both are related to the current practice of Islamic banks.

a) Rewards on Saving Accounts

Saving Accounts structured under mudaraba contracts, when bank acts as mudarib are rather controversial from Shari'a standpoint. Practically customer can withdraw or otherwise dispose his deposit at any time he wishes, this provision does not fit into frameworks established by mudaraba transaction concerning termination of mudaraba agreement. However, here I would concentrate on other problem with saving deposits. In conditions of growing competition on financial market banks designed a new method of attracting customers to open saving deposits. The method is such that bank promises certain advantages to the customers who holds saving deposits in its banking units. Advantages can be in form of gift, monetary reward etc. So far these advantages had rather unsteady character, hence did not invoke much attention. The situation has changed since banks started to offer advantages guaranteed by contract. For example HSBC started to guarantee advantages to the holder's of saving accounts such as: free HSBC's MasterMoney debit card, no monthly maintenance fee, no ATM fees, free internet banking, no issuance fee for money orders, official checks and travelers cheques[70]. This practice evidently contradicts Islamic prohibition of riba, donation is not any more charitable but is speculated by reward, that is bank gives awards for using customer's money.

b) Customer Protection

In mudaraba transactions, both parties are exposed to profit and losses. The issue deserves special attention when it comes to bank deposits. What usually makes banks attractive for the customer is security of deposits and guaranteed interest. When it comes to Islamic banks these two elements do not exist. To earn a profit from deposit under mudaraba transaction customer is exposed to risks of loss. Although, today there is no risk of losing deposit under current

[70] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

legal protection and insurance schemes, customer still faces some risks such as for example depreciation of value of deposit.

As we can see from above, problems concerning mudaraba transactions have roots in Islamic prohibition of interest. What makes first problem different from the second is that it emerged from modern practice of Islamic banks, hence is more luckily to be solved simple by legislative arrangements on a state level. Situation is different with customer protection rules, where despite all the possible legislative efforts it would remain islamically impermissible to eliminate risk factor from mudaraba transaction.

3.2 Musharaka, Murabaha, and Ijara

I decided to combine problematic aspects concerning musharaka, murabaha and ijara transactions. As these three transactions have one major common problem. That is not to say that circle of possible difficulties with their functioning is restricted to one or two area. For example murabaha and ijara transaction have another common problem, concerning enforceability of promise to buy which was discussed in previous section. However, it is not the task of this thesis to explore more of them. Moreover, in the next chapter of the thesis some other issues concerning application of musharaka and murabaha transactions will be discussed in a light of relevant jurisdictions.

a) Delay in Deferred Payment

Musharaka, murabaha and ijara transactions have an option of deferred payment of installments. Therefore, problem with sanctions for delay in deferred payment is common for all of them. Shari'a basically envisages two types of sanctions. First sanction applicable to all transactions is creation of charity fund, payments are made to this fund as a penalty for delay in deferred payments, and the other sanction is relevant to murabaha contracts when financial institution can ask for instant payment of the whole sum. On the one hand legislation may

create additional safeguards by creating more severe penalties; this could serve as solution to the problem of sanctions in Islamic jurisdiction since penalties would be Shari'a compliant. On the other hand the issue is more problematic in non-Islamic jurisdiction where courts and legislators are not familiar with Koranic rules, hence creating additional penalties would create additional problem of their compliance with Shari'a. According to Islamic law, if debtor is in difficulty to repay the he should be given more time, moreover, creditor is even encouraged to remit the debt as charity[71]. Therefore, as we could see Shari'a envisages very soft sanctions and it is often the case in non-Islamic countries where existing sanctions for delay in deferred payments are more severe then those established by Shari'a or what's worse contain elements of riba such as paying interest as penalty.

b) Estimation of Profit

Problem of estimation of profit margin in murabaha transactions polarized opinion of Islamic scholars. Profit in murabaha transaction is usually determined by using LIBOR system on a basis of current interest rate[72].Determination of profit on basis of interest rate is rather controversial from Shari'a standpoint but in absence of ratings of Islamic financial products this is the best possible solution taking into consideration gharar prohibition of uncertainty. So far, this form of profit determination has not been prohibited as far as other aspects of murabaha transactions remain Shari'a compliant.

c) Responsibilities of Lesser

Number of issues concerning Ijara transaction can be identified as problematic. In previous section I already mentioned problem with operating structure of Ijara concerning absence of secondary market for specific types of equipment. Another problem with binding nature of promise when ijara is structured as full-pay out lease have also been referred to in murabaha transactions, since this is common problem of both transactions. Finally, what I would like to indicate here is the problem of responsibility of lesser. According to standards established by

[71] C.G. Weeramanty, "Islamic Jurisprudence in International Perspective", Saruadany, Visha Lekha 1999, p.67

[72] M.T. Usmani, "Murabahah", an online publication by: accountancy.com.pk, , available at: http://www.accountancy.com.pk/docs/islam_murabahah.pdf, last visited November 12th 2007

Shari'a for ijara contract, lesser is responsible for all repairs. Lesser should also undertake costs of repair which cannot be imposed on lessee as in this case the amount of rent increased by this costs would be difficult to determine, hence this would amount to gharar. The logic behind this clause is such that since lesser is the owner of the property then repair would benefit him[73]. In non-Islamic jurisdictions, there are however different rules concerning responsibility of lesser. Namely, lessee not the lesser has duty to undertake repairs. Therefore, in the countries where Shari'a is not the governing law, serious problems with clash of Shari'a rules and legislative norms of county may arise.

3.3 Sukuk

There are many problems streaming from specific structures of sukuk, however I am not going to discuss all of them. Since in previous section I have already mentioned one of the problems namely absence of authoritative rating of Islamic financial products. Now I will rather turn to the general problem that was caused by growth of sukuk market and its spread to non-Islamic jurisdictions.

a) Enforceability of Sukuk in Non-Islamic Legal Systems

Today enforceability of sukuk in non-Islamic jurisdiction is major issue of concern. In order for sukuk to be enforceable in non-Islamic jurisdictions it has not be in compliance with secular laws of the state. In case of sukuk it is not just one aspect of legal system but many legal disciplines, such as tax laws, bankruptcy laws, and laws on sales and so on. Additionally, secular courts are not prepared to handle disputes concerning sukuk or rather concerning application of Shari'a principles[74].

[73] F. E. Vogel, S.L. Hayes, "Islamic Law and Finance: Religion, Risk and Return", Kluwer Law International, 1998, p.144

[74] M.J.T. McMillen, "Contractual Enforceability Issues: Sukuk and Capital Markets Development", Chicago Journal of International Law, Winter 2007

3.4 Takaful

Islamic insurance is one of the most popular Islamic financial products. There are many differences between takaful and conventional insurance schemes but this is not the major cause of problems that emerged on way of development of takaful based insurance. Discussion about difficulties with takaful schemes will be continued in next chapter; here I would like to stress one major problem of Islamic insurance that is relevant for all jurisdictions, though in different degree.

a) Re-takaful

Fast growing demand for takaful based insurance, creates the situation when it is necessary to develop reinsurance schemes. Re-takaful is designed to reduce workload of takaful operators, through delegation of part of takaful operations to reinsurance operators. The main requirement to takaful operators is that they should invest funds in Shari'a compliant transactions, to comply with this requirement there should be enough Shari'a compliant financial products available on financial market. Today this issue is practically settled, especially in Islamic countries however there is a problem of small number of re-takaful operators[75]. Consequently, takaful companies are forced to cooperate with conventional insurance companies. This practically means absence of effective control over funds managed by conventional reinsurance companies; hence these funds may not always be invested in Shari'a compliant transactions.

In this section, it tried to sum up and underline problems concerning Islamic financial transactions. Here I must note that summary of the problems is not in any way exhaustive. It is rather small list of major issues that emerged on way of development of Islamic banking and financial products in Islamic and non-Islamic jurisdictions. In next section I will show

[75] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

how Islamic banking and Islamic financial products work in UK, US and Malaysia. This will provide a clear picture of application of Islamic finances in practice.

CHAPTER II – DEVELOPMENT OF ISLAMIC BANKING AND ISLAMIC FINANCIAL PRODUCTS

1. Islamic Banking and Islamic Financial Products in Common Law Countries

1.1 United Kingdom

Today, in the age of globalization, it is difficult to reconcile traditional Islamic methods and prohibitions of conducting financial activities with demands of Western financial market. Many obstacles are on the way of integration of Islamic banks in the countries where Shari'a is not majority religion and legal system is not dominated by the rules of Islamic law. To incorporate Islamic bank into national financial system state must be willing to provide smart policy and certain degree of accommodation on legislative level. Many European countries faced problems on way of incorporation of Islamic banks and Shari'a based financial transaction but in spite of all difficulties there is a very strong demand for Shari'a compliant financial products. Many factors contributed to the increased demand for Islamic financial products. Among those factors are growth of Islamic population in Europe and it's willingness to apply Koranic rules to financial activities, many Islamic countries, have rich supplies of oil and huge influx of money from its export, these money became a very attractive for Western World and Western financial institutions started to seek possible solutions how to attract this investments, additionally as market researches showed, Shari'a based products are cost effective and economically competitive to the traditional financial products offered by Western Banks. Currently most successful European country to incorporate Islamic banking and financial transactions is United Kingdom. This section will examine present situation concerning Islamic banks and Shari'a compliant financial products in UK.

a) Islamic banks and financial products operating in UK

London is a western standpoint of Shari'a compliant financial products offered by Islamic banks as well as traditional banks and financial institutions. In 2004 Islamic Bank of Britain started operating; it was first fully Shari'a compliant bank that was set up in Europe, the bank was designed to serve Islamic population in Europe[76]. Before incorporation of Islamic Bank of Britain, other Islamic banks in UK were operating as branches of banks of foreign countries. Such bank was United Bank of Kuwait which had branch in UK to provide financial services for Muslim population in UK, called Islamic Investment Banking Unit. However, Islamic Banks are not the sole financial institutions that can provide Shari'a compliant transactions. Many UK based big financial corporation such as Barclays Bank, Lloyds TSB started to offer specific types of operations, like Islamic mortgages specially tailored to Muslim customers, in 2006 market reached the value of 950 million USD. In 2006 Lloyds TSB announced that: "It would be offering Islamic financial services in all its branches in the UK. From today, Britain's two million Muslims will have access to current accounts and mortgages which comply with Islamic law (sharia), in every one of the Bank's 2000 branches"[77]. HSBC British large financial corporation started to offer Islamic financial product through its worldwide spread branches. Islamic retail products offered by HSBC are not mainly oriented to Muslim residents of UK, introduction of these products was oriented to establish in the Arab World and take share from Malaysian financial market. Some of these instructions started to operate its branches in Muslim countries, for example "HSBC Holdings, already have an Islamic finance unit and extensive experience through its global operations, HSBC has significant presence in many Muslim countries including Malaysia, Pakistan and Bangladesh … HSBC Holdings also owns a minority stake in the Saudi British Bank that has eighty branches in the Kingdom. These financial networks give the bank

[76] K. Balz, "Islamic finance for European Muslims: The diversity management of Shari'ah-compliant transactions", Chicago Journal of International Law, Winter 2007

[77] N. Raphaeli, " Islamic Banking – A Fast-Growing Industry" , "Memory" the Middle East Media Research Institute, Inquiry and Analysis Series – No. 297, 2006

unparalleled business knowledge of different Muslim societies"[78]. Many Shari'a financial institutions are managed from London and have headquarters there. For example DI (Dar Al Istithmar), is a join venture , which was created by Russell Wood, Oxford Islamic Finance and Deutsche Bank and operates independently from this companies, was incorporated in UK and has headquarters in London[79].

b) Incorporation and regulation of Islamic banks

Operation of Islamic banks in UK as in any other non-Islamic legal systems has many problematic aspects that are being solved with common efforts of British government, legal authorities and courts. First of all Islamic banks have to comply with Islamic law, otherwise they will loose credibility in the eyes of potential customers, secondly in order to operate in certain jurisdiction outside Islamic jurisdiction they have to comply with rules and legislation of this jurisdiction, therefore problem of conflict of laws may arise. Finally beside purely legal issues, financial aspects of operation of banks remain, they must be economically viable. In order to operate in the territory of UK, Islamic bank has to satisfy requirements stated by Financial Service Authority (FSA). Financial Service Authority is an independent body, accountable to Parliament through Treasury Ministers and regulates financial services and institutions in UK. Before creation of FSA different state and independent bodies were regulating different fields of financial activities, from 2001 FSA stands as a single regulator that makes it easier and customer friendly to manage whole range of financial activities. Powers given to FSA includes regulation of Islamic banks and financial services, annual reports published by FSA portrait Islamic financial activities in UK, including contemporary problems and legislative changes to solve these problems. Some of the requirements to obtain authorisation are: "bank should have its headquarters and locations clearly designed, along with its representatives. Moreover, bank must have adequate resources and liquidity to

[78] K. Balz, "Islamic finance for European Muslims: The diversity management of Shari'ah-compliant transactions", Chicago Journal of International Law, Winter 2007

[79] Dar Al Istithmar official web site, available at: http://www.daralistithmar.com/, Last visited September 21st 2007

finance its operations. And finally, it must have sound operational systems and management to supervise all forms of the transactions by which the bank fulfils its objectives"[80]. To draw a clear picture of current situation of Islamic banks and financial institutions we will trace FSA reports and review speeches of FSA authorities starting from 2002 and ending with last speech in June 2006.

In September 2002, Howard Davis chairman of FSA made a speech on seminar on Islamic Finance. From the points and remarks he made during his speech, we can draw a picture of situation of Islamic banks and finances in UK at that time.

In 2002, purely Islamic bank was not yet established. He defined incorporation of fully Shari'a compliant Islamic bank as one of the objectives. At the same time he stressed the danger of money laundering, and added that institution should be protected from people who want to use them for money laundering purposes.

Chairman addressed the issue of authorization of Islamic banks, he pointed out that they should be treated on equal basis with other banks, and no standards of authorization can be lowered. He said that "if it was to be successful, an Islamic bank would need a reputation for capital soundness and proven management, it would in any but the very shortest term be entirely counterproductive to authorize a bank on a different basis from that which we apply to conventional institutions"[81].

The issue of special importance was to clearly define, the types of products that are going to be offered by banks. It is essential that potential customers are aware of the risks and benefits they are undertaking. Double stamp duty was defined as a main problem on a way of development of Islamic retail products.

[80] F. Atbani, " Islamic legal authorities for Islamic banking system: The authorization of Shariah compliant banks in the UK", Company Lawyer, 2006

[81] M. Foot "The Future of Islamic Banking in Europe", speech at Second International Islamic Finance Conference , available at : http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/SP150.shtml, last visited July 4th 2007

Speech made by Michael Foot, FSA managing director at Second International Islamic Conference in Dubai, September 2003.

Firs of all he stressed significance of potential customers to be fully aware of types of transactions they are offered. It is especially important because EU Directives require customer and investors protection. Disclosure of transactions was called to be safeguard from potential misuse of Banks from money laundering purposes.

Managing director indicated that is not up to FSA to check and supervise compliance of banks with Shari'a, it is responsibility of banks themselves.

Double stamp duty was again named as a main problem but this time government was called to take effective measures to resolve the problem, since there was a very strong demand on Islamic mortgages.

Speech of Chairman of FSA, Callum Mc'Carthy, at Muslim Council of Britain Islamic Finance and Trade Conference in June 2006. In 2006 first fully Shari'a compliant Islamic Bank was established and double stamp duty was abolished, it can be said that significant steps forward were already undertaken.

In his speech, chairman already spoke of UK as a "global gateway of Islamic finance"[82], offered by Islamic and non Islamic banks. He distinguished social and economic reasons for introduction of regulatory framework over Islamic transactions. As a social reason he named a number of Muslim residents of UK at the same time, speaker stressed financial capacity of Muslim residents of UK. The issue of customer protection and their awareness about risks and befits of Islamic retail products was used as a justification to introduce strong regulatory framework on transparency of transactions. Principles of transparency were rather used as a pretext to gain confidence of potential customers

[82] C. McCarthy "Regulation and Islamic Finance" speech at Islamic Finance and Trade Conference , 2006 available at : http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml , last visited July 4th 2007

For the first time it was mentioned that Muslims are to be provided with possibility to conduct their financial activities in accordance with their religious believes and convictions. Second economic reason was growth of Islamic financial market. If London was to defend its international character it was essential to accommodate full range of Islamic financial transactions.

c) Court's Decisions

As to the regulations of operation of Islamic Banks, they operate according to common law principles. Islamic banks are not completely independent because in case of disputes they might be subjected to English courts.

First case brought to English courts concerning Islamic finance was in 2002, dispute between Islamic Investments Company of the Gulf (Bahamas) Ltd. ("IICG") v Symphony Gems N.V. & Others. IICG in 2000 entered in murabaha agreement with Symphony. Contracting sides agreed that contract would be based on rules of Shari'a but they choose English law as governing law and subjected dispute to English courts. According to agreement IICG had to buy from "Precious" large quantity of diamonds and sell them afterwards to Symphony. IICG made payment to "Precious" before it received payment from Symphony, when "Precious" failed to deliver diamonds, Symphony refused to pay to IICG claiming that goods were not delivered. Symphony argued that "some parts of the transaction took place under the laws of the Kingdom of Saudi Arabia where the Contract would be prohibited and finally putting forth an argument of ultra virus according to the laws of Bahamas where IICG has been chartered"[83]. English Court rejected the arguments of Symphony and stated that delivery was caused by the failure from the side of claimant to make proper arrangements, as to the part of the dial that had reference to Saudi Arabia was so insignificant that it could not invoke invalidate contract and finally ultra virus argument was also rejected.

[83] S. Messmann, "Islamic Banking and Finance- Transplantable Models from Malaysia to the EU?"

In 2004 English court decided another dispute concerning murabaha agreement, between Beximco and Shamil Bank. The contract stated that it was subjected to Shari'a and governed by English law. Beximco claimed that in reality contract was hidden loan with interest and since contract had to be governed according to both Shari'a and English law, it was invalid under Shari'a and he was not obliged to pay. London High Court decided that according to Rome Convention, English law is the only applicable law in present case. Furthermore court went on to say that religious principles cannot influence that validity of contracts governed by established legal system and that such norms can only be applicable if they do not contradict norms stated by established legal system[84].

d) Arbitration

The other option would be to refer disputes to the arbitration. According to the rules of arbitration, parties can decide upon the law that will be applicable to the disputes, therefore Shari'a can be applied to disputes that will end up in the arbitration. The major problem with arbitration disputes is that not all of them can be referred to arbitration tribunals, additionally costumer protection laws do not allow to make arbitration mandatory applicable to disputes concerning Shari'a. Moreover, arbitration judges, as well as other judges are not experienced and usually lack sufficient knowledge on Islamic law. Recent trends show that more and more disputes, involving Shari'a are referred to the arbitration.

Above mentioned cases clearly show the difficulties that English courts as well as any courts of other European countries could face when they had to deal with Islamic law, especially when conflict of laws takes place. It is also highly problematic for secular court to decide dispute that involves religious doctrines. Moreover, as English court observed, Islamic law is not precisely determined, since there is no consensus among Islamic scholars and there is no highest authority within Islam to determine numerous issue rising within Islamic law and religion. Interesting aspect of courts approach is that despite all problematic aspects of

[84] A. Junius, " Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law Under German Conflict of Laws Principles", Chicago Journal of International Law, 2007

deciding disputes involving Islamic law, court opened the possibility for Islamic law together with national norms to be applicable to the contracts. English Courts stated that: "it would generally uphold agreements in which religious Islamic parties are participants so long as the agreements can be reconciled with English law"[85].

e) Consumer Protection

Muslim living in UK and seeking to have Shari'a compliant financial transaction has several options. First is offered by Ansar Finance, so called communal option. For example if person, wants to buy a car, he joins the association and makes certain amount of contribution to this association. After established period of time, he can take interest free loan. Problem with this solution is that it is suitable for small and carefully designed communities. On the other hand the advantage of this model is that it preserves "the social idea of Islamic banking, where "cooperative" and "communal" element plays and important role"[86]. Another option is costumer credit so called "tawarruq" offered by Islamic Bank of Britain. Bank makes the trade in commodities in a name of his client; the client receives funds which he disposes according to his will.

One of the major issues with costumer protection is that Islamic banks and financial products are not oriented to Muslim population residing in UK. We can bring an example of HSBC Corporation which operates in many Islamic countries but does not offer wide range of Islamic financial products to UK Muslim population. There were attempts to justify reluctance of HSBC towards Muslim community. Among the reasons named was that many Muslims residing in UK were already using conventional banking and number of Muslims willing to participate in Shari'a based transaction was called "trivial and therefore not worth the trouble"[87]. The survey conduced by Loughborough University in 1997 can be used to

[85] A. Junius, " Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law Under German Conflict of Laws Principles", Chicago Journal of International Law, 2007

[86] K. Balz, "Islamic finance for European Muslims: The diversity management of Shari'ah-compliant transactions", Chicago Journal of International Law, Winter 2007

[87] A. Thomas, "Methods of Islamic Home Finance in the United States", The American Journal of Islamic Finance, 2001, available at:

confirm this statement. Survey showed that 66% of questioned Muslims did not take a loan, but only 23% said that they did not take a loan due to negative attitude towards paying interest and finally 33% said that they did not objected against paying an interest or they had already paid an interest. On the other hand 45% of question refused to give explanation why they would refuse to take a loan and 24% said that they did not need a loan[88].

Putting aside the fact of viability of providing Shari'a compliant financial products, we can reach the legal question of protection of rights of Muslims as consumers. 23% of Muslim residents of UK, who would not use conventional banking because of unwillingness to pay an interest, are about 400.000 people, hence too significant number not to be considered. Certainly, Muslims as any other residents of UK should be allowed to conduct Islamic based financial products in case they would resent using options offered by conventional banks.

f) Taxes

The other transaction is based on murabaha contract, where bank makes purchase on behalf of the client and resells it afterwards to the client. Usually this kind of transaction involves a transfer of property from seller to bank and then from bank to client. Problem with murabaha transaction is that bank actually becomes an owner of the property, it has to pay taxes, and plus when property is resold to the client, client also has to pay taxes; therefore here we have double taxation. Additional problem with this transaction is the responsibility for the defects of the property, usually banks are unwilling to take the risk for the defect, on the other hand consumer do not have right of direct claim to the seller. These problems do not appear when we deal with tawarruq transaction, because bank does not acquire ownership on the subject of the contract and also it is much easier to calculate financial aspects of the transaction. The problem with tawarruq is that, it is not recognized by all Islamic scholars as fully Shari'a compliant, since it does not involve any risk for the financial institution, only profit.

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http://www.failaka.com/Library/Articles/Methods%20of%20Islamic%20Home%20Finance%20-%20AST%202002.pdfm , last visited in November 3rd 2007

[88] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.118-119

As we could see from above given example, Islamic consumer in UK is offered wide range of possibilities to enter into Shari'a based financial transaction. However, considering peculiarities of each transaction, difficulties with conducting these transactions still remain. In the UK, government is trying to solve these problems and integrate Shari'a based transactions into British financial system. Financial Service Authority created a working croup which consisted of "regulators, Shari'a scholars, bankers, accountant, lawyers, and representatives of the Muslim communities"[89]. As a result in 2004, tax law was amended, to exclude selected provisions of Islamic financial transactions from double taxation. Exceptions, so far do not involve all Shari'a based transactions they are rather narrowly tailored to specific transaction, in order to abolish discrimination towards Islamic products and make them more competitive in British financial market.

g) Possible Solutions

Lately, London became the capital of Islamic finance and Islamic banking, outside the Islamic countries. Several factors contributed to achievement of this result. First of all majority of Muslim population of UK is originally from Pakistan, where Islamic religion is rigorously observed and most Koranic prohibitions and rules are applied to every day life including finances, therefore there is strong demand for the Shari'a compliant financial products. Importance of this factor can be seen on German example, where in spite of significant amount of Muslim population, most of whom are from Turkey, which is secular state and where Islam is not so strictly observed, there are no fully Shari'a compliant banks, practically no Shari'a based retail products are available and double-taxations is not yet abolished.

Secondly, English as official language of the country is second most important language of Islamic finances after Arabic, many articles, rules and opinions of scholars are available in English language. It is important to stress the need for education over types and methods of

[89] K. Balz, "Islamic finance for European Muslims: The diversity management of Shari'ah-compliant transactions", Chicago Journal of International Law, Winter 2007

operation of Islamic types of transactions. On the one hand potential consumers of Islamic financial products have to be aware of all risks and benefits. On the other hand to provide full development of Islamic financial products and make them work in non-Islamic jurisdiction, it is essential to have well trained professionals. Professional, who are not only familiar with functioning of Islamic banks and financial transactions but also with regulatory framework of UK. Education is also important when it comes to judiciary. Although, civil courts would not apply Shari'a principles to the disputes on Islamic finances and would not engage into interpretation of religious doctrines, when it comes to arbitration Shari'a can be selected as governing law. So far, not all cases concerning Islamic financial products can be referred to arbitration but it is important for judges to know concepts of Shari'a.

In 1991 Institute of Islamic Banking and Insurance was established in London. Institute has wide range of activities, it does research, publishes books and articles, offers degrees in Islamic Banking and insurance, serves as authority concerning questions about Islamic finances. What is more important, enrolment to studying programs does not discriminate on basis of gender, nationality or religion. Opening of the institute, gave raise to range of positive responses:

> "The Institute of Islamic Banking and Insurance has been instrumental in breaking down the barriers that previously existed between the UK based practitioners of Islamic finance during the early 1990s. This in turn has resulted in new levels of co-operation that have served to greatly expand the transaction flow and asset base of our marketplace."

Stella Cox pioneer in Islamic instruments in the UK 90

"I take this opportunity to congratulate the Institute on the excellent work achieved and to thank the IIBI for its contribution to the development of Islamic banking."

Mr. Abdou-El-Ilah Begaid portfolio management, Credit SuisseGeneva, Switzerland [91]

Although UK is regarded as Western capital of Islamic Banking and Finances, most of the Islamic retail products are still not available, additionally vast majority of available products

[90] Institute of Islamic Banking and Finance, available at: http://www.islamic-banking.com/institute/index.php ,last visited July 4th 2007

[91] Ibid

are not consumer oriented. One the one hand if we take Islamic insurance products such as Takaful, we may say that delay in its spreading in UK lies within the Muslim community itself. Since insurance involves certain amount of risk factor and risk is prohibited by Koran, it is difficult to develop insurance schemes. On the other hand even most popular Islamic retail product among Muslim community, which is also getting significant attention from non-Muslim clients are Islamic mortgages, still have many problematic aspects, practical, legislative and what's more important they are not designed in a fully Shari'a compliant way. For example in shared ownership scheme, where bank becomes an owner together with client, client can reside in a property at the same time paying rent to the bank, buying out the bank shares until he covers whole sum, however this transaction cannot be said to be fully Shari'a compliant because "lessee still need a load and is not in a position to sell or lease the property under the terms of such transaction"[92].

Consequently, despite abolishment of double stamp duty was significant step forward, further changes are needed. It is necessary to broaden a scope of application of abolishment of double stamp duty, to include all types of Islamic transactions which involve double transfer of property. Furthermore, it would be desirable to introduce comprehensive laws that would regulate relationship between banks and tenants in respect of risks of damage of the property, at the same time taking into consideration requirements of Shari'a.

1.2 United States

The United Stated is very interesting country from the standpoint of Islamic banking, not only because it is huge financial market but also because there has been numerous considerations with existence of Islamic financial institutions after terrorist attacks in 2001. After tragic events, whole existence of Islamic banking in US became questionable; Muslims and Islamic

[92]E. Lunn, "Pillars of Faith", 2004, available at: http://db.riskwaters.com/public/showPage.html?page=191085 , last visited July 19th 2007

institutions were closely monitored. It is interesting to see, how US government handle the situation and whether it was solved at all. I will try to picture what are main problems faced by Islamic financial institutions in US nowadays.

a) Problems of Islamic Banking and Islamic Financial Products in US

A major difficulty that Islamic Banking faces in US is that US is federal state. This means that Banks are subjected to federal and state regulations, no single regulator, complicated structure of incorporation and structure of financial institutions, lack of information on Islamic financial structures, lack of finances because there is no bank.

Unlike UK and Malaysia, there is no fully Shari'a compliant bank in US, however in 2005; University Bank declared that it had opened fully Shari'a compliant subsidiary[93].Islamic financial transactions are conducted by various kinds of financial institutions. There are many problematic aspects connected to the lack of established bank, as well as there are many problems on the way of establishment of Islamic bank.

To become a bank in its traditional meaning, Islamic bank needs to comply with difficult system of norms and regulations. US has dual banking system, which means that banks are subjected to federal and state laws. If financial institution that wishes to be established as a bank has to define whether it wants to be federal or state bank, it is necessary to determine applicable regulations and institutions which will supervise the establishment. US system distinguishes forms of banking institutions, whether it is formed as commercial banks, credit union or saving association, will be crucial to designate monitoring body and determine the range of permitted activities.

Beside the uniform requirements that apply to all forms of financial institutions such as structure of management, grounds to expect profitability and capital, there are specific requirements that depend on type of banking institution. Credit Unions have relative smaller

[93] K.J.Tasy, "Islamic Finance: A Growing Industry in the United States", North Carolina Banking Institute, 2006, available at: http://www.unc.edu/ncbank/Articles%20and%20Notes%20PDFs/Volume%2010/KimTacyPDF.pdf ,last visited July 23rd 2007

amount of permitted financial activities, these activities are basically restricted to consumer lending and noncommercial deposits. Credit Unions are regulated by National Credit Union Administration. Commercial Banks have wide scope of financial transactions and normally they are governed by both federal and state laws, therefore every financial activity that it wishes to conduct has to be in accordance with federal and state laws. As to the limits imposed on Credit Unions they cannot own a real-estate and enter into joint ventures. What distinguishes Saving Associations from Commercial Banks is that former can own a real estate for various financial activities, such as management and resale. Prime regulator of Saving Associations is the Director of the office of Thrift Supervision[94].

As we could see there is no single regulatory body of banking institutions in US. Charter and form of activities determine which state establishment will supervise establishment and activities of financial institution. To see how complicated is US regulatory system we can take an example of state bank, which is regulated by State Banking Commissioner but if it insured it might be also regulated by Federal Deposit Insurance Corporation. Important factor is whether banking institutions is established as Savings Association or Credit Union, because former is regulated by the Director of the Office of Thrift , whereas later is regulated by the National Credit Union Administration[95].

From above mention we can see why fully Shari'a compliant Islamic Bank has not yet been established in US. It is not correct to say that under current structure of US regulatory framework it is impossible to establish Islamic Bank or rather Islamic Financial Institution, it would be rather more appropriate to say that it is impossible to establish Financial Institution in one of the forms, either Credit Union, Commercial Bank or Saving Association that can offer all range Islamic Financial products. Although, many possible obstacles still remain there are Financial Institutions operating in US that offer different range of Shari'a compliant

[94] M.J. Taylor , "Islamic Banking- the Feasibility of Establishing an Islamic Bank in the United States", American Business Law Journal, 2003

[95] M.J. Taylor , "Islamic Banking- the Feasibility of Establishing an Islamic Bank in the United States", American Business Law Journal, 2003

financial products. In this section we will discuss what the possibilities are for Muslims living in United States to enter into Shari'a compliant financial transactions.

United State is huge market for Islamic Finances; there is significant amount of Muslim population from Africa and Arabic countries. Exact number of Muslims in US is not estimated because Census does not gather information on religious identity of population[96], however according surveys and polls approximate number is deduced to be around 6 millions. After terrorist attacks in 11/9/2002 there was significant influx of Islamic capital back to Arabic countries but according to survey conducted in 2004 about 300 million was generated in US and there were signs of future growth of these numbers[97]. Today there is very strong demand for Shari'a compliant retails products, especially for mortgages, since most of Islamic population in US has income above average, they want to invest money in housing, and at the same time they do not want to take traditional loans because of prohibition of riba. In 2002, Muslim population of Twin Cities reached 130.000, they did not have sufficient amount of money to buy houses and they requested mortgage scheme that would not contradict principles of Islam. Federal Reserve of Minneapolis together with US Department of Housing and Urban Development worked out alternative to traditional mortgages that would be in compliance with Shari'a[98].

b) Housing and Homeownership

Commercial Banks according to federal regulations are restricted to hold property, bank cannot buy a property on behalf of client and afterwards resell it to the client, bank actually only lends money but never acquires ownership, therefore bank does not share a risk (for example risk of damage) and that means that transaction is not compliant to Islamic Law.

[96] United States: Muslim Population Circa 2000 http://www.theislamproject.org/education/United_States.html , last visited July 23rd 2007

[97] SHAPE Financial Corp., http:// www.shapefinancial.com/aboutus.htm, read in the article of C. Wu, "Islamic Banking: Signs of Sustainable Growth" , Minnesota Journal of International Law, 2007 , last visited August 8th 2007

[98] C. Wu, "Islamic Banking: Signs of Sustainable Growth" , Minnesota Journal of International Law, 2007

Today there are number of financial schemes available to Muslim population, who wants to enter into Shari'a compliant mortgage transaction.

HSBC Mortgage Corporation based in New York, developed transactions based on murabaha contract. On a basis of HSBC Mortgage scheme, HSBC buys a property on behalf of a client and sells it to the client straight away, avoiding actual acquiring title of the property and paying taxes. Client pays back in a form of installment payments which amount to the initial purchase price and plus pays profit margin[99].

American Finance House-Lariba, based in California, conducted first Shari'a compliant mortgage in 1987[100], today Lariba operates in 25 states. In order to be Shari'a compliant, in interest-free transaction "the rate of return in based on rental value of the home you are trying to buy"[101]. According to model under which Lariba operates, client and Lariba sign joint lease-purchase agreement (Islamic model called ijara-wa-iqtina), they buy property together[102]. Both own a share in a purchased property, in series client makes payments every month until he becomes a full owner of property.

The Neighborhood Development Center started to operate in 1993. What distinguishes NDC from financial corporations is that it has a form of nonprofit community corporation offering wide range of services, including loans. The NDC offers murabaha financing schemes to Muslims and non-Muslim costumers, similar to HSBC murabaha contract and receive 10% profit margin[103].

As I noted earlier there is strong demand for Islamic mortgages, present situation is that demand exceeds supply. The main reason for lack of finances is that major capital provides for Islamic mortgages are not big banks but small financial corporations or community based

[99] N. Bennet, N. Foster, "Alternative Financing: Issues and Opportunities for Lenders and Interest-Averse populations" 2002, available at: http://minneapolisfed.org/pubs/cd/02-1/islamic.cfm , last visited July 23rd 2007
[100] C. Wu, "Islamic Banking: Signs of Sustainable Growth" , Minnesota Journal of International Law, 2007
[101] H. Lewis, " Borrowing is Still Possible when Interest Is Banned By Religious Law", op. cit, available at: http://www.bankrate.com/brm/news/mtg/20000714.asp ,last visited September 1st 2007
[102] N. Bennet, N. Foster, "Alternative Financing: Issues and Opportunities for Lenders and Interest-Averse populations" 2002, available at: http://minneapolisfed.org/pubs/cd/02-1/islamic.cfm , last visited July 23rd 2007
[103] N. Bennet, N. Foster, "Alternative Financing: Issues and Opportunities for Lenders and Interest-Averse populations" 2002, available at: http://minneapolisfed.org/pubs/cd/02-1/islamic.cfm , last visited July 23rd 2007

financial enterprises. In 2000, it was estimated that demand reached a level of billion USD but there is no company capable of providing even 10% of this amount[104]. In March 2001, Freddie Mac (the Federal Home Loan Mortgage Corporation), government-chartered financial company, which was established by Congress in 1970 to provide support for rental housing and homeownership[105] announced that they are going to invest in Islamic contracts; they started with buying contracts worth one million from Lariba[106]. In 2002, Freddie Mac and Fannie Mae[107] became two biggest Islamic financial products financing companies, the controlled about 90% of total market. More then 528 millions was invested in Islamic mortgages only by Freddie Mac[108]. Freddie Mac and Fannie Mae adopted special approach to handle with specific form of contracts established by US laws which did not comply with essence of Islamic mortgage transaction. Once clients sing standard contract, simultaneously they sign a contract designed by Lariba which replaces terminology related to installments, clients sign both agreements relying on reputation of Freddie Mac and Fannie Mae[109].

Perhaps the best solution developed by Fannie Mae and Freddie Mac was introduction of secured mortgages. In this case lessee process is structured into a note, owner of the property sell a note to Freddie Mac and afterwards holder of the property grants a mortgages in order to secure the note. Transaction is permissible under Shari'a prohibition of gharar because note represents an ownership of the property[110].

c) Taxes

[104] H. Lewis, "Borrowing is Still Possible when Interest is Banned by Religious Law", available at: http://www.bankrate.com/brm/news/mtg/20000714.asp, last visited September 1st 2007

[105] Official site of Freddie Mac, available at: http://www.freddiemac.com/news/archives/multifamily/2007/20070925_Campus_Apartments.html , last visited July 24th 2007

[106] S. Sachs, "Pursuing an American Dream While Following the Quran" , The New York Times on the Web, July 2001, http://www.islamfortoday.com/americandream.htm (Last visited July 23rd 2007)

[107] Shareholder-owned company, rechartered by Congress in 1968, funded with private capital raised from investors. Information available at http://www.fanniemae.com/aboutfm/index.jhtml?p=About+Fannie+Mae (Last visited July 24th 2007)

[108] C. Wu, "Islamic Banking: Signs of Sustainable Growth" , Minnesota Journal of International Law, 2007

[109] C. Wu, "Islamic Banking: Signs of Sustainable Growth" , Minnesota Journal of International Law, 2007

[110] A. Thomas, "Methods of Islamic Home Finance in the United States", The American Journal of Islamic Finance, 2001, available at: http://www.failaka.com/Library/Articles/Methods%20of%20Islamic%20Home%20Finance%20-%20AST%202002.pdf , last visited in November 3rd 2007

There are serious problems with tax issues arising from Islamic types of transactions which involve paying a rent or better to say lease agreements. Under such agreements, financial institution acquires a property and leases it to client according to deferred installment scheme. If transaction is to be fully Shari'a compliant then owner of the property, in this case financial institution must bear risks connected with maintenance and damage of the property. In this case it is in compliance with US tax code which says that the party that takes risk of the ownership can have tax benefits, including benefit from depreciation[111]. On the other hand, these types of transaction involve transfer of property twice. Once when financial institution acquires ownership from owner, and second time when client of financial institution pays a full price of the property through paying rents and becomes a full owner. Hence, we have here problem with double tax duty, similar problem that was faced in the UK. Additional problem in US is that these are mainly taxes regulated on state level and it would be difficult to create exceptions on a level of general federal regulatory framework[112].

d) Regulatory Framework

In April 2005, on Arab Bankers Association of North America Conference on Islamic Finance, executive Vice President of Federal Reserve Bank of New York, William L. Rutledge, made a speech. He raised the problematic aspects that are on a way of development of Islamic retail products in US market. From his speech we can see what was the situation and position of Shari'a compliant financial products in US. Rutledge characterizes, approach to Islamic financing as "ad hoc", namely specific problems are dealt with after they emerge. He stresses that US approach towards Islamic financial institutions is very flexible, with special concern on problems of each financial institution and this is the reason why Islamic banking experienced rapid growth last years. As an example he gave an interpretive letter

[111] J.H. Story, "Understanding Islamic Law and Shari'ah Compliant Real Estate Investment Practices in US", Sheppard Mullin Richter and Hampton LLP, 2003, available at: http://www.uslfg.com/oldnews.cfm?FuseAction=details&Users_ID=29, last visited in November 3rd 2007

[112] A. Thomas, "Methods of Islamic Home Finance in the United States", The American Journal of Islamic Finance, 2001, available at: http://www.failaka.com/Library/Articles/Methods%20of%20Islamic%20Home%20Finance%20-%20AST%202002.pdf , last visited in November 3rd 2007

drafted in 1999, by Office of the Comptroller of the Currency (OCC). The letter dealt with murabaha agreements and proposed to allow commercial banks to purchase assets and immediately resell it to clients because in this case both transaction will take place at the same time, bank acts as "riskless principal"[113].

Rutledge in his speech also drew attention to establishment and transparency issues. He said that Islamic banks should have the same licensing standards as other financial institutions, he pointed out that although they are not qualified to give opinions on compatibility of Islamic financial products with Islamic Law, it is important to be knowledgeable about these products to conduct effective supervision over institutions that are offering them. High licensing standards and effective supervision increases the credibility of Islamic financial institutions, they become more attractive to potential costumers, and this was the reason why special attention was drawn by the scholars and financial institutions themselves to provide more information on Islamic products, to maintain the equal standards of licensing with conventional financial institutions and support regulations requiring strict transparency. The case reached the level when bank regulators were lobbied by lenders "by pointing out that element of Islamic mortgages place the same, if not a higher, premium on disclosure and customer protection, which are the main principles of its laws"[114]. As we could see, element of transparency play an important role in state and financial institutions relationship, what's very important it desire and effort shared by both sides. US disclosure policy, regulated also by Truth in Lending Act is not too burdensome to comply with, however it has number of specific elements such as those concerning capital adequacies[115].

e) Sukuk

[113]Speech of W. L. Rutledge, Executive Vice President of Federal Reserve Bank of New York at Arab Banks Association of North America Conference on Islamic Finance: Players, Products & Innovations in New York City, April 2005, available on http://www.ny.frb.org/newsevents/speeches/2005/rut050422.html , last visited July 24th 2007

[114] C. Wu, "Islamic Banking: Signs of Sustainable Growth" , op. cit., Minnesota Journal of International Law, 2007

[115] Speech of W. L. Rutledge, Executive Vice President of Federal Reserve Bank of New York at Arab Banks Association of North America Conference on Islamic Finance: Players, Products & Innovations in New York City, April 2005, available on http://www.ny.frb.org/newsevents/speeches/2005/rut050422.html , last visited July 24th 2007

Remarkable progress on a way of development of Islamic financial products was made in 2006 by transaction worth 165.7 million sukuk backed by US oil and gas assets[116]. To truly appreciate meaning of this transaction it is important to know all difficulties that it had to overcome. On the one hand we have legality of transaction from the standpoint of Islamic law; on the other we have suitability of transaction in the frameworks of not Islamic legal system.

In a first place let's look at the transaction from viewpoint of compliance with Shari'a. Islamic scholars up to date did not reach consensus over compatibility of sukuk to Islamic prohibition of riba. Part of the scholars are of the opinion that once sukuk itself, is equivalent to money, the transaction can be amounted to the trade of money, the others say that if transaction is actual transfer of goods then it is permissible under Islamic Law. Additionally to riba requirements, company that issues sukuk has to abide to other Islamic prohibitions such as gharar and haram (prohibited types of activities, such as gambling, trade of alcohol etc.)

Second issue is compatibility of sukuk transaction with legal norms of the country where transaction takes place, especially when country is not Islamic. In respect of US laws, there is a requirement that every sale of security has to be register under United States Securities Act; additionally transaction has to meet tax, corporate and security law requirements[117]. Finally usually very problematic that often serves as a main point of disagreement between parties is choice of country where arbitration will take place in case of potential disputes of parties. To realize above mentioned sukuk transaction many specialists from Western and Islamic

[116] A.H. Abdel-Khaleq, R.F. Richardson "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings", Symposium: Islamic Business and Commercial Law , Chicago Journal of International Law, University of Chicago, 2007

[117] A.H. Abdel-Khaleq, R.F. Richardson "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings", Symposium: Islamic Business and Commercial Law , Chicago Journal of International Law, University of Chicago, 2007

countries were involved. Banks in London and Beirut prepared transaction with assistance of counsel in Dubai and Houston[118].

f) Possible Solutions

Islamic banks and financial institutions in US went through difficult path of development and this path is not yet over but finalization of sukuk transaction in 2006 was a real breakthrough. This transaction is a final proof that there is increasing demand on Islamic financial products in US. US system of licensing and supervision over financial institutions is very difficult and complex, net of state organs realizes different functions. Beside that, there are extra difficulties with a choice of form and place of registration of financial institution. So far, there is no such a form of financial institution that can be registered according to US standards that would allow providing all forms Islamic financial products, plus financial institutions is usually simultaneously subjected to federal and state laws and has to comply with all of them.

Taking into consideration that there is a significant growth of Muslim population together with their average income, it is not surprising that more and more Muslims are willing to purchase property. Truly faithful Muslim will not conduct transaction that is not in accordance with Islamic Law, this is the reason why Islamic mortgages became so claimed. Demand strongly exceeded supply, because Islamic mortgages were usually offered by small community based financial institutions and they lacked resources. Today problem with financing is almost settled, big financial giants appeared on market, though Freddie Mac and Fannie are not banks, they successfully realize Shari'a compliant mortgages. But what is most important is desire and active participation of government in development of Islamic finances. Government adopted individual and flexible approach that brings to better tailored decisions and at the same time helps to exercise more effective control. In US there are two major types of Shari'a compliant transactions which best fit into legislative framework, tax codes and at the same time into requirements of Islamic law.

[118] Ibid

First solutions applied in US, particularly by Lariba were the variations of ijara transaction, so called ijara wa-iqtina (leasing and acquisition) and ijara muntahi bitamlik (lease to own). The scheme of transaction is following, costumer selects and house and financial institution approves it, institution buys a house (becomes and owner) and leases it to costumer, costumer pays a rent and plus makes payment to the separate account to buy out a lease. Transaction is based on mutual promise, financing institution promises to sell a house and costumer promises to buy it. Additionally, costumer is able to give mortgage against leasehold. Transaction is both Shari'a compliant and fits into US legislative framework, including possibility of securitization by a mortgage. However, there are still two unsettled points, tax deductibility and issue of rights and responsibilities between owner of the property and tenant[119]. These questions are to be regulated on a state level and require some degree of legislative accommodation.

The other option practiced in US is partnership schemes constructed under murabaha or musharaka agreement, where client enters into shared equity ownership with financial institution. Under these schemes financial institution or partnership buys a property and client pays rents until he buys out his share in a property. Transaction would perfectly fit into requirements of Islamic law; however in US commercial banks are government sponsored partnerships are not allowed to own a property[120]. Solution here can be similar to that adopted by OCC discussed earlier in this section. On a state level it would be to allow commercial banks to be hold a property in case of Islamic financial transaction, ownership of the bank might be restricted to definite term, on a condition that share of the bank with gradually

[119] A. Thomas, "Methods of Islamic Home Finance in the United States", The American Journal of Islamic Finance, 2001, available at: http://www.failaka.com/Library/Articles/Methods%20of%20Islamic%20Home%20Finance%20-%20AST%202002.pdfm , last visited in November 3rd 2007

[120] A. Thomas, "Methods of Islamic Home Finance in the United States", The American Journal of Islamic Finance, 2001, available at: http://www.failaka.com/Library/Articles/Methods%20of%20Islamic%20Home%20Finance%20-%20AST%202002.pdfm , last visited in November 3rd 2007

decline. On a federal level, government can provide certain level of accommodation for partnerships that would enter into Shari'a compliant homeownership schemes.

To sum up, today's tendency is such that soon Islamic finances and financial institutions will become full right member of US financial market. Taking into consideration peculiarities of US federal system, to complete this task it is not enough to have general policy or to provide legislative changes only on a federal level. For example it would be ineffective to regulate issues such as taxes only on a federal level because apart from the federal taxes in US we have also local taxes. Therefore, it is more difficult for US to provide solutions for development of Islamic banking and financial products then for UK and Malaysia. On the other hand as we could see, what is necessary is small legislative changes to accommodate Islamic financing in the US market, however this changes have to been done first on federal level as general state policy and then on a state level with detailed accent to particular problems.

2. Islamic Banking and Islamic Financial Products in Mixed Banking System

2.1 Malaysia

Malaysia is interesting for numerous reasons, first of all it is considered to be the Mecca of Islamic financing. Secondly in Malaysia "different legal systems coexist there, i.e. the common law inherited from the British colonial period, the Shari'a, and the indigenous unwritten law in the provinces of Sabah and Sarawak"[121]. Finally although Malaysia is country with majority of Muslim population large numbers of clients of Islamic banks are not Muslims but ethnic Chinese.

a) Islamic Banking in Malaysia

[121] S. Messmann, "Islamic banking and finance- Transplantable models from Malaysia to EU?"

First Islamic financial institution in Malaysia was established in 1969, Pilgrimage Fund Board served Muslims who wanted to make savings for pilgrimage to Mecca[122]. First Islamic Bank was established in 1983, Bank Islam Malaysia Berhad (BIMB). Now bank has 90 branches in Malaysia and offers more then 50 Islamic banking products, bank has Muslim and non-Muslim clients[123]. Second Islamic bank was only established in 1999, it was Bank Muamalat Malaysia Berhad (BMMB) with headquarters in Kuala Lumpur, offering banking services irrespective to religious believes and race[124]. Incorporation of second Islamic bank, called for competition between banks it resulted in better costumer service and range of offered financial products was increased.

b) Regulation of Islamic Banking

Activities of banks in Malaysia are regulated by the Banking Act of 1973; Act stated that interest rate is an important element of operation of banks and banned them from trading. This statement was incompatible with main principle of Shari'a, namely prohibition of interest (riba). In 1983, Malaysian government created separate legislation for Islamic banks and enacted Islamic Banking Act which amended several provisions of Banking Act and served as legal basis for incorporation of first Islamic bank. Nowadays, two regulatory systems coexist, one for conventional and other for Islamic banking system[125]. Islamic Banking Act provides that Islamic bank has to operate in accordance with Shari'a and has to establish Religious Supervisory Council to supervise the compliance of financial products with Islamic law. However, there are many loopholes in the Act and different problems may arise, because it fails regulate number of issues. The Act, does not state the scope of authority of Religious Supervisory Council outside the bank. Moreover, Act does not regulate the issues when the conflict of laws, between civil and Islamic law arise. According to Malaysian civil

[122] A. Bidin, "The Impact of Islamic Law in the Banking System and Financial Market: a Malaysian Perspective", Company Lawyer, 2001.

[123] Information available on official web site of Islamic Bank Malaysia Berhad, at: http://www.bankislam.com.my/How_it_all_began.aspx , last visited August 8th 2007

[124] Information available on official web site of Bank Muamalat Malaysia Berhad, at: http://www.muamalat.com.my/index.php?pg=corporate_information&ac=12 , last visited August 4th 2007

[125] Overview of Islamic Banking in Malaysia, at: http://www.bnm.gov.my/index.php?ch=174&pg=467&ac=367 , last visited September 24th 2007

procedures, disputes on commercial issues will be brought before the civil courts. Principles of English law will be applied to disputes concerning Islamic financial products, as to principles of Islam whether or not to consider them (mostly they are considered) is left to discretion of courts. Therefore, all disputes concerning finances, including Islamic financial products, additionally opinions and decisions of Religious Supervisory Council are subjected to review of civil courts and implemented in line with existing common law system[126].

Second major regulation concerning Islamic banking was The Banking and Financial Institutions Act (BAFIA) which came into force in 1989. BAFIA vested authority to regulate activities and supervise commercial banks to Bank Negara of Malaysia. Under powers given by BAFIA, in 1997 Bank Negara established National Shari'a Advisory Council for Islamic Banking and Takaful (NSAC), to give final authoritative opinion on Islamic financial products. Religious Supervisory Councils established in Islamic Banks, were interpreting the same provisions of Islamic law differently, this cause many tensions and necessity for creation of single regulator emerged. NSAC coordinates and bring to conformity all issues and different opinions concerning Islamic finances and Islamic insurance. NSAC also gives opinions on compliance of Islamic banks and Islamic insurance companies with principles of Shari'a.[127]Although NSAC can issue authoritative decision in a case of disagreement, when a subject matter concerns dispute over applicability of Shari'a, parties can still challenge decision in the court.

c) Documentation

Another big problem concerning Islamic finances in Malaysia is issue of documents. Documents concerning Islamic financial transactions have to satisfy Islamic and civil law standards. For example contact concerning immovable property has to comply with Islamic

[126] A. Bidin, "The Impact of Islamic Law in the Banking System and Financial Market: a Malaysian Perspective", Company Lawyer, 2001.
[127] V. Low, "One Country, Two Systems: Banking in Malaysia", Journal for International Banking Law, 1998.

regulation, civil law regulations and plus requirements prescribed by National Land Code[128]. Many disputes concerning Islamic transactions still raise and determination of court responsible for regulation of disputes might be problematic. Federal Constitution of 1988 gave Shari'a courts jurisdiction to review cases where Shari'a is applicable however there are some instances where civil courts have jurisdiction to review cases concerning application of Shari'a, in this cases where we have clash of jurisdictions, mainly decision given by civil courts will take precedence[129].

d) Court's Decisions

To see how the disputes concerning Shari'a are regulated by civil courts and to what extent they apply principles of Islamic law, I will review 3 latest court decisions, and the last decision on a case Malayan Banking Bhd v Ya'kup Oje & Anor was issued on 30th of August 2007. First decision I will discuss was reviewed by the High Court in August 2006, case Affin Bank Bhd v Zulkifli Bin Abdullah. The matter of dispute was an Al-Bai Bithaman Ajil (BBA) deferred installment sale contract. Bank applicant of the case, bought a property on behalf of the defendant (former employer of the bank) and immediately resold it to the client on a sale price (profit margin, upon deferred payments). The price paid by the bank amounted to RM345.000; the defendant had to pay in 216 installments subject to reduction so far as defendant remained employed by the bank. To secure the payments, defendant registered land change on a property in favor of bank. Defendant paid RM 7,500 in installments before he left employment. The tenure was revised and bank claimed RM958, 909, 21 under revised tenure, after bank deduced payments made by defendant. Court had to determine price that defendant had to pay to plaintiff. First of all Court distinguished BBA from conventional loan, under BBA agreement bank could claim unexpired tenure, in another words bank could claim sale price. The Court came to the conclusion that it is unfair if defendant is denied the benefits of tenure and required to pay for it. Furthermore, profit margin if it charged on unexpired tenure

[128] A. Bidin, "The Impact of Islamic Law in the Banking System and Financial Market: a Malaysian Perspective", Company Lawyer, 2001.
[129] Ibid

is not earned profit and contradicts BBA principles. Once the tenure is shortened it can be calculated again. Finally Court agreed to recognize order on the sale of the property, but amount of money charged by the bank would be calculated as profit per day, until final price is paid[130].

Another dispute decided by the court in 2006 was the case Malayan Banking Bhd v Marilyn Ho Siok Lin. The dispute concerning BBA agreement, where bank (applicant) purchase a property at price of RM500,000 and resold it to the defendant at price RM995,205,64, defendant had to pay RM 4,107,00 per month during a period of 240 month. Defendant charged the property in favor of bank, after a period of 14 month defendant failed to pay installments. Bank requested to sell the property at price of RM928, 589, 12 which was the amount of the sale price minus amount paid by defendant. Defendant claimed that bank should only be given 14 month interest. The High Court stressed that although price of RM995,205,64, is defined by agreement, the Sarawak Land Code S.148(2) (c) establishes that "… the court after hearing the evidence may take such order as in the circumstances seems just"[131] therefore court has the power to override terms of contract if it finds them to be unjust. Court added that person who takes BBA load should not be put in worst circumstances then person that takes conventional loan. Court found the claim of appellant to be unjust[132].

Two above mentioned formed a precedent for the courts, latest case decided by High Court serves as an example of application of rules established in these two cases. Facts, issue and decision in Malayan Banking Bhd v Ya'kup Oje & Anor were similar to those in previous two cases. Interesting in this case is that court acts in more sophisticated way in argumentation of decision which indicates that High Court is already familiar with this type of cases and worked out the line how to decide cases on BBA disputes. When balancing court stresses out

[130] Dispute Resolution Electronic Bulletin, Shearn Delamore & Co, 2006 available at: http://www.shearndelamore.com.my/filelibrary/e_bulletins/eBulletin_JulyAug2006.pdf, Last visited August 29th 2007

[131] Sarawak Land Code , s 148(2)(c) , section 9th of case Malayan Banking Bhd v Marilyn Ho Siok Lin, available at: http://www.cljlaw.com/public/cotw-070914.htm (Last visited August 29th 2007)

[132] The Kuala Lumpur Regional Center for Arbitration, 2007, available at: http://www.rcakl.org.my/pdf/jan2007KLRCA.pdf , last visited September 24th 2007

that there is a need to promote further Islamic Banking on the one hand, but on the other hand costumers should be protected within frameworks of justice and equity. Moreover, it is evident that court is trying to find common principles of Shari'a and common law, so not to decide in favor of one of them. Setting aside the agreement, is done in a name of justice, court turns to legal provisions of Malaysian common law system but at the same time sited relevant provisions of Koran and additionally says that: "…under the secular law has rightly attempted to act within the parameters of justice and equity to attain a just result and to ensure that excess profit is not made in the name of Islamic principles"[133].

e) Arbitration

The other option to settle disputes involving Islamic financial transactions is arbitration. In 1978 Malaysian government create Kuala Lumpur Regional Center for Arbitration (KLRCA), an independent international organization. In 2005 enacted Arbitration Act based on UNCITRAL Model Law on International Commercial Arbitration. In 2007, KLRCA together with Bank Negara Malaysia and Securities Commission of Malaysia worked out Rules for Arbitration in Islamic Banking and Financial Services. Rules provide for methods of solving disputes concerning Shari'a aspects of Islamic banking and insurance services[134].

f) Insurance

Takaful, Islamic insurance has long been present in Malaysian financial market, because insurance is not generally popular among Muslim population. Therefore, thought there have been a wide range of takaful products and providers it only recently started to develop. In 1986 total assets of takaful products made up 0,5 million USD by 2002 it already reached 900 million USD, amounting to 5,2 per cent of all Malaysian insurance sector[135] Although, Islamic insurance reached such a significant development there are number of problems

[133] Malayan Banking Bhd v Ya'kup Oje and Anor, sec. 10, available at: http://www.cljlaw.com/public/cotw-070914.htm, last visited August 19th 2007)

[134] The Kuala Lumpur Regional Center for Arbitration, 2007, available at: http://www.rcakl.org.my/pdf/jan2007KLRCA.pdf , last visited September 24th 2007)

[135] Report on International Conference on Takaful 2003 , available at: http://www.islamic-banking.com/takaful/takaful_keynote.htm , last visited August 19th 1007)

related to insurance. In 1997 Bank Negara of Malaysia established Shari'a Advisory Council for Islamic Banking and Takaful, to provide authoritative opinions on issues concerning takaful and Islamic banking[136]. Malaysia was the first country that adopted a special law on Islamic Insurance in 1984, and set up special committee called Badan Pegus Khas to provide analytical work on project of the law before law was adopted. Government encourages establishment of takaful operators by easy process of licensing and providing tax benefits to those who make agreements with takaful operators[137].

Despite legislative efforts there are still number of issues that remain unsettled. First problematic aspect with operation of takafuls is that takaful operators should invest in Shari'a compliant financial transactions; hence Islamic financial market in the county must be big enough to allocate such investments. Second problem with takafuls follows from the first one. Attempting to invest only in Shari'a compliant transactions, significantly increase insurance prices and takaful becomes less attractive then traditional insurance. Third problem is connected with relatively undeveloped reinsurance system, so called re-takaful. Consequently, takaful operators are often forced to conduct reinsurance transactions with traditional reinsurance operators[138]. And finally, there is problem with mudaraba model which is usually applied for takaful, but the model used in Malaysia is different from traditional mudaraba transaction and it is called "Malaysian modified mudaraba model". In this model takaful became commercial venture based on profit. Justification for using of modified model is that expenses of takaful, if traditional mudaraba is used would be too high and it cannot stand the competition on insurance market[139]. Besides the insurance Malaysia is one of the leaders in

[136] Overview of Islamic Banking in Malaysia, available at: http://www.bnm.gov.my/index.php?ch=174&pg=467&ac=367, last visited November 4th 2007

[137] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.192

[138] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.195

[139] M. Obaidullah, " Islamic Financial Services", Islamic Economics Research Center, Jeddah, 2005, available at: http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html , last visited August 23rd 2007

issuing Islamic bonds-sukuk. In 2005 Malaysia, issued sukuk worth 1.27 billion, it was largest sukuk of the year[140].

g) Conclusions

To conclude, it can be said that Islamic banks and financial transactions are widely developed in Malaysia. It should be noted that growth of Islamic banking sphere took place intentionally with active participation of government with reform on legislative level. Today there are eleven Islamic Banks in Malaysia and additionally most of conventional banks offer wide range of Islamic products. Conventional banks were permitted to offer Islamic products, without obtaining special license, as long as Islamic products they offer are Shari'a compliant[141].As a result we have more then 100 Islamic financial products available on Malaysian market. As estimated by 2010, share of Islamic Banking in Malaysia, will be amounted to 20% of overall market[142].

System of justice is well arranged. Disputes concerning Islamic finances are successfully solved, with application of Shari'a and common law. Most interesting is combination of these two legal systems. Formally, court has to follow Malaysian legislation which is based on common law, but in decisions Koran is more often sited then relevant norms of legislative system. From 2007 the other alternative of dispute resolution appeared. Now KLRCA applies principles of Shari'a to the cases concerning Islamic finances.

As to the Islamic insurance, takaful started to intensively develop only recently. Many issues are not solved yet. However, very significant governmental support and analytical prognoses is very optimistic sign. Easy licensing process will bring increase of takaful operators; growth of Islamic financial market would eliminate the problem of investments into Shari'a compliant transactions and consequently demand for retakaful operators will result in supply.

[140] E. Rutledge, " Sukuk has Entered English Lexicon and is here to Stay", Kajeh Times, 2006, available at: http://www.gulfinthemedia.com/index.php?m=search&id=232407&lang=en , last visited September 23rd 2007

[141] Messmann S., "Islamic banking and finance- Transplantable models from Malaysia to EU?"

[142] A. Kobiakov, "Islamic Banks of Malaysia", 2007, available at: http://www.warandpeace.ru/ru/analysis/view/14965/ , last visited September 23rd 2007

As to problem of competitiveness of takaful with traditional insurance, the answer is that one the one hand takaful will still have customers who would choose takafuls over traditional insurance for religious reasons, on the other hand once problem of investing into Shari'a compliant financial products is solved and number of takaful operators is increased, prices of takaful insurance will become more competitive.

Malaysia can be considered to be the capital of Islamic banking; it is unique because of the ability to combine two financial systems, conventional banking and Islamic banking. Two financial systems coexist, in line with each other and both systems have opportunities and conditions of successful development. Islamic financial products are offered by Islamic banks as well as conventional banks and available for Muslim and non-Muslim clients. Disputes on Islamic financial transactions are decided by civil courts with application of Shari'a principles, and all above mentioned exists in one multi-religious county, with majority of Muslim population and British colonial traditions.

3. Major Problems on a Way of Development of Islamic Banking and Finances - Conclusions

In the last section of this chapter, I will make a comparative analyze and sum up issues concerning Islamic Banking and Islamic finances that are still on agenda in US, UK and Malaysia. I will also examine problems of transparency and disclosure, which are sore points and up to date hang as shadow over image of Islam as religion and Islamic banks as an institutions used for money laundering by terrorist organizations. Today we cannot definitely answer to what extent are this suspicions justified, the same as we cannot bring Islam under one line of terrorism. However, we can discuss how these issues influenced activities of Islamic banks and Islamic financial institutions.

I will start a summary from issues of incorporation and supervision of Islamic Banks and financial institutions. In UK and Malaysia there is singe regulatory authority. In UK from 2001, with entry into force of Financial Service and Markets Act, Financial Service Authority regulates banks and insurance companies, in Malaysia; Bank Negara Malaysia is responsible for regulation of Islamic banks. Situation is different in US, not only there is no a singe regulator but also no single form of financial institution that would be capable to offer all range of Islamic financial products. Regulatory authority in US is divided among different governmental and independent bodies on federal and state level, what makes it more difficult to effectively supervise activities of financial institution and even more difficult when these bodies do not coordinate. Therefore, bank or financial institution in whatever form it chooses to be incorporated in US, is subjected to state and federal regulations and remains under control of several governmental bodies.

Further, problems arise with making contracts that involve Islamic products. For contract to be valid, it should be made in form that is established by relevant jurisdiction, but contracts concerning Islamic financial transactions require some special provisions and so far the form of contract that contains this provisions was no legalized neither in US, in UK and even in Malaysia. What is usually done to solve these problems is that standard contract is signed and additional contract that reflects real transaction is made. If we want this scheme to work it is necessary that clients keep confidence in the other contracting party. But precisely under these conditions it is especially difficult for new companies to start and establish in market.

Another difficulty rise when it comes to resolution of disputes in civil courts. So far, cases concerning Islamic finances are not viewed through prism of religious freedom but from purely financial standpoint. Here we can compare the decisions of UK and Malaysian courts. Courts in UK have more reserved attitude towards influence of religious norms over validity of contract. Excellent example was Beximco case where courts precisely stated that English law is the only applicable law towards contract, theoretically court did not exclude the

possibility of taking principles of Shari'a under consideration but is rather impossible on practical level since British courts lack knowledge of Islamic Law, we can suppose that the same difficulties would be faced by US courts as well. Opposite picture appears in cases decided by Malaysian counts. Malaysian courts are very keen on applying Shari'a principles to the disputes concerning Islamic transactions, and though disputes that I gave as an example were decided under common law, we could see from the decisions that court tried to reconcile Shari'a with common law principles. Moreover, it was obvious that Malaysian justices were very knowledgeable on Islamic law and they knew how to formulate a decision in a way that recognized the validity of both legal systems.

Finally we come to problems of transparency and disclosure. In UK transparency issues were raised in C. McCarthy's speech, chairman of FSA talked about transparency as a tool to gain confidence of costumers. True enough that there is mistrust against Islamic banking but McCarthy does not speak about prejudice, he rather insists that customers have to be aware of potential loses and benefits. Education, on issues related to Islam is other aspect of transparency, as referred in UK. It is worth to note that in this respect a lot is being done with active participation of government. In Malaysian context, issues of transparency are rather raised in respect of taxes. Islamic Banks of Malaysia are not viewed as a source of money laundering for terrorist activities.

Different and much more complicated picture is in US, especially after terrorist attacks of 9/11. Everything Islamic is under suspicion and closely monitored. As I already mentioned US system of supervision of financial institutions is very complex, but recently a lot of attention has been given to the education of regulators on Islamic financial products, that was stressed in numerous conferences and meetings. Since it is well known that approach of US regulatory authorities towards Islamic institutions is individualistic then it can be easily said that individualist approach, plus knowledge of Islamic finances will allow for closer monitoring of each institution. Closer monitoring is often claimed to result in increased public

trust, which is doubtful statement because immediately raises the question why to monitor so closely something that is not suspect.

General notion of Islamic banks as institutions used by terrorist for money laundering purposes has long been known and can hardly be surprising especially in US context and indeed what is needed is more information, but information that is based on objective data. To start with it is good to know how the money laundering is being done. For example very often money are laundered, through correspondent accounts in the country where bank does not have branches. This type of operation was done in 90-ties, when for Al-Qaeda was channeled from Sudanese Bank Ash-Shamal through branches of two big US banks[143]. What is worth to stress here that operation was conducted through conventional banks and as other money laundering operation did not require participation of Islamic banks. Money laundering has been done for ages and it is not in any case new for US, where millions of dollars are laundered by drug dealers, additionally in most of the cases banks and financial institutions used by terrorists were conventional ones. So the big question is whether it is justified to apply special safeguards towards Islamic banks and financial institutions or is it just general distrust towards everything that is Muslim. In 2006, negative attitude was expressed by public opinion when it became news of common knowledge that DP World a port operator which is based in Dubai will be running US terminal. Moreover, Prince Mohamed al Faisal al Saud, who founded Dar al-Maal al-Islami Trust (DMI), was named as one of the defendants in the lawsuit brought by families of victims of terrorist attacks of September 11. As a proof for alleged relations of DMI with terrorist organizations, lawyers for plaintiffs claimed that some of the people who were suspected to have connections with Al-Qaeda had accounts in DMI units. As an example was named Wael Jelaidan, suspected by US government to be one of founders of Al-Qaeda had bank account in Swiss Banking unit of DMI[144]. This gives us a

[143] A. Vassiliev, "Financing Terror: from Bogus Banks to Honey Bees", article "Terrorism Monitor", 2003, available at: http://www.jamestown.org/images/pdf/ter_001_004.pdf (Last visited September 29th 2007)
[144] T. Landon Jr. , "Muslim Financiers Fight Suspicion in US", International Herald Tribune, 2007, available at: http://www.iht.com/articles/2007/08/08/business/trust.php?page=1 , Last visited October 3rd 2007

questions whether Islamic bank should check all potential clients before bank allows them to open an account and whether bank should be held responsible for operations of its clients and if the answer is yes, should this formula be applied to conventional banks as well.

Despite many obstacles on a way of development of Islamic banking and finances, they managed to survive and develop. There are many differences among discussed jurisdictions but what they have in common is more important. This is strong and steadily growing demand for Islamic financial products. As long as there is a demand, government will have to take all necessary steps to create appropriate legislative framework, to make all necessary changes and to accommodate Islamic banks and Islamic financial institutions.

CHAPTER III – FREEDOM OF RELIGION

1. Islamic Banking and Islamic Financial Products v Freedom of Religion

1.1 Introduction

Islam is not just a religion it is lifestyle of every Muslim. Adherence to Islam means complying with Islamic religion and Islamic law. Muslims up to date believe that Allah established set of rules that regulates every aspect of their life. Staring from family law and ending with economics and foreign relations[145]. Consequently banking and finances is the part of religious practice and religious believes of Muslims.

Koran contains numerous provisions which regulate financial activities but most important is prohibition of interest. Interest is the core incentive for modern banking, on the hand interest in not acceptable, according to Koran it is a grave sin. Moreover, Islam makes no distinction between payer and receiver of interest, hence Muslims are forbidden to use conventional banks.

Although, so far Islamic banking is viewed from financial prism, it is also part of Islamic religion. Freedom of religion is recognized on constitutional level in almost all countries, it is also guaranteed by numerous international conventions. But if Islamic banking is not recognized as a part of Islam then protection of religious freedom would not be applied. Since Islamic banking and financial products have many characteristics different from conventional banks and financial products, they are sometimes incompatible with secular laws designed on model of traditional banking system. It can be barrier on way of development of Islamic banking, especially in non-Islamic states. Therefore, it is often necessary that state provides

[145] J. Al-Din Zabarozo, " Interest and Its Role in Economy and Life", 2007, available at: http://www.islamreligion.com/articles/538/ , last visited September 21st , 2007

certain degree of accommodation on legislative level as it was done in US, UK and even in Malaysia. After all, every Muslim has right to practice his religion, to conduct financial activities in a way that does not contradict his religious doctrines and finally he cannot be compelled to participate in transaction that are strictly forbidden by Koran, because of absence of Shari'a compliant alternatives.

1.2 Islamic ***Banking and Islamic financial products v United Kingdom***

The UK has two main established state churches: Presbyterian Church of Scotland and Church of England. UK follows accomodationist model of the state, it has established churches but generally allows for free practice of other religions. Churches do not receive funding as such, but if they are registered as charity organization they can be exempted from taxes, if they use income for charitable purposes. In 1998 Human Rights Act was adopted, the act incorporated ECHR into domestic law; therefore, freedom of religions is recognized on legislative level.

Muslims constitute 3% of UK population; majority of them is from South Asia[146]. So far public authorities were very flexible towards degree Muslim community. Only in 2007 there has been made some legislative changes to restrict religious manifestation. One of the examples was guidance issue by Department of Education which provided that school could restrict manifestation of religion particularly, full-face veils were prohibited. Another example was revision of British Airlines dress code policy which allowed Muslims to wear turbans but restricted wearing crosses. Here under public pressure the policy was changed and employees were allowed to wear religious symbols[147].

Despite the efforts of government there is a still general prejudice towards Muslim among British population. There have been a number of accidents directed against Muslims such as

[146] International Religious Freedom Report, released by Bureau of Democracy, Human Rights, and Labor, 2007, available at: http://www.state.gov/g/drl/rls/irf/2007/90206.htm, last visited October 19th 2007
[147] Ibid

oral insult, physical harassment, anti Islamic literature and etc. Therefore, among British community discrimination on religious grounds is present and is specially targeted towards Muslims. Government tries to maintain accommodation policy but question is how far accommodation can reach. On the one hand, since Muslims are targeted more then representatives of other religious group then degree of accommodation towards them should be higher but on the other hand higher level of accommodation might be considered as advancement of Islam. In 2006 Parliament adopted Equality Act, act states that it is illegal to discriminate on a grounds of religious believes in different areas such as employment, use of property, public services and so on. In the same year, organizers of Olympic Games in London were accused of scheduling games in a way that coincides with Ramadan, what puts Muslim sportsmen in a big disadvantage, since they will be fasting[148]. It may be argued that Muslim sportsmen would be discriminated or put in obvious disadvantage but can state go so far as to reschedule Olympic Games in order to accommodate needs of Muslims.

Although Islamic Banks and financial products are not considered from the religious freedom standpoint, they are more developed in UK then in other European countries with bigger percentage of Islamic population. Despite still existing general prejudice towards Islamic banking, so far economical interest and strong demand were enough for government to take all necessary steps to change legislative framework in order to accommodate Islamic products. Although Islamic banking and financial products in UK are not customer oriented we can still talk of right of every Muslim to be able to exercise his religious freedom in financial aspects. Prohibition of interest and other Koranic financial provisions stand on equal foot with wearing a veil or ban on eating pork. Therefore, it is not surprising that while state accommodates one aspect it should try to accommodate financial aspect as well. It would be incorrect to say that if Islamic banking and Islamic finances were considered from the religious freedom standpoint they would have bigger degree of accommodation in UK then

[148] International Religious Freedom Report, released by Bureau of Democracy, Human Rights, and Labor, 2007, available at: http://www.state.gov/g/drl/rls/irf/2007/90206.htm, last visited October 19th 2007

now when they are rather taken from financial side. Accomodationist model of state and church relations in UK, as well as status of religious freedom, together with general practice leads to a friendly environment for development of Islamic Banking and Islamic financial products. Whether taken as right to religious freedom or as a part of financial system, the reality is that Islamic banking and financial products did not exercise or are unlucky to exercise in the future any major difficulties, neither on legislative nor on a practical level.

1.3 Islamic Banking and Islamic financial products v United States

Religious freedom has long history in the United States. It started when Roger Williams, who was prosecuted because of his faith, escaped and founded Rhode Island. He was the first to advocate state neutrality towards religion. Notion of church and state separation first appeared in a letter of Tomas Jefferson to a group of Danbury Baptist. James Madison was another great advocate of separation between church and state. The vision of Jefferson's and Madison's church v state relations was affirmed in Virginia Statute for Religious Freedom.

The main guarantors of religious freedom in US are so called Establishment and Free Exercise clauses of the first amendment of Constitution. Establishment clause states that: "Congress shall make no law respecting an establishment of religion…"[149] Free Exercise clause says that" Congress shall make no law… prohibiting free exercise thereof".[150] Up to date, about one hundred cases concerning freedom of religion was decided by US Supreme Court. If we trace decisions of the court we can see that lately there has been a shift in direction of equality rather then freedom. Supreme Court over years lowered the wall of separating state from religion, moving more towards model of accommodation. Namely state

[149] First Amendment of US Constitution , available at: http://www.law.cornell.edu/constitution/constitution.billofrights.html#amendmenti , last visited October 11th 2007

[150] Ibid

should remain neutral and not advance one religion over another, as long as this condition is met and state treats all religions equally state can legislate and interfere into religious matters.

Aim of this chapter is to reflect development of Islamic banking and financial products in a light of religious in particular jurisdiction. Islamic Banking has long been seen as purely financial rather then religious standpoint. So far in US there are no cases that would reflect the problem of establishment of Islamic bank from the freedom of religion angle. In this section I decided to discuss theoretical possibility of establishment of Islamic Bank in US. Challenge the establishment of Islamic bank under Establishment clause and review under Free Exercise clause and try to predict possible outcome of this challenge.

In previous chapter I already discussed the possibility of establishment on Islamic Banks in US. As I noted it would be permissible under US legislation to establish Islamic Bank, but it would be impossible under one of the forms of financial institution to offer the whole range of Islamic financial products. In 1999 Office of the Comptroller of the Currency (OCC) issued an interpretive letter, which allows commercial bank to purchase a property and hold it until buyer makes final payment[151]. Proposal was designed to allow commercial banks to conduct financial transactions based on murabaha agreement[152]. Certainly the letter issued by OCC can be said to be an accommodation of Islamic model based financial transaction, which would be impermissible if wall of separation between state and religion is kept high. However, there have been changes in the application of the establishment clause in jurisprudence of US Supreme Court. The court shifted its approach from strict separation towards more accommodation model. Previously court used test called Lemon test, under Lemon test state had to demonstrate that (1) that the State action has a primary secular purpose; (2) that the State action does not have the primary effect of advancing or inhibiting

[151] Commercial Banks in the US are not allowed to own assets, such as real estate.

[152] Speech of W. L. Rutledge, Executive Vice President of Federal Reserve Bank of New York at Arab Banks Association of North America Conference on Islamic Finance: Players, Products & Innovations in New York City, April 2005, available on http://www.ny.frb.org/newsevents/speeches/2005/rut050422.html, last visited July 24th 2007

religion; and (3) that it is not an excessive government entanglement[153]. Since Agostini decision court does not any more apply 3rd prong of Lemon test.The new test applied to establishment cases, was firs developed by Justice O'Conner in the Lynch v Donnelly[154] case. She examined whether legislation was secular in purpose and whether it had effect of endorsing religion, therefore left out the issue of entanglement. In Agostini case[155] court stated that entanglement should be analyzed from the point of view of the effect of the state action. To invalidate the aid effect should be direct and significant advancement of religion, but the aid is permissible if it is indirect or incidental. In the above mentioned cases the word "aid" involved governmental financing, in the case of Islamic bank and OCC interpretive letter we have to deal with legislative initiative. Here the state was not neutral and practically advanced Islam over non-religion in order to accommodate the needs of Muslims. If the OCC letter was challenged under Establishment clause, it could fail Lemon test on its very first prong, since letter did not have secular purpose. Can it be said the fact that legislation concerning Islamic banks and financial products are not yet challenged under Establishment clause saves them from being struck down? The answer to that question lies in the way Establishment clause is interpreted. According to its earlier interpretation government would be banned from any aid to religion but latter different approach was developed. The way US Supreme Court interprets Establishment Clause is that government should be neutral, which is non-preference of one religion over another or religion over non-religion. It is so called accomodationist interpretation of Establishment Clause when state is allowed to interfere into religious sphere if the aim of interference is to ensure freedom of exercise. Therefore, legislation or governmental act that accommodates Islam would most probably stand constitutional challenge of Establishment Clause if it is designed to result in achievement of freedom granted by Free Exercise Clause.

[153] Case Lemon v Kurtzman, 403 U.S. 602 (1971)
[154] Case Lynch v Donnelly 465 U.S. 668 (1984)
[155] Agostini v Felton 521 U.S. 203 (1997)

Next step would be to look at whether conducting financial activities, through Shari'a compliant banks and with Shari'a compliant financial products is the part of religious convictions of every Muslim and to what extent this is permissible under Free Exercise Clause. As I noted earlier Koran unlike the other Holly Books, strictly regulates all aspects of life of every Muslim. Islam is not just a religion but it is the lifestyle that every Muslim needs to adhere. Conventional banks and financial transaction in modern financial system are based on interest; Koran has very strong prohibition of interest. According to wording of Koran receiving interest is 36 times bigger sin then adultery which is punished by throwing stones to death[156]. Consequently it is impermissible for Muslim to conduct financial transactions based on interest and in the interest based institution. Evidently it is a part of freedom of exercise for every Muslim to perform financial activities in accordance to prescription of Islam. It is not to say that state in under obligation to set up Shari'a compliant banks or financial products, but government should make no laws that burdens free exercise of Islam.

US Supreme Court designed Sherbert test[157] which was applied to free exercise cases, according to test law that burdens free exercise must stand strict scrutiny test[158] as long as it is sincere religious conviction. Later on, Sherbert test was overturned in Employment Division v Smith case[159], where Supreme Court held that free exercise was no exempted from laws of general applicability. In response in 1993 Congress issued Religious Freedom Restoration Act (RFRA), which prevented laws from restricting free exercise, basically RFRA aimed to restore Sherbert test. Fours years later Supreme Court stroked down RFRA[160], it remained only applicable to federal acts, additionally most of the states passed their own RFRA's. In

[156] A.J. Jhuravlev, M. Kemper, R.I. Bekkin, A.D. Larionov , D.A. Al-Sharaireh, I.H. al-Askalani, "Islamic Finances in Modern World: Economical and Legal Aspects", UMMA , Moscow, 2004, p.25
[157] See Case Sherbert v Verner, 374 U.S 398(1963)
[158] See Case United States v Caroline Products 304. U.S. 144 (1938) , footnote 4
[159] See Case Employment Division v Smith, 494 U.S. 872 (1990)
[160] See Case City of Boerne v Flores, 521 U.S. 507 (1997)

2006, Supreme Court ruled on Gonzales case[161], where court practically restored application of strict scrutiny test towards burdening of free exercise.

Finally laws that regulate activities of financial institutions and financial transactions are of general applicability. The do not target but indirectly infringe free exercise of Muslims to conduct Shari'a compliant financial transaction. Although US Supreme Court jurisprudence does not give definite answer whether strict scrutiny test will be applicable to the cases concerning Islamic finances, most probably court would not strike down such regulations as banning commercial banks to hold assets. On the other hand legislator can pass regulations to ensure the free exercise of Muslim to conduct their financial activities according to Shari'a, such as interpretive letter issued by OCC. This kind of legislation can stand Establishment Clause challenge, under new accomodationist reading of the clause, because it is enacted to ensure the Free Exercise.

1.4 Islamic Banking and Islamic Financial Products v Malaysia

Status of religious freedom in Malaysia is defined by Federal Constitution of Malaysia. According to the Constitution Islam is official religion of the state[162] but article 11 guarantees every person right to practice and profess his religion[163]. On appearance despite being Islamic state, Constitution seems to guarantee freedom of religion. In practice it creates implications for realization of this freedom by complicated system of courts. Malaysia incorporated common law system; judicial review is conducted by civil courts, at the same time courts of special jurisdiction, Islamic courts so called Syariah Courts were created. Syariah Courts are created by Parliament, their status is not defined in the constitution, and hence they are exercising the powers vested by Parliament. Problem rose with amendment of article 121 of

[161] See Case Gonzales v O Centro Espirita Beneficente Uniao do Vegetal, 126 S. Ct. 1211 (2006)

[162] Article 3 of the Federal Constitution of Malaysia, available at: http://www.malaysia-today.net/malaysia_constitution.pdf, last visited November 27th 2007

[163] Article 11 of the Federal Constitution of Malaysia, available at: http://www.malaysia-today.net/malaysia_constitution.pdf, last visited November 27th 2007

Malaysian Constitution which defined that judiciary and High Court are subordinated to the Parliament. Consequently Parliament by enacting laws, can subject legal disputes to be decided by Syariah Courts. So far Syariah Courts have jurisdiction over persons who profess Islam in certain aspects such as family law or minor criminal offences etc, in many cases this resulted in concurrent jurisdictions between civil and Syariah courts until article 121 was amended, at the same time High Court still maintains the right to supervise the inferior courts. So far disputes concerning Islamic banking and finances are referred to civil courts, because regulation of corporations and banks fall within the State List provided in the Constitution[164] but there is a tendency that jurisdiction of Syariah courts will be broadened. According to law, every citizen of Malaysia, from birth is recorded to be a Muslim; religion of every citizen is recorded in identity card. The cases between Banks and person when person is Muslim can be easily referred to Syariah court. In this section I will discuss, to what extent transferring jurisdiction over Islamic finances to Syariah courts will have impact over right to freedom of religion. To illustrate the impact of Syariah courts and application of Islamic law freedom of religion, I will discuss the latest case decided by Highest Court which caused a lot of controversies and polarized public opinion.

Lina Joy was born as Muslim; in 1989 she converted to Christianity. Later on she decided to marry Christian, however according to Civil Marriage Provision of the Law Reform Act, Muslims are not allowed to have only civil marriage, and hence Lina Joy's marriage to Catholic would not have any legal consequences[165]. Lina Joy requested National Registration Department (NDR), to remove the word "Islam" from her identity card. NDR denied her request on a basis that first she should obtain certificate of apostasy from Syariah Court. Syariah Court denied her request and finally case reached to Highest Court. Decision of Highest Court was celebrated as a victory of Islam, when court proclaimed that NDR was

[164] A. Bidin, "The Impact of Islamic Law in the Banking System and Financial Market: A Malaysian Perspective", Company Lawyer , 2001

[165] International Religious Freedom Report of 2007, released by The Bureau of Democracy, Human Rights, and Labor, available at: http://www.state.gov/g/drl/rls/irf/2007/90143.htm , last visited October 19th 2007

right to when it request Ms. Joy to bring documental proof that she was no longer Muslim, Syariah Court was held to be a proper authority to determine the issues of apostasy of the applicant.

Although Highest Court did not find a breach of the article 11 of Constitutions, it is evident that Lina Joy was practically prevented from exercising her freedom of religion. Decision of the court could be also argued under UDHR, ICCRP and numerous international documents to which Malaysia is a party. Lina Joy was not the first person who was denied the request of apostasy from Syariah Court; on the contrary it is exception from general practice to grant such permission. Breach of the right to change religion leads to further legal consequences, as in the case of applicant she was not only denied to religious freedom but also right to marry, results can be even more grave when it comes to custody over children. If child is born in a marriage where one of the parents is Muslim then Islamic authorities have power to remove custody from parent of other religion. This legal provision is often used; often man would simply convert to Islam to gain custody over children. The current practice in Malaysia is that Muslims cannot change their religion; state successfully imposes religion through Syariah courts so far mostly in family law, control over disputes in areas which are restricted to competence of states is slowly moving to Syariah courts[166]. Even when it comes to civil courts they are keener to cite and apply Shari'a laws, but so far when it comes to financial disputes civil courts try to reconcile Shari'a principles with civil law principles. However, when it came to freedom of religion court went further and advanced Shari'a over constitutional principles and international standards. In Lina Joy's case Chief Justice said that "Muslims cannot join or leave a religion according to their whims and fancies"[167]. In another words, Chief Justice confirmed that person cannot change his religion at his will and at the same time stressed application of his words to Muslims. Furthermore, Chief Justice also

[166] International Religious Freedom Report of 2007, released by The Bureau of Democracy, Human Rights, and Labor, available at: http://www.state.gov/g/drl/rls/irf/2007/90143.htm , last visited October 19th 2007

[167] B. Kuppusamy , "No Freedom of Worship for Muslims Says the Court", 2007, op. cit. available at: http://ipsnews.net/news.asp?idnews=37973, last visited October 21st 2007

added that Muslims "have to follow the requirements of their religion which is a complete regionaa way of life"[168]. The wording of this phrase is very strong and we can imply that since finances are regulated by Koran as well then disputes concerning Islamic finances would be solved in accordance with Islamic as well. Moreover, the words are directly addressed to Muslims, so it can be said that Muslims to certain level are discriminated on religious grounds.

I discussed Lina Joy's case to draw a clear picture of dangerous tendency to involve religious courts into civil law disputes. Banking and finances are not yet seen as a part of religious freedom. Even when cases involving Islamic finance are decided by civil courts they broadly apply Shari'a principles. If one day this kind of disputes will be referred to the Syariah courts, there is a high probability that there will be no place left for civil law doctrines. There is no doubt that Syariah courts will upheld Koranic rules and prohibitions, but freedom of religion does not involve adherence to one religion, it is freedom to profess and practice any religion of ones choice, in all possible aspects of life including finances. Muslims cannot be compelled to conduct financial transaction that are Shari'a compliant as well as they cannot be deprived a possibility to conduct this transactions according to his religious beliefs, and precisely the court is the institution that should guarantee freedom of choice to practice or not to practice religion.

1.5. Conclusions

The aim of this chapter was to demonstrate the Islamic finances from the standpoint of religious freedom. To show what are the potential problems of Islamic banking and Islamic finances from free exercise angle in UK, US and Malaysia. Three different jurisdictions have different degree of presence of Shari'a compliant institutions and financial products. Three

[168] Ibid.

countries that guarantee freedom of religion on highest legislative level besides being parties to numerous conventions that guarantees religious freedom. All of them have judicial bodies that at least theoretically constitute independent branch. In conclusion I will summarize the differences and similarities, point out the problems and decide what level of protection have Islamic Banking and Financial products as part of religious freedom in UK, US and Malaysia.

It evident that there is governmental support for Islamic banking and finances, significant degree of accommodation was shown on legislative level. In UK, United States and Malaysia laws have been revised in a way to enable further development of Islamic financial products. What is especially relevant for UK and US is that governmental organizations and state regulators declared the willingness to deepen their knowledge in Islamic finances in order to understand better activities of Islamic banks and Islamic financial institutions. In other words whether recognized as part of religious freedom Islamic finances experience significant growth in all three jurisdictions.

Separate issue is attitude of secular courts towards Islamic finances as a part of religious freedom. In US example I discussed the theoretical possibility of establishment of Islamic Bank under Establishment and Free Exercise Clauses. I tried to predict what would be the decision on court relying on latest cases decided by US Supreme Court jurisprudence. But the reality is that so far case concerning Islamic finances as a part of religious freedom has never been brought before US courts. It is even questionable whether US courts would decide similar cases on merits, especially if case would require interpretation of religious doctrine. In case White Lick Quarterly Meeting of Friends, by Hadley v. White Lick Quarterly Meeting of Friends decided in 1883, court made it clear that it is obligation of courts to protect fundamental freedoms, therefore they could decide the cases that involve religious organization but on if the case would not have involve interpretation of religious doctrine[169].

[169] Case discussed in the Legal Opinion of Becket Fund for Religious Liberty, available at: http://www.becketfund.org/files/1f27b.pdf, last visited October 12 , 2007

Similar attitude can be read from Beximco decision[170], made by English court. Additionally, court said that Shari'a might be applicable as long as it does not contradict common law, hence clearly advancing secular law over religious one.

In a light of US and UK courts attitudes opposed is approach of Malaysian court towards freedom of religion. Malaysia has complicated system of courts. There are Syariah courts which exercise jurisdiction over matter that fall within State List, such as issues that are administrated by states. Generally Syriah courts can review legislation enacted by state, issues of family law where on side of dispute is Muslim. Sometimes Syariah court exercise concurrent jurisdiction with civil courts. So far the legislation provides that decision of civil courts would prevail if case of concurrent decisions[171]. Banking fall within the Federal List therefore belongs to the competence of civil courts. However, as we could see on an example of Lina Joy's case, civil courts support decisions made by Syariah courts. What's more, even in the cases where disputes concerning Islamic finances were decided by civil, court would broadly apply principles of Islamic law. Although in Malaysia, Shari'a is not law per se, until it is enacted by Parliament in a form of law, Malaysian civil courts are freely referring to Koranic provision as if they were citing relevant peace of legislation.

In UK and US, Islamic Banking and financial products as a part of religious freedom should be protected once they are recognized as a part of fundamental freedom. What is certain is that protection offered to Islamic banking and financial products by the courts will be under secular laws, as to government it will try to accommodate Islamic banking on legislative level. As to Malaysia, Islamic Banking and financial products will be protected because they are Islamic and not because they are part of religious freedom.

[170] Beximco Pharmaceutics Ltd v Shamil Bank of Bahrain EC, 28 January 2004, available at: http://www.ipsofactoj.com/international/2004/Part12/int2004(12)-009.htm, last visited October 12, 2007

[171] A.Bidin , "The Impact of Islamic Law in the Banking System and Financial Market: A Malaysian Perspective", Company Lawyer, 2001

CONCLUSIONS

Despite all problems that I underlined in thesis, the fact that Islamic banking and Islamic financial products reached very high level of development and integration into Western financial markets still remains. Therefore, it is time to face the reality and accept the presence of Islamic finances in financial market of almost all jurisdictions all around the world. It is advisable to take example of US and UK and accommodate Islamic financial products.

After Islam is fastest growing religion, there is significant presence of Muslim population almost in every county. We can imagine the situation of Muslim living in the country where he is not able to conduct Shari'a compliant financial transaction. He is forced either to use conventional banks what can be compared to conducting great sin, or to face the situation when he is not able to use such services as banking accounts, financial transfers, loans or purchase property on mortgage. In other words he can choose to be in breach of his religious doctrines or be deprived of most of the financial services which constitutes important part of everyday life, hence be discriminated on certain level. Here comes the point when state has to interfere and make sure that there is no breach of right of freedom of religion or discrimination based on religion.

Confidence towards Islamic banking is already undermined by existing prejudice, here additionally problem is that Islamic banks work on profit and lose sharing basis. Since main capital of the banks is generally comprised of deposits it is difficult to convince potential costumer to invest money in a bank when he not only does not have a certain profit but also might loose initial investment. Today this problem is practically solved by different insurance schemes; however client must be aware of existence of safeguards which is not always the case. Further, if we set aside that potential borrower has religious interest to borrow from Islamic bank then we come to the purely financial considerations. If potential borrower has sound business and wants to take a loan he would rather prefer to take a loan from

conventional bank at fixed rate then take a loan from Islamic bank and share a profit which would constitute a higher percentage. On the other hand if business involves high level of risk then borrow would prefer to take loan from Islamic bank to share potential looses[172]. This scheme, besides putting Islamic banks in less favorable conditions comparing to conventional banks, increases a level of social injustice that contradicts teachings of Koran.

The aim of this thesis was not only to reveal existing problems with application of Islamic financial products in UK, US and Malaysia and show how they were solved but also to propose solutions to existing issues that have not been solved yet. I divided possible solutions into five big groups, I will only point out direction, and more concrete adaptation of these solutions will depend on degree of their applicability to different states. Proposed solutions are the following:

First of all I would like to stress importance to education over issues concerning Islamic finances. I would advice that special policy is designed and implemented to provide more information on Islam in general with special attention to distinctive feature of Islamic financial transactions. It is important to be familiar with structure and methods of Islamic finances before starting their implementation into financial market of the state. Without proper knowledge it is rather impossible to identify and solve the problems which would definitely emerge on a way of their development. Importance of education on Islamic banking and Islamic finances has already been recognized and underlined by state authorities in US and UK. Moreover, it is impossible to overcome general prejudice towards Islamic finances, as it often the case in US without proper understanding of how they function and how they are different from conventional ones. Finally, as it was stated in decisions of court in UK, Shari'a principles can be applicable to dispute resolutions if they do not contradict common law

[172] A. Thomas, "Methods of Islamic Home Finance in the United States", The American Journal of Islamic Finance, 2001, available at: http://www.failaka.com/Library/Articles/Methods%20of%20Islamic%20Home%20Finance%20-%20AST%202002.pdfm , last visited in November 3rd 2007

principles. However, without proper knowledge of Shari'a it is practically impossible to take any of them into consideration and apply them to disputes concerning Islamic finances.

Secondly, it is advisable to appoint single regulator of banks and financial institutions. Efficiency of this approach can be seen on example of UK. Since FSA became single regulator, significant legislative changes has been done, government policy towards Islamic banks has been established and implemented. In consequence this led to incorporation of fully Shari'a compliant bank in 2004. This approach is especially relevant to the current situation in US, where financial institutions face many problems with regulatory framework. Not only they are subjected to state and federal laws and hence to regulatory bodies on both levels but also to agencies that regulate different spheres of their activities.

Thirdly, legislative framework that regulates banking and finances should be designed in a way to allow exceptions. Again UK can be referred as an example; abolition of double stamp duty was crucial step to accommodate Shari'a based financial transactions. In US, first step has already been made when OCC issued interpretative letter to allow commercial banks to hold a property. This was significant step that allowed developing Shari'a based homeownership schemes.

Fourthly, it is important to develop secondary marker for Islamic financial products. Many Islamic financial transactions such as ijara and especially takaful depend on availability of secondary markets. I have already stressed importance of insurance in development of Islamic finances and banking. Insurance is not only usually required by state laws but also increases trust of potential customers. However, in this case we need not simple insurance but insurance which is Shari'a compliant. Since takaful operators make their profit out of investing, if they are to function in particular jurisdiction it is necessary to have variety of Islamic financial products available on market. Development of secondary markets can be fostered by high level of involvement of governmental organizations and government sponsored entities to prepare appropriate legislative framework as it was done in US.

Finally, it would advisable to recognize right of every Muslim to conduct financial activities in Shari'a complaint way as a part of religious freedom. After all finances in Islam are regulated by Koran, Islamic finances are distinct from conventional ones, paying interest is sinful. So why not to admit that financial activities are the same religious conduct for every Muslim as wearing a weal or praying in Mosques. Once Islamic finances are recognized as a part of religious freedom then claim to make Islamic banks and Islamic financial products available on market would be stronger. Religious freedom is guaranteed by constitutions of most of the countries and numerous international instruments. Therefore, state has an obligation to protect religious conduct as a part of free exercise. In other words, if Islamic finances are recognized as religious conduct then Muslim community in every state can claim accommodation of Islamic banking and Islamic financial products.

My thesis provided reader with basic concepts of functioning of Islamic finances and main Koranic prohibitions towards Islamic financial transactions. I tried to trace a path of development of Islamic banking and financial products in UK, US and Malaysia. I identified major problematic aspects and made general recommendation and proposed solutions applicable to particular problems. The rest is up to reader and states to agree with my proposals and apply proposed solutions or to find their own methods to solve the current problems that already emerged or eventually will emerge on a way of development of Islamic banking and financial problems in particular jurisdictions. Whatever will be the choice there are facts which cannot be denied. The fact is that Islamic banking and financial products can coexist and develop in mixed banking systems as it is done in Malaysia. Another fact is that Muslims cannot be discriminated or be forced to conduct financial activities which contradict their religious doctrines. The other fact is that despite existing problems and numerous issues Islamic banking and financial products managed to survive and reach high rate of growth because there is an increasing demand on Islamic financial products. After all putting aside

religious and economical incentives, as long as there is a demand, all that states can do it to accommodate Islamic banking and Islamic finances.

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