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Islamic Finance: Overview and Policy Concerns

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Summary

Islamic finance is based on principles of *shariah*, or "Islamic law." Major principles of *shariah* are a ban on interest, a ban on uncertainty, adherence to risk-sharing and profit-sharing, promotion of ethical investments that enhance society, and asset-backing. The international market for Islamic finance has grown between 10% to 15% annually in recent years. Islamic finance historically has been concentrated in the Persian Gulf countries, but has expanded globally to both Muslim and non-Muslim countries. There is a small but growing market for Islamic finance in the United States. Through international and domestic regulatory bodies, there has been effort to standardize regulations in Islamic finance across different countries and financial institutions, although challenges remain. Critics of Islamic finance express concerns about possible ties between Islamic finance and political agendas or terrorist financing and the use of Islamic finance to circumvent U.S. economic sanctions. Proponents argue that Islamic finance presents significant new business opportunities and provides alternate methods for capital formation and economic development.

Background

Islamic finance is based on *shariah*, an Arabic term that is often translated into "Islamic law." *Shariah* provides guidelines for aspects of Muslim life, including religion, politics, economics, banking, business, and law.[1] *Shariah*-compliant financing (SCF) constitutes financial practices that conform to Islamic law. Major principles of *shariah* that are applicable to finance and that differ from conventional finance are:

- **Ban on interest (*riba*):** In conventional forms of finance, a distinction is made between acceptable interest and usurious interest. In contrast, under Islamic law, any level of interest is considered to be usurious and is prohibited.

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[1] Michael Silva, " Islamic Banking Remarks," *Law and Business Review of the Americas*, Spring 2006, 12, 2.

- **Ban on uncertainty:** Uncertainty in contractual terms and conditions is not allowed, unless all of the terms and conditions of the risk are clearly understood by all parties to a financial transaction.
- **Risk-sharing and profit-sharing:** Parties involved in a financial transaction must share both the associated risks and profits.
- **Ethical investments that enhance society:** Investment in industries that are prohibited by the *Qur'an*, such as alcohol, pornography, gambling, and pork-based products, are discouraged.
- **Asset-backing:** Each financial transaction must be tied to a "tangible, identifiable underlying asset." Under *shariah*, money is not considered an asset class because it is not tangible and thus, may not earn a return.[2]

Some question how lenders profit from financial transactions under Islamic law. For instance, in a real estate setting, SCF takes the form of leasing, as opposed to loans. Instead of borrowing money, the bank obtains the property and leases it to the *shariah*-compliant investor, who pays rent instead of interest. Earnings of profits or returns from assets are permitted so long as the business risks are shared by the lender and borrower.[3]

International Scope of Islamic Finance

Modern Islamic finance has existed internationally since the 1970s. Currently, Islamic finance represents a small but growing segment of the global finance industry. Estimates vary of the total size of assets held internationally under Islamic finance, ranging upwards from $800 billion and with growth rates of 10% to 15% annually over the past ten years.[4] The global market for Islamic bonds, known as *sukuk,*[5] is estimated to be $70 billion currently and is projected to reach $100 billion by 2010.[6] Global issuance of *sukuk* has increased more than five-fold from 2004 to 2007 (see **Figure 1**).[7]

In some countries, such as Iran and Pakistan, Islamic banks are the only mainstream financial institutions. In others, SCF exists alongside conventional banking.[8] The Persian Gulf region and Southeast Asia, led by Malaysia, historically have been the major centers for SCF. For oil producers in the Gulf region, Islamic finance may offer investment opportunities for their growing revenues from oil exports. There also has been a growing

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[2] The National Bureau of Asian Research, "Islamic Finance: Global Trends and Challenges," Volume 18, Number 4, March 2008. Standard & Poor's, "Islamic Finance Outlook 2008."

[3] Andreas Jobst, "The Economics of Islamic Finance and Securitization," International Monetary Fund (IMF) Working Paper WP/07/117, August 2007.

[4] David Oakley, Shannon Bond, Cynthia O'Murchu, and Celve Jones, "Islamic Finance Explained," *Financial Times*, May 30, 2008.

[5] Islamic bonds are constructed as profit-sharing or rental agreements that are tied to physical assets.

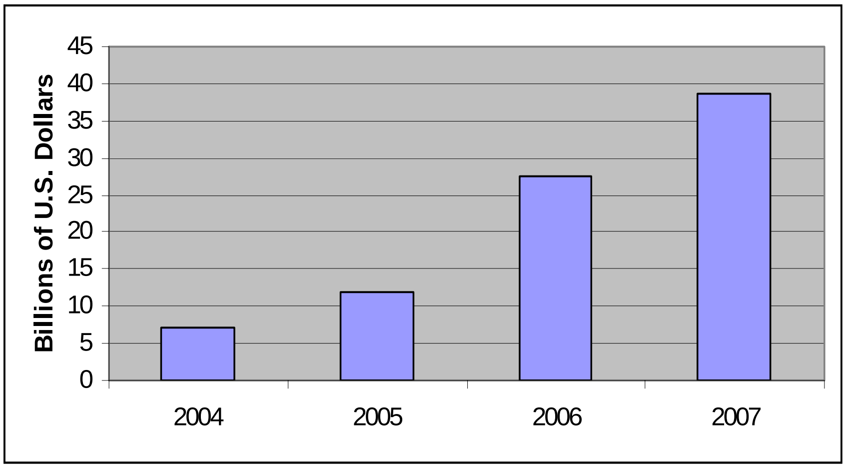
[6] Standard & Poor's, "Islamic Finance Outlook 2008."

[7] Andreas Jobst, Peter Kunzel, Paul Mills, and Amadou Sy, "Islamic Bond Issuance - What Sovereign Debt Managers Need to Know," IMF Discussion Paper, PDP/08/3, July 2008.

[8] Shirley Chiu, Robin Newberger, and Anna Paulson, "Islamic Finance in the United States," *Society*, September/October 2005.

awareness of and demand for Islamic finance options by Muslim consumers. In recent years, SCF has expanded into Africa, particularly Sudan.[9]

Figure 1. Global Issuance of Islamic Bonds, 2004-2007



Note: Data from the Islamic Finance Information Service access through the International Monetary Fund.

Support for Islamic finance varies in the Middle East. In some countries, such as Libya and Morocco, Islamic banks are considered by some to be tied to Islamic political parties and consequently have been refused licenses. Other countries, including Jordan, Tunisia, and the Sudan, have been receptive to Islamic finance, viewing Islamic financial products as an opportunity for creating capital and fostering economic development.[10]

Islamic finance is growing in Europe and North America, areas in which Muslims are in the minority. In August 2004, the United Kingdom's Financial Services Authority (FSA) approved a banking license for the Islamic Bank of Britain (IBB), the country's first Islamic bank. The IBB would serve the consumer market with *shariah*-compliant products.[11] In March 2006, the FSA licensed the European Islamic Investment Bank as the United Kingdom's first independent bank for *shariah*-compliant investments.

Islamic Finance in the United States

With an estimated five to seven million Muslims in the United States, there is growing interest for Islamic finance and business opportunities for lenders. Some have suggested Islamic finance may be an attractive option for investors as conventional finance faces challenges from the U.S. subprime lending crisis and recession concerns.[12] In the United States, SCF largely exists in personal home mortgages. Guidance Residential (Reston, Virginia) reportedly has financed over 5,000 *shariah*-compliant mortgages since

[9] Vikram Modi, "Writing the Rules: The Need for Standardized Regulation of Islamic Finance," *Harvard International Review*, Spring 2007.

[10] Ibid.

[11] Standard & Poor's, "Islamic Finance Outlook 2008."

[12] Peter Apps, "Global financial centers battle for Islamic markets," *International Herald Tribune*, July 25, 2008.

2002.[13] Other financial intermediaries that provide Islamic-based home mortgages include University Islamic Financial (Ann Arbor, Michigan), Devon Bank (Chicago, Illinois), and American Finance House Lariba (Pasadena, California). HSBC is the only large commercial bank that offers U.S. Islamic finance and is focused on New York.[14] The Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Corporation (Freddie Mac) purchase *shariah*-compliant mortgage contracts from financial intermediaries, allowing providers to originate further mortgages. In 2007, Freddie Mac reportedly purchased more than $250 million in Islamic home loans, a small but notable fraction of the enterprise's $1.77 trillion in business activities.[15]

Other forms of *shariah*-compliant services are offered in the United States as well. For instance, Devon Bank and Zayan Finance offer SCF for commercial real estate. *Shariah*-compliant mutual funds are offered by intermediaries such as the Amana Mutual Funds Trust, Azzad Funds, and the Dow Jones Islamic Fund.[16] In 1999, the Dow Jones presented its first Islamic market index, which follows *shariah*-compliant stocks internationally. The Dow Jones maintains more than 70 indices in its Islamic series and is advised by an independent *Shariah* Supervisory Board counsel.[17]

International financial intermediaries also provide SCF in the United States. Islamic investors from the countries of the Gulf Cooperation Council (GCC) have sought to diversify their financial portfolios geographically and to invest their oil wealth in U.S. assets. For instance, the Bahrain-based Arcapita Bank has structured many *shariah*-compliant transactions in private equity and real estate in the United States.[18] Additionally, U.S.-based companies have taken advantage of alternative funding sources through Islamic-financing abroad. According to Standard & Poor's, Loehmann's Holdings, Inc. and East Cameron Gas Company have issued rated *shariah*-compliant bonds.[19]

Islamic Finance Regulation

Financial institutions seeking to offer *shariah*-compliant products typically have a *shariah* supervisory board (or at a minimum, a *shariah* counselor). The *shariah* board would review and approve financial practices and activities for compliance with Islamic

[13] N.C. Aizenman, "A Higher Law for Lending," *The Washington Post*, May 13, 2008.

[14] Shirley Chiu, Robin Newberger, and Anna Paulson, "Islamic Finance in the United States," *Society*, September/October 2005.

[15] N.C. Aizenman, "A Higher Law for Lending," *The Washington Post*, May 13, 2008.

[16] "Islamic Finance Gaining Traction in the U.S.," *Dinar Standard*, November 22, 2007.

[17] Dow Jones, "Dow Jones Islamic Market Index: World Measures With a New Perspective," data current as of March 31, 2008.

[18] "Ali: Islamic Banking is a Rapidly Growing Industry," Council of Foreign Relations interview, June 8, 2007.

[19] Standard & Poor's, "The Islamic Financial Industry Comes of Age," Commentary Report, October 25, 2006.

principles. Such expertise raises the attractiveness of *shariah*-compliant financial intermediaries to investors considering SCF.[20]

Shariah is open to interpretation and Islamic scholars are not in complete accordance regarding what constitutes SCF. Islamic finance laws and regulatory practices vary across countries. The lack of concurrent viewpoints makes it difficult to standardize Islamic financing.[21] Many observers view standardization of SCF regulations as important in increasing the marketablity and acceptance of Islamic products.

International institutions have been established to promote international consistency in Islamic finance. For instance, the Islamic Financial Services Boards (IFSB) puts forth standards for supervision and regulation.[22] As another example, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), issues international standards on accounting, auditing, and corporate governance.[23] Many leading Islamic financial centers around the world have adopted international SCF regulation standards.[24]

U.S. federal banking regulators have provided some formal guidance about Islamic products. The Office of the Comptroller of the Currency (OCC) issued two directives concerning *shariah*-compliant mortgage products. In 1997, the OCC issued guidance about *ijara* ("lease"), a financial structure in which the financial intermediary purchases and subsequently leases an asset to a consumer for a fee. In 1999, the OCC recognized *murabaha* ("cost-plus"), under which the financial intermediary buys an asset for a customer with the understanding that the customer will buy the asset back for a higher fee.

U.S. Policy Concern and Issues for Congressional Interest

As Islamic finance activities grow in the United States, critics raise concerns about the related capital adequacy and system risks. Proponents of Islamic finance assert that the ban on risk-taking mitigates many concerns. Some also view the integration of ethics and values into finance as a positive development, especially in light of recent U.S. business corruption scandals. Many investors reportedly consider SCF to be more reliable than conventional financing, given the recent global credit crisis and fears of economic recession.[25] Some observers suggest that full disclosure of SCF-related risks may alleviate investor concerns and increase accessibility to Islamic financial products.[26]

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[20] Juan Solé, "Introducing Islamic Banks into Conventional Banking Systems," IMF working Paper WP/07/175, July 2007.

[21] "Islamic Banks: A Novelty No Longer," *BusinessWeek*, August 8, 2005.

[22] Ibid. Information about standards issued by the IFSB are available at [http://ifsb.org].

[23] AAOIFI standards are available on AAOIFI's website, [http://www.aaoifi.com/].

[24] "Watchdog is developing governance standards," *Misr Information Services and Trading News*, July 28, 2008.

[25] Peter Apps, "Global financial centers battle for Islamic markets," *International Herald Tribune*, July 25, 2008.

[26] Vikram Modi, "Writing the Rules: The Need for Standardized Regulation of Islamic Finance," *Harvard International Review*, Spring 2007.

The growth of Islamic finance in the United States may have implications for congressional oversight. Congress may be interested in evaluating the relationship between the current U.S. banking legal and regulatory framework and Islamic finance. Current U.S. laws and regulation may be broad enough to accommodate some aspects of Islamic finance. Others aspects of Islamic finance may pose some unique challenges to U.S. laws and regulations, such as applying rules created for conventional, interest-based products to Islamic products.[27] There is debate about whether or not, or the extent to which, regulators should apply rules on conventional products to Islamic product counterparts.[28]

Some express concerns about the national security implications of Islamic finance, specifically that Islamic banking transactions may channel funds to terrorists or "facilitate terrorists' access to funds." Others assert that the risks of Islamic finance are not significantly greater or different than those from conventional finance and that the majority of recent terrorist financing cases related to SCF have been thrown out of court. In congressional testimony, one observer stated "there is no reason - in theory - to suspect that Islamic finance would be particularly immune or particularly vulnerable to abuse by money launderers or terrorist financiers."[29] Some proponents also assert that security-related concerns about Islamic finance stem from a lack of understanding of SCF or from stereotyping.[30] There may be a "conflation" of Islamic finance with *hawala*, an informal trust-based money transfer system prominent in the Middle East and many Muslim countries. *Hawala* transactions are based on an honor system, with no promissory instruments exchanged between the parties and no records of the transactions. Some analysts consider the *hawala* system particularly susceptible to terrorist financing.

Congress also may be interested in the possibility of Islamic finance as a vehicle for sidestepping U.S. and international economic sanctions. For example, the Sudanese government reportedly issued Islamic bonds to Gulf investors in order to circumvent U.S. sanctions.[31]

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[27] Thomas C. Baxter, "Regulation of Islamic Financial Services in the United States," Remarks Before the Seminar on Legal Issues in Islamic Financial Services Industry, March 2, 2005.

[28] Vikram Modi, "Writing the Rules: The Need for Standardized Regulation of Islamic Finance," *Harvard International Review*, Spring 2007.

[29] Mahmoud A. El-Gamal, "Islamic Finance in the Middle East," testimony prepared for U.S. Senate Committee on Banking, Housing and Urban Affairs, "Money Laundering and Terror Financing Issues in the Middle East" hearing.

[30] Michael Silva, " Islamic Banking Remarks," *Law and Business Review of the Americas,* Spring 2006, 12, 2.

[31] "Turning towards Mecca: Islamic banks join in the race of Africa," *Economist*, Vol. 387, Issue 8579, May 10, 2008.