

Economics of Financial Markets Current Economic Crisis Effect on Islamic Bank of Britain

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Abstract:

Recently, it has been noticed that the Muslim population is growing rapidly in the United Kingdom. Due to this increase there is an increasing demand for Islamic financial products. This makes the Islamic financial market a sizeable market to cater.

Therefore, the aim of this paper is to highlight the effect of recession on the Islamic bank of Britain especially the role of monetary policy.

The discussion showed that, the Islamic bank and finance was increasing at a surprising rate (from 15% to 20%) and has managed this growth during the financial crisis that affected conventional banks and made them suffer terribly.

There were several reasons which helped the Islamic bank to survive during that recession, which are: Islamic bank is bound to stay away from interest rate, derivatives and short sales of debt. High demand for Islamic products, Sharing losses as well as profits, which supports both parties (the bank and investors).

Also, the discussion showed that the monetary policy known as **Quantitative easing**, has no benefits for the Islamic banks as they are not allowed to buy government bonds because it has a fixed interest rate on it and that does not correspond with Sharia law.

In addition, the **Islamic British Bank** was not affected by the raising of the interest rate that approved by the monetary policy committee to bring **inflation** down, because the basic principle of Sharia law is to ban interest rates.

Finally, the discussion showed that the Islamic bank has the potential to grow more in the future not only in the UK but also in the other European countries like France and Germany as the demand for Islamic banking is increasing and a number of bankers are learning the principles behind the Islamic banking industry.

Introduction

In this short paper the Islamic bank of Britain (IBB) is discussed. The aim of this paper is to highlight the effect of recession on the IBB especially the role of monetary policy. The monetary policy of the central bank sets the interest rate and targets the inflation. IBB is different from other banks as it works without interest. In the current situation the central bank uses the quantitative easing technique (which is to increase money supply in the market) to come out of recession, and reduce the interest rate but IBB cannot benefit from this technique. This paper is divided into five parts. The first part discusses the general trend of Islamic banking and financial products in United Kingdom (UK).

The second, part discusses the background of IBB along with its growth and competition in the market. The third, part explore the effect of regulation on the IBB. The fourth, part current recession in UK is discussed along with the performance of IBB in the current recessions. In the same part conventional banks performance is compared with IBB. Finally, the fifth part the future prospective of Islamic bank of Britain is discussed.

Islamic banking and Islamic finance

Islamic Banking and finance (IBF) is very popular in the west especially in United Kingdom (UK). Many authors conducted research's to highlight the reasons for this popularity. According to (Malik at el, 2011) the key point of highlighting this is to 'provide an account of developments that has made Islamic finance in UK from an almost 'no-go area' to a 'sought after' issue. The reasons are the UK government support and the faster growth in Muslim population.

Purpose of Choosing IBB

The purpose of choosing Islamic bank of Britain is to highlight the effect of current recession on IBB and comparing it with other conventional banks. Islamic banking is interest free, economy is more stable when there is interest free monetary policy because one of the driver of inflation is interest rate if economy is interest free than 'inflation will grow at its natural level'. (Ahmed, 2010)

I. General Trend of Islamic Financial Products in the UK

In UK conventional banks are much more in numbers than Islamic banks because of the trend from last decades. There are about 8 Islamic banks in UK till 2008 (Ahmed, 2008). But now there is an increasing demand for Islamic financial products. The reasons for increasing demand for Islamic products in the UK are:

- ☐ Growth of Muslim population in the UK
- ☐ Growth in Islamic financial products and government support
- ☐ Muslims visitors visit UK every year

1. Growth in Muslim population:

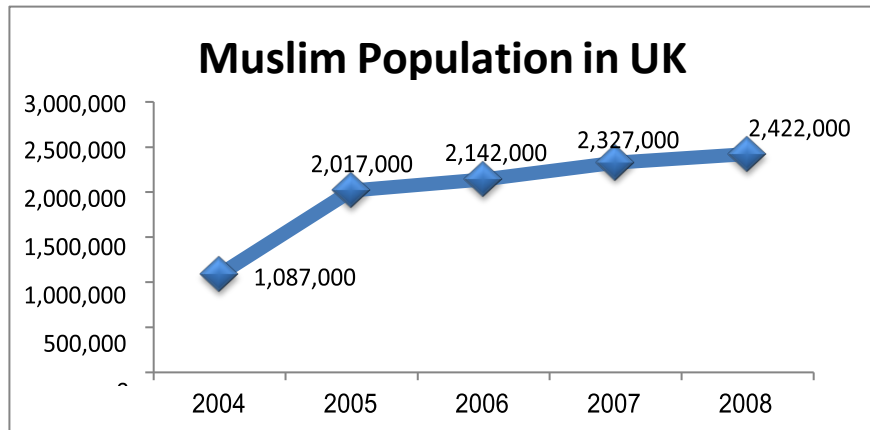
The Muslim population is growing rapidly from last many years in UK. It is about 3.3% out of overall population of UK (Ahmed, 2008). According to (Brahmachari, 2010) thirty years ago there were only 82,000 Muslims which increased to 2,424,000 in 2008.

Table 1: Muslims in Great Britain

Year	2004	2005	2006	2007	2008
Population	1,087,000	2,017,000	2,142,000	2,327,000	2,422,000

Source: Labour Force Survey

Figure 1: Muslim population in UK from 2004-2008



Source: Labour Force Survey

The population is increasing remarkably. Due to this increase there is an increase demand for Islamic financial products. From 2004 to 2005 it increases by approximately 50% which is due to the large number of immigrants in 2004 as well as with the higher fertility rate of Muslims. This can be understood by looking at the table which shows the components of population change.

Table 2: Components of population change for the UK, mid-2001 to mid-2009
Thousands

	01-02	02-03	03-04	04-05	05-06	06-07	07-08	08-09
Population at the start	59,113	59,319	59,552	59,842	60,235	60,584	60,986	61,398
Births	663	682	707	717	734	758	791	787
Deaths	601	605	603	591	575	571	570	570
Natural changes	62	77	104	127	159	187	220	217
In migration	488	518	541	604	581	606	566	562
Out migration	345	363	354	340	392	394	375	385
Net migration	143	155	186	264	189	212	191	176
Other changes	0	2	-1	3	1	3	1	1
Net migration & O.changes	143	156	186	267	190	214	192	177
Total change	205	233	290	394	349	401	413	394
Population at the end	59,319	59,552	59,842	60,235	60,584	60,986	61,398	61,792

Source: Office for National Statistics, General Register Office for Scotland, Northern Ireland Statistics & Research Agency.

2. Growth in Islamic financial products and government support:

Table 3: Growth of Islamic financial products in different countries

Rank	Country	Assets (US \$Billions)	Growth, 2007 (%)
1	Iran	235.3	27.5
2	Saudi Arabia	92.0	26.1
3	Malaysia	67.1	32.3
4	Kuwait	63.1	44.3
5	United Arab Emirates	49.1	35.9
6	Bahrain	37.4	42.8
7	Qatar	21.0	77.5
8	United Kingdom	18.1	60.7
9	Turkey	15.8	65.5
10	Pakistan	6.3	39.0

Source: Wilson, 2009

Islamic financial products are growing as there is an increasing demand for these products in UK. In 2007 these products grow by above 60% in UK. Another important factor is that in 2009 it is recorded that 20% of the IBB customers were non-Muslims (IBB website). 'UK Government is committed to provide its citizens freedom in the way they live and conduct their commercial activities as long as they are not violating the laws of the country' (Malik et al 2010). Government is supporting Islamic banking and financial products.

3. Muslims visitors visit UK every year:

There are a large number of Muslim visitors visiting UK every year. As they are providing Islamic services so they attract investment from Muslim countries like: Qatar International Islamic Bank commits £20million capital injection to IBB (IBB Website). According to Malik et al (2010) there are about half a million Muslims visits UK every year. 'This makes a sizeable market to cater.' So, Market is very impressive and this trend continues and there is a potential for IBB to grow fast and come out of recession.

II. Introduction of Islamic Bank of Britain

Islamic banking is very popular in the UK; because of this popularity IBB PLC was incorporated on 11th July 2002. The bank is providing all the services according to Shari'a Law like Ijara, Mudaraba, Musharaka, Wakala etc < (<http://www.islamic-bank.com/>) >

1. History of IBB:

It is UK's first Islamic bank approved by FSA (Financial service authority) in 2004. Secondly it was the first standalone Islamic retail bank in the Western world. It is launched on the London Stock Exchange AIM market on 12 October 2004.

Basic Principles:

- ❑ Basic principle of Islamic bank is '*Interest prohibition*' this means that any type of interest is prohibited whatever the service or product they are providing.
- ❑ The second most important principle of Islamic banking is that they are not allowed to enter in any type of '*virtual transaction*'.

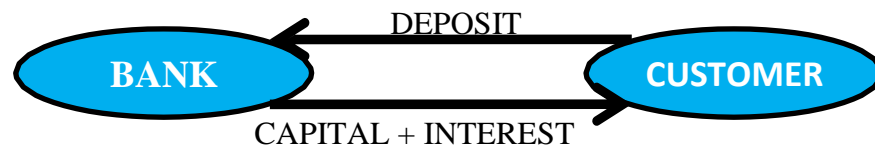
Difference between IBB and Conventional banks:

In conventional banks customers deposit and get capital plus interest. In Islamic system customer deposit than bank pool all funds in commodity trade or consumer financing. When bank gets the profit/loss it is shared with customer. This concept makes Islamic banking different from conventional banking (Figure 2).

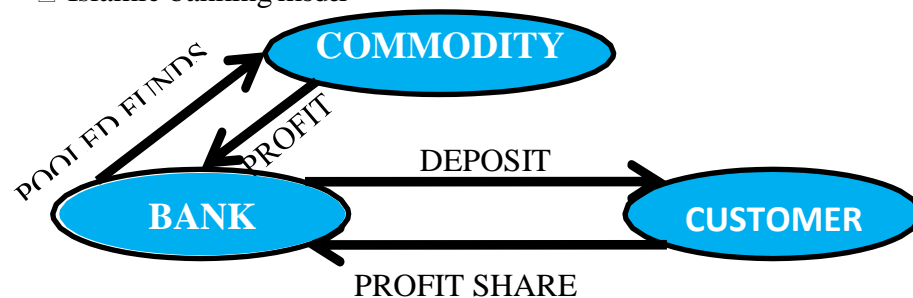
The mortgage system is also different form conventional banks. In this customer is not paying interest, bank pay full to the owner and the owner delivers that to customer. Customer than pay profit plus cost of the house to bank in every payment the ownership of house transfers to customer and at the end when customer pay full house is 100% transfer to customer (Figure 3).

Figure 2: Difference between conventional and Islamic saving account

□ Conventional banking model



□ Islamic banking model



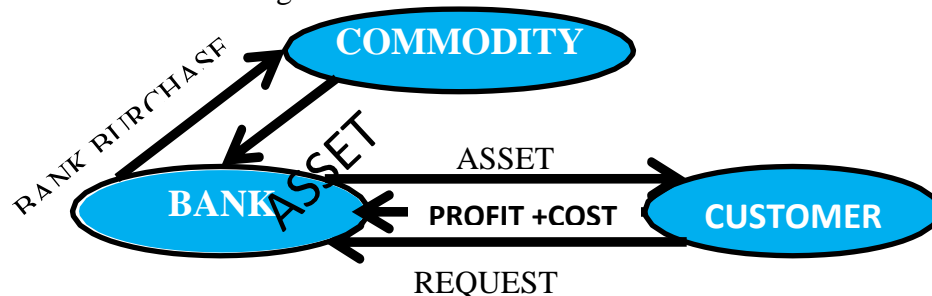
Source: Concept taken from IBB website

Figure 3: Difference between conventional and Islamic Mortgage

□ Conventional banking model



□ Islamic banking model



Source: Concept taken from IBB website

IBB's financial products

As other banks they are also providing services like Current/saving Account, Personal finance, Home Purchase Plan etc. The current account is similar to that of conventional bank but saving account and home purchase plan are different as explain above. Now, they are offering new product 'Sukuk' which is like bond but without interest (IBB website).

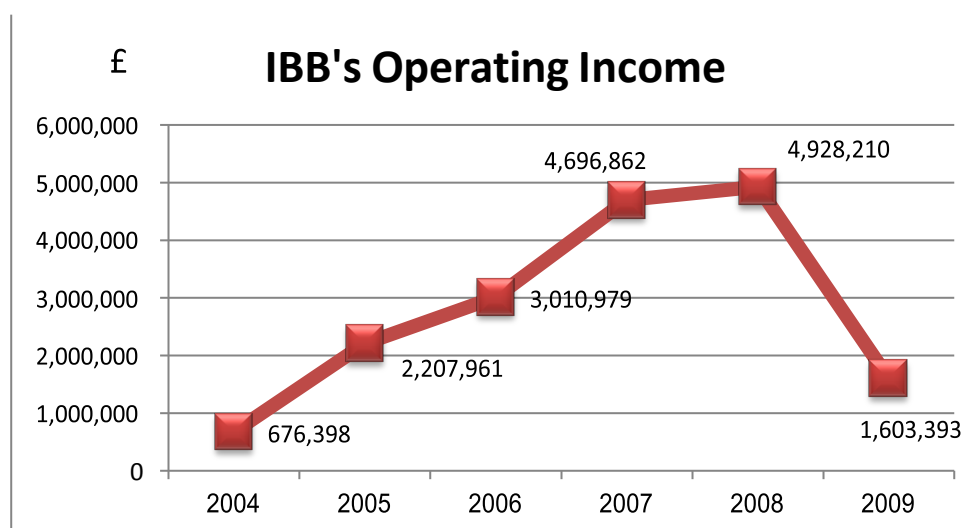
The difference between Sukuk and the conventional bond is that 'Sukuk holder is entitled to share in the revenue generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization of the Sukuk assets' (Nisar, 2007) and another difference is that this certificate is non-tradable on Stock exchange and 'instead is held until maturity or sold at par' (Nisar, 2007).

2. Growth of IBB from 2004 to 2009

□ IBB's Operating Income Growth

From 2004 – 2008, IBB's operating income had increased rapidly which nearly 600%. It shows that IBB has run its business effectively. However, in 2009, because of the effect of the recession, its income decreased dramatically from £5 million to only over £1.6 million.

Figure 4: IBB's Operating Income Growth from 2004-2009

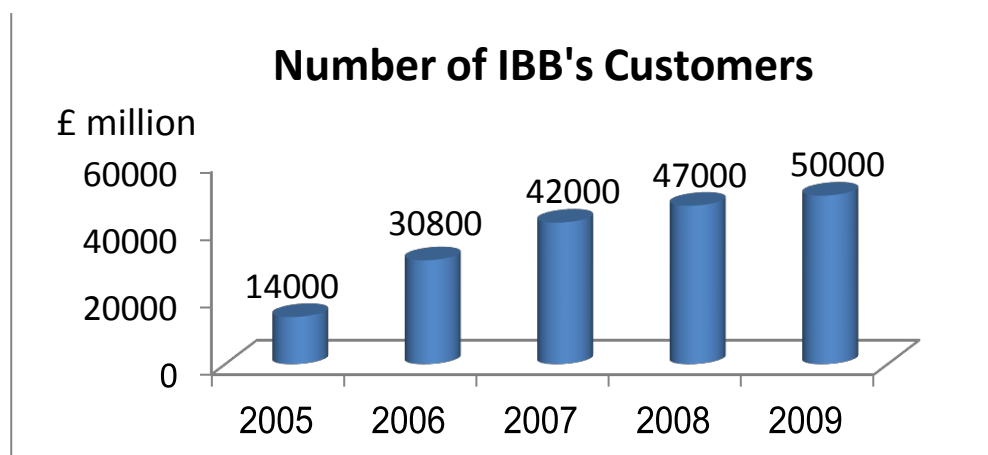


Source: Calculated from Annual Reports of IBB from 2004 – 2009

However, this drop is because businesses that IBB has invested in made loss, not because IBB cannot attract its customers. In fact, the number of IBB's customers has been continuously growing since its establishment even in 2009: from 14,000 customers in 2005 to 50,000 in 2009. It indicates that there is still a huge demand for Islamic financial services in the future.

□ IBB's Customers Growth

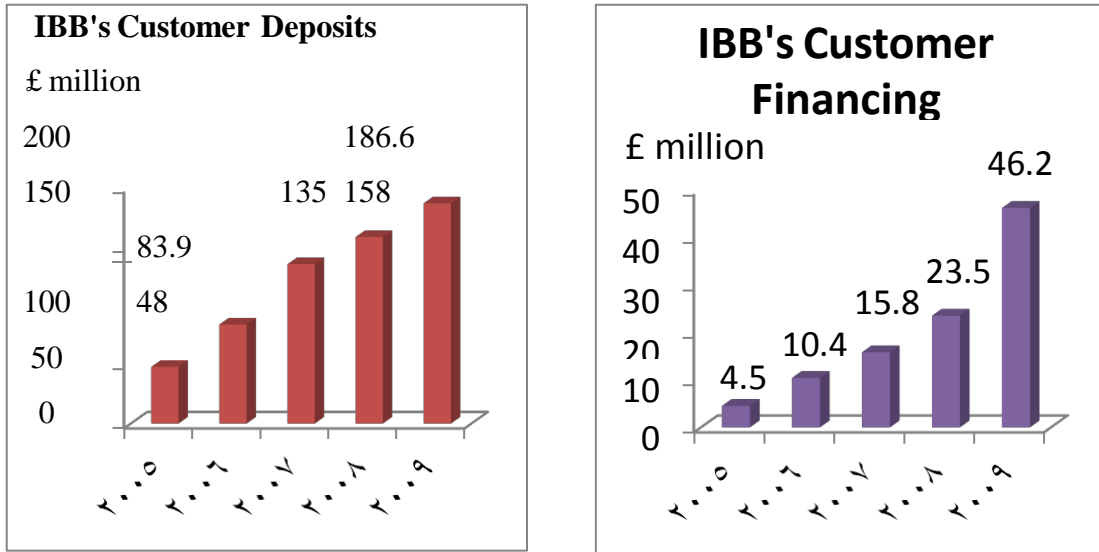
Figure 5: IBB's Customers Growth from 2005-2009



Source: Calculated from Annual Reports of IBB from 2005 – 2009

As the result of the growth of the number of its customers, IBB's Customer Deposit as well as Customer Financing has been rising even in the current recession.

Figure 6: IBB's Customer Deposits and Customer Financing Growth



Source: Calculated from Annual Reports of IBB from 2005 – 2009

3. Competition

With the support from the government, UK has been become the global center for international Islamic banking. In 2009, in the UK, there are five ‘fully Sharia-compliant’ banks and seventeen high street institutions supplying services specially for Muslim clients such as HSBC, Lloyds TSB, Barclays, RBS (Beckford, 2009). Therefore, in comparison with other non-Muslim countries, the competition in the UK is really high.

Moreover, UK has also been a world center of conventional banks for a long time so the competition in UK market that IBB has to face is extremely big, especially when Islamic banking is only in the early period with lacking of skilled staff and funds. In fact, IBB now only has eight branches in the UK, thus, it is inconvenient for its customers.

Among IBB’s competitors, HSBC Amanah can be considered as the biggest one. HSBC Amanah was established in 1998 which is earlier than IBB. It supplies various Sharia-compliant services with high quality and good attitudes. Besides, HSBC is the world local bank and also the biggest bank in the UK so it has many advantages of experienced and trained staffs, funds as well as reputation. It is the only bank in non-Muslim country which is in Top 10 leading Islamic bank by assets in 2008 (Wilson, 2009).

However, mainstream banks with Islamic products are also in difficult now. According to Knight (2010), firstly, as Muslim community highly appreciates fairness and equality in society, a part of them cannot feel comfortable with the rest of activities of those conventional banks. Thus, although HSBC and Lloyds TSB provide the same products with IBB but they cannot attract Muslim customers. Secondly, the expenses for Islamic products are much higher than their conventional ones. Thus, in 2010, Lloyds decided to stop its Sharia mortgage (Knight, 2010). This creates a good opportunity for IBB to develop further.

Besides, the principles of ethic business of IBB have attracted more and more people’s attention (not Muslim). Up to now, 20% of IBB customers are non-Muslim. Moreover, IBB has also provided new ethical and stable products to meet various customers ‘needs and compete directly with conventional banks (Property wire, 2009). Thanks to its effort, IBB was voted as ‘The UK’s best Islamic Financial Institution’ by Global Finance Magazine in 2009 (Asian News, 2009).

III. The Effects of Regulation

1. Opportunities:

United Kingdom is the first country that has publicly announced its intention to encourage Islamic Finance (Malik, A. Malik, M.S. & Shah, 2011). In 2006, Gordon Brown declared that UK is well placed to become the gateway of Islamic Finance in the West. The UK's approach for this matter is 'no obstacles, but no special favors' (FSA, 2007).

According to FSA (2007), since early 2000s, a series of changes in tax and legislation have been made to remove barriers for Islamic Finance's development. All Finance Act from 2003 to 2007 have significant adjustment to create a fair position for Islamic financial institutions.

- ❑ The Finance Act 2003 abolished the multiple payment of Stamp Duty Tax on Islamic mortgages. Before that, people who used Islamic mortgages had to pay double stamp duty on the bank's purchase of the property and on the property transfer from the bank to the customer at the end of the mortgage.
- ❑ The Finance Acts 2005 and 2006 had some further modification to put other Islamic products on the same tax position as the conventional ones.
- ❑ The Finance Act 2007 gave more details for the Sukuk (equivalent to bond in conventional terminology)'s tax framework.

Furthermore, IBB also gains benefits from EU passporting. As it is located in the UK, it can 'passport' or, in other word, expand its business activities to any country that is a member of European Union without the need of the physical presence in the host country. This regulation helps IBB easily contact an approximate 15 million potential customers in the Europe (FSA, 2007).

2. Challenges:

The main regulation problem for IBB is the conflict between the rules and principles of Islamic Shari'a and the UK legal definition of 'deposit'. The UK law defines a deposit as a 'sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by parties' (FSA, 2007).

It means that a bank's customers are guaranteed of full repayment except if the bank goes bankrupt. However, according to Islamic law, interest is a bad thing and interest-bearing deposit is not permitted so Islamic banks raise their deposits as profit and loss sharing accounts. Thus, their customers are required to accept the risk of loss of their initial capital if the Islamic banks make loss in their investment using customers' deposits.

To solve this problem, the UK Financial Services Authority (FSA) required IBB to be legally entitled to full payment for its deposits but its customers have the right to accept or decline this deposit protection. Nevertheless, this solution is considered as 'squaring the circle' (Archer & Karim, 2009). This is still unaccepted by many Muslim scholars and organizations.

This main problem also leads to other related issue: corporate governance. IBB's customers who are the holders of deposits are exposed to the risks of equity investors but they have no governance rights (Archer & Karim, 2009). Along with the possessive of shares, equity investors are always given the rights of receiving adequate information about their investment performance as well as appointing or dismissing the board of directors. However, those customers do not have such rights or any other powers in governance.

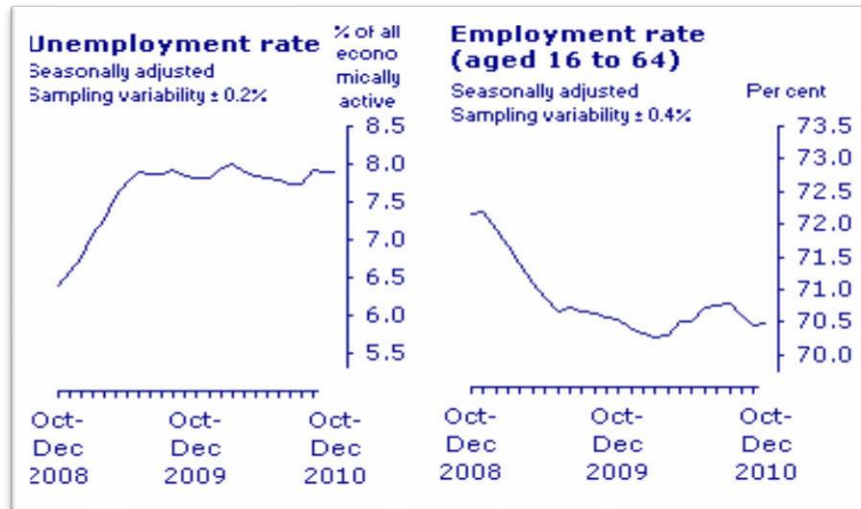
Another problem caused by the restriction of using interest is liquidity management. Two of efficient instruments that are often used by conventional banks, which are inter-bank deposits and government or corporation bonds or notes, are also not allowed by Sharia law. To increase the liquidity of Islamic bank in the UK, some systems and products that meet the Sharia criteria have been developed but they are not really applicable or acceptable. Besides, the Islamic securities markets are quite small and illiquid (FSA, 2007)

IV. Effect of Recession on Islamic Bank of Britain Recession in the UK:

A recession is a significant fall in the economic activity extending across the economy and continuing for more than a few months, and is commonly observable in employment, real income, production and other indicators. A recession starts when the economy reaches the top point of activity and ends when it reaches a trough. Recession is characterized by:

- **A rise in unemployment:** in fact, it takes time for unemployment to increase, despite the fact that when the economy is recovering; it takes time for unemployment to decline. The total number of unemployed people increased by 44,000 in 2011. On the other hand, the number of people in employment aged 16 and over fell by 68,000 and the number of people working part time fell by 62,000. Finally, people who work full time increased by 66,000.

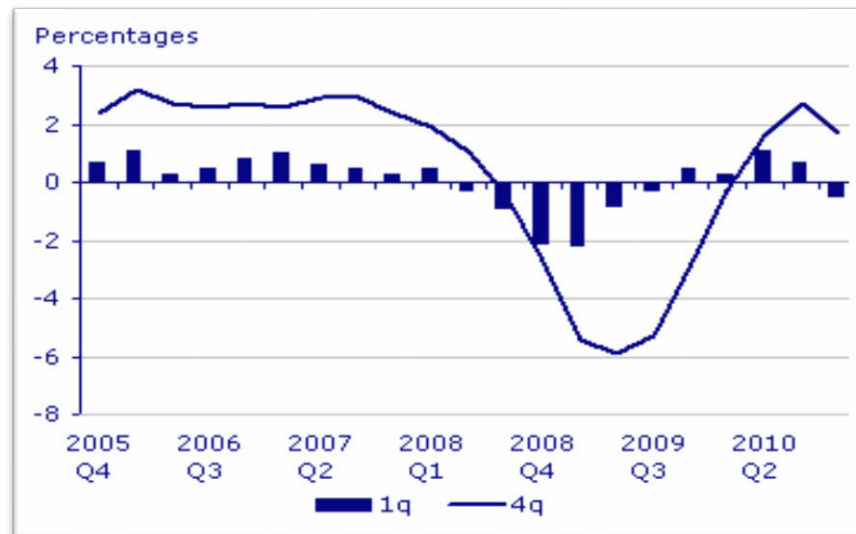
Figure 7: Employment and unemployment rate from 2008-2009



Source: Office for National Statistic

- ❑ **GDP Growth:** Gross Domestic Product decreased by 0.5% in the last quarter of 2010 which contrasted with an increase of 0.7% in the previous quarter. In fact, the GDP evaluate was significantly impacted by the bad weather in December. The full amount of services output fell by 0.5% in the last quarter of 2010 compared with an increase of 0.5% in the last quarter. The biggest participant in the decrease in this quarter was from business services and finance.

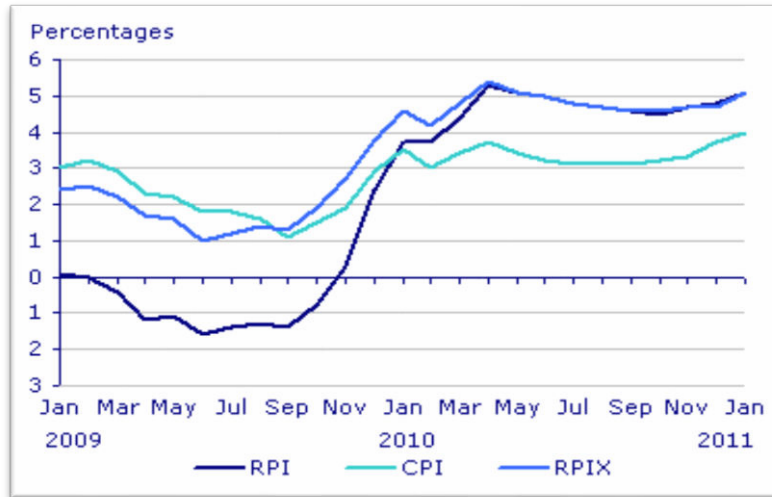
Figure 8: Real GDP quarterly growth from 2005-2010



Source: Office for National Statistic

- ❑ **Inflation:** It can be noticed that inflation increases above the target which is 2%. The figures were illustrated by the Office for National Statistics. The consumer price index annual inflation is still at 4%, which jumped from 3.7% in December. There are two main factors that had an impact on the data for January, which were the rise in the rate of VAT and the increase in the price of crude oil. Annual inflation recorded by the retail prices index was still at 5.1% in January, which increased from 4.8% in December.

Figure 9: RPI, CPI, RPIX quarterly figures from 2009-2011

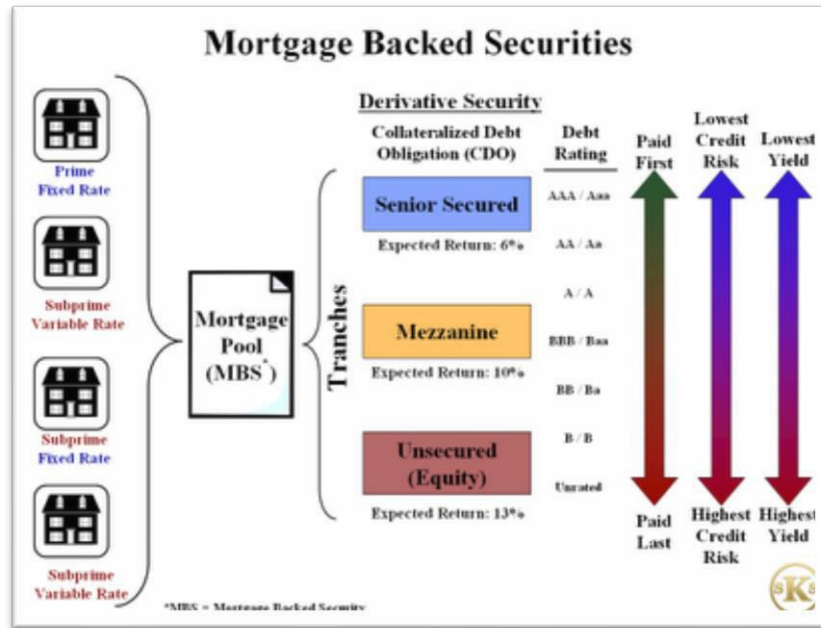


Source: Office for National Statistic

Current Recession in the UK and Islamic British Bank

The recession has affected all sectors, from the car industry to retail, however the financial sector is one of the hardest hit. The financial sector is one of the most crucial sectors in the UK in terms of national output and foreign currency. It makes an important contribution to tax, income and corporation revenues. In fact, the financial sector is in deep recession and there is rising unemployment. There are many factors contributing to the current recession, however, this paper will look at the derivative market and the way in which it was one of the factors that caused the current crisis. The first type of derivatives which is commonly used by the conventional banks is CDO (Collateralized Debt Obligation) which is a type of structured credit product in assets-backed security. The objective of that product is to make tiered cash flows from mortgages. The structure of CDO initially is that all the cash flows from a CDO and a collection of mortgages are pooled together. The pool of payments is parted into rated tranches; also each tranche has a different stated debt rating to it. The highest tranche is usually the “AAA” rate senior, the middle tranche is known as the mezzanine tranche and finally the lowest tranche is “AA” or “BB”. Each tranches’ rating determines how much principle and interests are at each tranche.

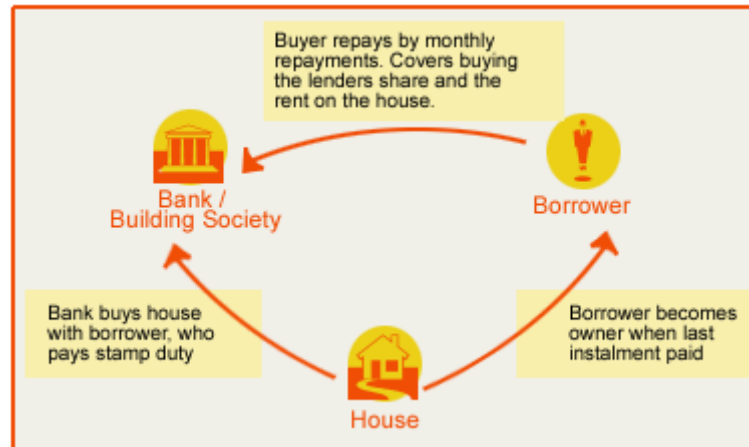
Figure 10: Mortgage Backed Securities



Source: Economic outlook

There was such a great demand for these CDOs but not enough mortgages, so as a result the conventional banks created CDOs, namely a **synthetic CDO**. This type of derivative caused a huge problem for the banks; **firstly** they struggled with how to list their assets on their books. CDOs have been listed at inflated prices while in reality is not true when the banks have to list them at the current market value. Banks faced a problem and everyone noticed that they did not have the assets which they claimed to have. The second problem was leverage, most of the conventional banks had a leverage of 30 to 1; that means that for every pound of their own that they invested in these mortgages, and they used £30 that was borrowed to invest. The lack of transparency in the derivative market (especially the type of derivatives which are traded over the counter and synthetic contracts) resulted in many dilemmas that ultimately led to a recession. **Islamic mortgages** are different; they are more transparent and clearly understandable. The first step involves the client choosing the property and agreeing a price, and then the bank enters into a contract to buy the property. After that, the bank sells the property to the client at a higher price. Finally, the higher price is paid by the client in equal installments over the fixed term.

Figure 11: Home Purchase Plan in Islamic system



Source: Islamic and Halal mortgages

1. Performance of Islamic bank during the recession

In fact, the Islamic bank shows a better performance than conventional banks. There are some reasons that help the Islamic bank to survive during a recession period, which are:

- ❑ The most contemporary worldwide downturn was associated with assets management and the concept of risk management. Providing these point assets are the cornerstones of the Islamic bank. They have to be real, have value and have marketable features, which helps the Islamic bank to earn some profit even during times of recession.
- ❑ The Islamic bank continues its high performance because they enjoy a built-in stabilizer to support them in managing the economic downturn, so rather than pay interest to depositors, those with investment “Mudaraba” accounts share in the bank’s profits and losses. So if profits decrease, depositors absolutely obtain a lower return, and if profits increase, they receive a good return. This is different to conventional bank depositors receiving a return through the interest rate which is not related to the Islamic bank concept.

2. Monetary policy of the Bank of England and Islamic British bank

The aim of the monetary policy is to stabilize the price and control the inflation, because a stable price can help to build sustainable long-term economic growth. In 2009 it was announced by the monetary policy committee that it would start to inject money into the economy, known as **Quantitative easing**. The Central Bank creates money that is used to purchase government bonds and other financial assets in order to increase money supply and the excess reserves of the bank system. However, the Islamic bank cannot benefit from quantitative easing as they are not allowed to buy government bonds, because it has a fixed interest rate in it and that does not correspond with Sharia law. Moreover, they cannot receive money from someone and then expect to benefit (interest as Usury/Riba) as it is not acceptable in Sharia law to make money out of money. Wealth can only be made through legitimate trade and investment in assets and money must be used in a productive way. So the money which has been injected into the economy has no benefits for the Islamic bank.

❑ Interest rate

The monetary policy committee discussed that on the 23rd February 2011 the interest rate needed to rise faster than the market expected to help bring **inflation** down. Conventional banks have to follow what is announced by the monetary policy committee simply because they deal with interest rates, yet for the Islamic bank, there is no obligation for them to do likewise. One of the monetary policy's objectives is to keep inflation at a target of 2%. On the other hand, the **Islamic British Bank** is not affected by the raising of the interest rate because the basic principle of Sharia law is to ban interest rates. Inflation does affect conventional banks as well as the Islamic banks.

3. Islamic British Bank's performance

The Islamic British Bank is a commercial bank established in August 2004. It offers Islamic financial services and products to the Muslim community who are living in the UK. IBB is not the first Islamic bank in the UK and in addition, HSBC offers some Islamic products and services. Indeed, the Islamic bank could operate better and more efficiently than a conventional bank during a recession.

According to the Islamic bank and finance in the UK (2005-2006), the Western bank and finance system has conserved the Islamic system's ability to be quiescent for a long time. Nevertheless, there has been resurgence of late. The Islamic bank and finance is increasing at a surprising rate (from 15% to 20%) and has managed this growth during the financial crisis that affected conventional banks and made them suffer terribly. There are several reasons which helped the Islamic bank to survive during that recession:

- ❑ Islamic bank is bound to stay away from interest rate, derivatives and short sales of debt.
- ❑ High demand for Islamic products
- ❑ Sharing losses as well as profits, which supports both parties (the bank and investors)

Over the last two years, the Islamic British Bank did not perform well; however it was not affected as much as conventional banks. As can be seen from the diagram below, there was a significant decline during September 2010, and it faced losses last year from £5.9 million to £9.5 million. There are some reasons which led to that result, which are:

- ❑ Islamic bank was impacted upon during the economic downturn, especially from the slump in the housing market.
- ❑ Cash flow was needed at the time to continue operating, so Qatar international investors injected £20 million of capital through the issuing of two million shares at 1p each.

Figure 12: IBB performance last three years



Source: yahoo finance

V. Future Perspective of Islamic British Bank

The development of the Islamic bank in the UK has been enormous since it started in 2002. However, there are only eight branches around the UK, in London, Birmingham, Manchester and Leicester. The lack of knowledge about the Islamic system made the Islamic market limited. Nevertheless, a number of British bankers are learning the principles behind the Islamic banking industry, and additionally, there are a reasonable number of universities offering courses in Islamic banking and services to encourage students to be active in this field. This reveals there is more demand for Islamic banking and services, as in the UK, the Islamic bank's focus in developing its products is to attract investors who are non-Muslims as well as Muslims. For instance, in the Manzil scheme, this type of product is very successful as there are between 50 to 80 potential clients a week who are interested in it and more than 40 who respond by e-mail to the website. This demonstrated that it is a product in high demand. Croft (2007) believes that Islamic mortgages will grow at an average of 47% per annum. The Islamic bank has the potential to grow not only in the UK but also in Europe, in countries like France and Germany.

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