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Islamic Finance: A Growing Industry in the United States

I. INTRODUCTION

The Islamic financial industry, which is governed by Shari'ah law, the divine law as revealed in the Koran and the teachings of the Prophet Muhammad,¹ has experienced considerable growth since its development in the 1970s.² There are now at least 265 Islamic financial institutions operating in approximately forty countries, with total assets topping \$262 billion³ and deposits over \$202 billion.⁴ Over the past few years, Western institutions have become increasingly involved in Islamic financing so that it is no longer exclusive to Middle-Eastern institutions.⁵ This increased interest is not surprising, considering the growth in the Islamic financial industry and that Muslims, led by Gulf Arabs, hold assets in all banks estimated at \$1.5 trillion and growing at a rate of 15% a year.⁶ Until 1997, financial institutions in the United States did not offer formal Islamic financing that was both sanctioned by a Shari'ah Board⁷ and publicly approved by a U.S. regulatory agency.⁸ Today, a small but growing number of entities now offer

1. J. Michael Taylor, *Islamic Banking – The Feasibility of Establishing an Islamic Bank in the United States*, 40 AM. BUS. L.J. 385, 416 (2003).

2. Though the first Islamic bank was established in Egypt in 1960, commentators agree that the Islamic financial “industry” first began its development in the 1970s. *Id.* at 393.

3. Assif Shameen, *Islamic Banks: A Novelty No Longer*, BUSINESS WEEK ONLINE, Aug. 8, 2005, http://www.businessweek.com/magazine/content/05_32/b3946141_mz035.htm.

4. Babback Sabahi, *Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for American Financial Institutions* 1 (Boston Univ. Sch. of L., Working Paper No. 385, 2004), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=2038&context=expresso>.

5. See, e.g., Shameen, *supra* note 3.

6. In large part due to high oil prices. *Id.*

7. A board of Islamic scholars that every institution offering Islamic financial services is required to have. See Sheikh Nizam Yaquby, *Shari'ah Requirements for Conventional Banks*, FAILAKA INT'L INC (2000), <http://www.failaka.com/Library/Articles/Requirements%20for%20Conventional%20Banks.pdf>.

8. Shirley Chiu et al., *Islamic Finance in the United States: A Small but Growing Industry*, CHICAGO FED LETTER, May 2005, available at http://www.chicagofed.org/publications/fedletter/cflmay2005_214.pdf.

formal Islamic financing products in the United States, with many customizing loan products for Muslim clients on an as-needed basis.⁹

This Note attempts to demonstrate the extent to which the United States has tapped into the Islamic financial market and some challenges that U.S. financial institutions may face as they seek to capture more of this market. Section II provides background information on Islamic finance and factors contributing to the rapid growth of the Islamic financial industry, including uniform standardization and the development of a secondary market for Shari'ah-compliant products.¹⁰ Section III provides a description of some of the Islamic financial services that U.S. financial institutions offer and addresses some practical issues that arise as a result, such as compliance with Shari'ah requirements, regulation, and supervision.¹¹

II. ISLAMIC FINANCE: BACKGROUND

A. *Islamic Prohibitions of Interest and Risk/Uncertainty*

The Koran governs all aspects of adherents' lives, including finance.¹² The Arabic word "riba" means "increase,"¹³ and under Shari'ah law, it includes the interest that must be paid by a borrower to a lender in addition to the principal amount as a condition for a loan or for an extension of its maturity.¹⁴ Riba is a capital sin of Islam¹⁵ and is prohibited by the Koran in order "to prevent usurious conditions in exchanges and loans."¹⁶ While minority opinions may differ,¹⁷ the consensus among Islamic scholars is that the prohibition of riba extends to all forms of interest.¹⁸ According to Islamic jurists, riba is prohibited

9. *Id.*

10. See *infra* notes 12-97 and accompanying text.

11. See *infra* notes 98-214 and accompanying text.

12. E.g., Ariel Berschadsky, *Innovative Financial Services in the Middle East: Surmounting the Ban on Interest in Islamic Law*, 9 U. MIAMI BUS. L. REV. 107, 108 (2001).

13. E.g., Barbara L. Seniawski, *Riba Today: Social Equity, The Economy, and Doing Business Under Islamic Law*, 39 COLUM. J. TRANSNAT'L L. 701, 707 (2001).

14. Taylor, *supra* note 1, at 389.

15. Reinhard Klarmann, *Construction and Lease Financing in Islamic Project Finance*, J. INT'L BANKING L. AND REG. 61, 61 (2004).

16. Seniawski, *supra* note 13, at 702.

17. See generally Berschadsky, *supra* note 12, at 108-09.

18. Taylor, *supra* note 1, at 390-91.

so as to avoid unearned gain or profit resulting from speculative or risky transactions.¹⁹

Shari'ah law also prohibits "gharar," which translates to an "unacceptable" level of risk or uncertainty.²⁰ As a result of this prohibition, contracts cannot involve the sale of an object not in existence, and forwards, futures and options contracts are generally unenforceable.²¹ Traditional forms of insurance are also impermissible because they involve an unacceptable level of uncertainty.²² While the prohibition of gharar is a well-settled principle in Shari'ah law, the point at which risk and uncertainty reach an "unacceptable" level is fact-specific and determined on a case-by-case basis.²³ Thus, high risk does not necessarily equal unacceptable risk.²⁴

B. *Financial Instruments Compliant with Shari'ah Law*

In response to the Islamic ban on interest and risk, Islamic financial institutions developed several tools for carrying out interest-free banking transactions based on the legal concepts of partnership and profit- and loss-sharing, rather than on a lender-borrower basis.²⁵ Under the profit/loss-sharing structure, a financial institution enters into a joint venture with a client in order to provide capital.²⁶ The risk assumed by the financial institution in the joint venture justifies any profit made from the transaction.²⁷

1. *Murabaha* (Cost Plus Financing): Although used as a method of finance, a murabaha is a sales contract, typically used to facilitate

19. Michael J.T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184, 1186 n.2 (2001).

20. Sabahi, *supra* note 4, at 5.

21. *Id.*

22. *Id.*

23. *Id.* at 5 n.16.

24. See generally *infra* notes 49, 56 and accompanying text (stating that musharaka and mudaraba are two financial instruments that are considered risky or "high risk," yet are accepted as Shari'ah-compliant).

25. See, e.g., Taylor, *supra* note 1, at 394-95.

26. Chiu et al., *supra* note 8.

27. *Id.*

short-term trade transactions.²⁸ In a murabaha transaction, rather than loaning the client money to purchase a good, the financial institution buys the good and sells it to the client at a marked-up price.²⁹ The client generally pays for the good in deferred payments³⁰ or over a stated installment period.³¹ Unlike in traditional financing, however, if there is a default the client is only liable to the financial institution for the contracted sale price and not any additional fees or interest.³²

The financial institution must assume ownership of the good before transferring it to the client.³³ The risk that the client might back out of the deal and force the financial institution to incur costs by finding another buyer justifies the profit that the institution makes from the marked-up price.³⁴ For this reason, it is important for financial institutions to deal only with trusted clients or those that provide some form of guarantee or collateral.³⁵

2. *Ijara* (Lease Financing): *Ijara* is similar to an installment leasing agreement and is typically used by financial institutions to provide funding for plant and machinery purchases.³⁶ In this transaction, the financial institution purchases a specified asset and leases it to the client in return for rent payments.³⁷ The duration of the lease and the rent for the entire term is fixed at the signing of the agreement, with the financial institution maintaining ownership of the asset.³⁸

In most *ijara* transactions, the lessee has an option to purchase the asset at the end of the lease period.³⁹ This is known as “*ijara wa iqtina*,” which literally means “lease and ownership.”⁴⁰ As discussed

28. Gohar Bilal, *Islamic Finance: Alternatives to the Western Model*, 23 FLETCHER F. WORLD AFF. 145, 153 (1999).

29. Taylor, *supra* note 1, at 395.

30. Sabahi, *supra* note 4, at 8.

31. Taylor, *supra* note 1, at 395.

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.* at 396.

36. Bilal, *supra* note 28, at 154.

37. *Id.*

38. *Id.*

39. See, e.g., Klarmann, *supra* note 15, at 65.

40. Islamic-Finance.com, http://www.islamic-finance.com/item_ijara_f.htm (last visited Jan. 30, 2006).

more fully in Section III,⁴¹ U.S. institutions have used this form of ijara to structure alternatives to home mortgaging.⁴² Even in instances where the lessee agrees to buy the asset at the end of the term, a price cannot be pre-determined for the sale,⁴³ nor can the purchase at the end of the term be made binding.⁴⁴ Some other differences between ijara and a traditional lease are: (1) in an ijara transaction, the lease begins the day the asset is delivered to the client rather than the day the contract is signed, as with a conventional lease; and (2) in an ijara transaction, the lessee will not be liable for the full rent if the asset is destroyed.⁴⁵

3. *Musharaka* (Partnership Finance): A musharaka, literally “partnership,”⁴⁶ agreement is typically a transaction where the financial institution provides a percentage of the capital needed to its client and the client contributes some capital along with management efforts and expertise.⁴⁷ The financial institution and the client proportionately share in both the profits and the losses on the basis of a formula agreed upon before the transaction is complete.⁴⁸ Because musharaka is essentially unsecured funding, it exposes a bank to a higher risk than it would face with murabaha or ijara, where funding is secured by an asset.⁴⁹

4. *Diminishing Musharaka*: This is a form of partnership where one of the partners promises to gradually buy the equity share of the other partner until title to the equity is completely transferred to the buying partner.⁵⁰

5. *Mudaraba* (Venture Capital Transactions): The mudaraba is a partnership agreement much like the musharaka except that in the mudaraba the financial institution provides all of the capital to a client and the client provides only management efforts and expertise.⁵¹ The

41. See *infra* Part III.

42. See, e.g., Chiu et al., *supra* note 8.

43. Islamic-Finance.com, *supra* note 40.

44. Bilal, *supra* note 28, at 154.

45. Taylor, *supra* note 1, at 397.

46. *Id.*

47. *Id.*

48. *Id.*

49. Bilal, *supra* note 28, at 157.

50. ISLAMIC FINANCIAL SERVICES BOARD, EXPOSURE DRAFT NO. 1, GUIDING PRINCIPLES OF RISK MANAGEMENT FOR INSTITUTIONS (OTHER THAN INSURANCE INSTITUTIONS) OFFERING ONLY ISLAMIC FINANCIAL SERVICES 35 (2005) [hereinafter IFSB EXPOSURE DRAFT 1] (on file with N.C. Banking Inst.).

51. Taylor, *supra* note 1, at 398.

financial institution is guaranteed an agreed upon percentage of the profits but bears all of the risk of monetary loss.⁵² The client serves as the financial institution's agent, called a "Mudarib," for investing and utilizing funds in the joint venture.⁵³ Financial institutions also use the mudaraba structure as the primary way to obtain assets from depositors.⁵⁴ In this situation, the financial institution acts as the Mudarib for a fee and invests the depositors' (the capital providers) money in various schemes.⁵⁵ Like the musharaka, mudaraba is a high-risk mode of financing and represents a small percentage of worldwide Islamic banking operations.⁵⁶

6. *Istisna* (Commissioned Manufacturing): This structure is primarily used for assets which are constructed or manufactured.⁵⁷ Under *istisna*, the financial institution pays the developer/contractor, generally in pre-determined installments, who then manufactures the plant or equipment, or purchases the commodities.⁵⁸ The client owes the financier the purchase price plus a predetermined markup and often a fee.⁵⁹ The *istisna* structure is better suited for long-term and large-credit transactions than *ijara*⁶⁰ and is distinguishable by the contractor's obligation to perform the work as well as supply the material.⁶¹

7. *Salam*: A *salam* contract is an agreement to purchase a specified type of commodity at a predetermined price, to be delivered on a specified future date, and in a specified quantity and quality.⁶²

8. *Sukuk* (Investment Certificate or Bond): The *sukuk* is one of the more innovative developments in the Islamic financial sector, and though distinguishable, the end result is much akin to a conventional bond.⁶³ Under a *sukuk* structure, each *sukuk* holder holds an undivided

52. *Id.*

53. *Id.*

54. Berschadsky, *supra* note 12, at 114.

55. Taylor, *supra* note 1, at 398.

56. *See* Taylor, *supra* note 1, at 398 (stating that mudaraba schemes represent less than ten percent of worldwide Islamic banking operations).

57. Bilal, *supra* note 28, at 154.

58. Klarmann, *supra* note 15, at 63 ("[T]he bank takes out insurance on the asset and factors in the cost of insurance at the time the rent is fixed.").

59. Berschadsky, *supra* note 12, at 116.

60. *Id.*

61. Klarmann, *supra* note 15, at 63.

62. IFSB, EXPOSURE DRAFT 1, *supra* note 50, at 36.

63. *Bahrain Bolsters the Islamic Finance Industry*, BANKER, Oct. 4, 2004, at 158, available at http://www.thebanker.com/news/fullstory.php/aid/2240/Bahrain_bolsters_the_

beneficial ownership in the underlying assets.⁶⁴ Sukuk holders are entitled to share in the revenues generated by the sukuk assets and are also entitled to share in the proceeds of the realization of the sukuk assets.⁶⁵

Sukuk can be divided into two broad categories: asset-based sukuk, which offers fairly predictable returns to their holders based on the underlying asset; and equity-based sukuk, which offers less predictable returns due to the profit- and loss-sharing in the underlying investment.⁶⁶

C. *Uniform Standardization*

Much of the rapid growth in the Islamic financial industry can be attributed to the development of new regulations and standards for Islamic financial services in the past few years.⁶⁷ Until recently, there were no internationally accepted standards for accounting, auditing, and governance among Islamic financial institutions.⁶⁸ In 1990, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was formed⁶⁹ to help provide standardization to the Islamic financial institutions and now has members, most of which are Islamic banks, from over twenty-five different countries.⁷⁰ The AAOIFI has developed over twenty basic Shari'ah-compliant standards and is the only organization that enjoys the full backing of the global Islamic

Islamic_finance_industry.html.

64. Tamara Box & Mohammed Asaria, *Islamic Finance Market Turns to Securitization*, INT'L FIN. L. REV. (July 2005), available at <http://www.lovells.com/Lovells/MediaCentre/Articles/Islamic+finance+market+turns+to+securitization.htm>.

65. *Id.*

66. ISLAMIC FINANCIAL SERVICES BOARD, EXPOSURE DRAFT NO. 2, CAPITAL ADEQUACY STANDARD FOR INSTITUTIONS (OTHER THAN INSURANCE INSTITUTIONS) OFFERING ONLY ISLAMIC FINANCIAL SERVICES 52 (2005) [hereinafter ISFB EXPOSURE DRAFT 2] (on file with N.C. Banking Inst.).

67. See Shameen, *supra* note 3.

68. Klarmann, *supra* note 15, at 61.

69. The AAOIFI was founded by the Islamic Development Bank in Saudi Arabia, Dar Al Mal Al Islami of Switzerland (represented by Shamil Bank of Bahrain), Al-Rajhi Banking & Investment Corporation in Saudi Arabia, the Dallah Albaraka Group in Saudi Arabia, the Kuwait Finance House, and Bukhary Capital in Malaysia. The Accounting and Auditing Organization for Islamic Financial Institutions, <http://www.aaofi.com/index.html> (follow "Organization" hyperlink; then follow "Members" hyperlink) (last visited Nov. 11, 2005).

70. *Id.*

financial industry.⁷¹ The detailed instructions provided by the AAOIFI as to which transactions are permissible and which are not are a valuable contribution to the Islamic financial industry.⁷² The emergence of an internationally accepted framework of standards greatly facilitates the structuring of new financial products and virtually eliminates the uncertainty that used to affect the Islamic financial industry.⁷³

Another organization that contributed to the development of a set of global standards is the Islamic Financial Services Board (IFSB).⁷⁴ The IFSB is an international standard-setting body of regulatory and supervisory agencies⁷⁵ dedicated to ensuring the soundness and stability of the Islamic financial industry.⁷⁶ Its work complements that of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors.⁷⁷ The IFSB recently adopted two prudential standards on risk management and capital adequacy,⁷⁸ issued an Exposure Draft for a third standard on corporate governance,⁷⁹ and is currently preparing a standard on Supervisory Review Process and another on Transparency and Market Discipline.⁸⁰

The prudential standard on risk management provides fifteen guiding principles of risk management for Islamic financial institutions.⁸¹ It provides specific guidance for six categories of risk: credit, equity investment, market, liquidity, rate of return, and

71. *Unified Standards for Islamic Banks Finalized*, BAHRAIN TRIB., May 10, 2004, available at <http://www.bahraintribune.com/ArticleDetail.asp?ArticleId=46725>.

72. Klarmann, *supra* note 15, at 62.

73. *Id.*

74. *Id.* at 61-62.

75. The IFSB was established by a group of governors and senior officials of central banks and monetary authorities of various countries with the support of the Islamic Development Bank, the International Monetary Fund, and the AAOIFI. Islamic Financial Services Board, <http://www.ifsb.org/index.php?ch=2&pg=1&ac=1> (last visited Jan. 18, 2006).

76. *Id.*

77. *Id.*

78. The two prudential standards are titled: (1) Guiding Principles of Risk Management Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services; and (2) The Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services. Islamic Financial Services Board, <http://www.ifsb.org/index.php?ch=5&pg=21&ac=34> (last visited Jan. 18, 2006).

79. Exposure Drafts are generally proposed standards to be adopted. *See generally id.*

80. Islamic Financial Services Board, *supra* note 75.

81. ISFB, EXPOSURE DRAFT 1, *supra* note 50, at 6.

operational.⁸² As a general requirement, every Islamic financial institution must have

a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report, and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with Shari'ah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.⁸³

The role of the supervisory authority is also described in general and as it pertains to each of the six risks.⁸⁴

The prudential standard on capital adequacy calculates the minimum capital adequacy requirements for credit, market, and operational risks for Islamic financial institutions.⁸⁵ It also addresses the minimum capital requirements for Shari'ah-compliant instruments, including murabaha, salam, istisna, ijara and ijara wa iqtina, musharaka and diminishing musharaka, mudaraba, and sukuk.⁸⁶

The Corporate Governance Exposure Draft sets out seven guiding principles of corporate governance and addresses the general governance approach of Islamic financial institutions, rights of investment account holders, compliance with Shari'ah rules and principles, and transparency of financial reporting in respect to investment accounts.⁸⁷

82. *Id.* at 8.

83. *Id.* at 9.

84. *Id.* at 33-34.

85. IFSB EXPOSURE DRAFT 2, *supra* note 66, at 9.

86. *Id.*

87. ISLAMIC FINANCIAL SERVICES BOARD, EXPOSURE DRAFT NO. 3, GUIDING PRINCIPLES ON CORPORATE GOVERNANCE FOR INSTITUTIONS OFFERING ONLY ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE INSTITUTIONS AND ISLAMIC MUTUAL FUNDS) 1 (2005) (on file with N.C. Banking Inst.).

D. *Development of a Secondary Market*

In addition to improvements in standardization, the development of a secondary market for Shari'ah-compliant products has also made providing Islamic financial services a more realistic and attractive option for Western institutions.⁸⁸ Islamic financial institutions, especially in the Middle East, often have excessive liquid assets that generate either no return or a very low return.⁸⁹ Islamic financial institutions must effectively manage this excess liquidity to ensure efficient operation.⁹⁰ An Islamic financial institution cannot use conventional methods utilized by other financial institutions with excess cash, such as lending the surplus in the interbank money market, investing in government securities, and lending to corporate clients,⁹¹ because they are interest-based and therefore not Shari'ah-compliant.⁹² Instead, Islamic financial institutions must use asset-based instruments⁹³ and exchange surplus funds on a partnership basis.⁹⁴

Secondary markets are an important source of liquidity management, and, because of the requirement that instruments be asset-based, a secondary market that is Shari'ah-compliant is closely related to a debt (bond) capital market.⁹⁵ The Bahrain-based Liquidity Management Centre (LMC) has substantially contributed to the establishment of such a secondary market comprised of a number of asset pools, each with varying risk and return profiles.⁹⁶ This secondary market helps Islamic financial institutions and corporate entities manage surplus funds by investing in Islamic debt securities known as sukuk bonds.⁹⁷

88. See Klarmann, *supra* note 15, at 62; Shameen, *supra* note 3.

89. Abdul Rais Abdul Majid, CEO, Int'l Islamic Fin. Market, Development of Liquidity Management Instruments: Challenges and Opportunities, Remarks at the International Conference on Islamic Banking: Risk Management, Regulation and Supervision (Sept. 30 – Oct. 3, 2003).

90. *Id.*

91. Abdul Jabbar Karimi, *Islamic Banking – Managing Liquidity Risk*, CONTINUITY CENTRAL, Sept. 23, 2004, available at <http://www.continuitycentral.com/feature0126.htm>.

92. Abdul Majid, *supra* note 89.

93. *Id.*

94. See Karimi, *supra* note 91.

95. Abdul Majid, *supra* note 89.

96. Klarmann, *supra* note 15, at 62.

97. *Id.*

III. ISLAMIC FINANCE IN THE UNITED STATES

The potential demand for the Islamic financial market in the United States is uncertain and difficult to measure. Because the U.S. Census Bureau does not record religion in its annual or decennial analyses,⁹⁸ there is no official count of Muslims in the country.⁹⁹ According to the U.S. Census Bureau's Current Population Survey, there are 2.1 million Muslims in the United States, which correlates to the American Religious Identification Survey's finding of 2.2 million Muslims.¹⁰⁰ Industry experts, academics, and Muslim leaders, however, estimate the figure at somewhere between 5 and 7 million.¹⁰¹ Despite the lack of an official count of the Muslim population in the United States, there is little question that this population is continually growing. Muslims represented 4% of new immigrants in 1990, 7% in 2000,¹⁰² and between 1995 and 2003, the percentage of immigrants from countries where Islam was the majority religion increased from 10% to 14%.¹⁰³ The U.S. Census estimated that the Islamic population will become the third largest religious group in the United States by 2010, with 10 to 16 million people.¹⁰⁴

Though the national demand for Islamic finance is uncertain, in specific geographic areas,¹⁰⁵ several institutions offer Islamic financial services in response to local demands.¹⁰⁶ There are currently nine institutions in the United States that offer these services,¹⁰⁷ typically murabaha, ijara, and musharaka financing, which are generally used to purchase cars, homes, and small businesses.¹⁰⁸ These institutions include two finance companies, LARIBA Finance House¹⁰⁹ and

98. MARKETING DEPT., HSBC USA, *MARKETING TO THE ISLAMIC POPULATION IN THE U.S.* 4 (2000).

99. Chiu et al., *supra* note 8.

100. *Id.*

101. *Id.*

102. *Id.* This figure represents 72,000 individuals that immigrated into the United States. *See id.*

103. *Id.*

104. MARKETING DEPT., HSBC USA, *supra* note 98, at 4.

105. *See infra* notes 109-17 and accompanying text.

106. *Id.*

107. Chiu et al., *supra* note 8.

108. *Id.*

109. Located in Pasadena, CA. *Id.* at Figure 1.

Guidance Financial Group;¹¹⁰ three banks, Devon Bank,¹¹¹ University Bank,¹¹² and HSBC;¹¹³ two nonprofits, Neighborhood Development Center¹¹⁴ and World Relief;¹¹⁵ and two for-profit wholesaler/consultants, SHAPE Financial Group¹¹⁶ and Reba Free.¹¹⁷ On December 30, 2005,¹¹⁸ University Bank, a privately-owned bank, announced that it had formed a 100% Shari'ah-compliant subsidiary, University Islamic Financial Corporation (University Islamic).¹¹⁹ Focused exclusively on serving Muslims, University Islamic will initially offer home financing, deposit accounts and Islamic mutual fund shares, products already offered by University Bank,¹²⁰ and is negotiating with a government-sponsored enterprise to create a secondary market for its Islamic mortgages.¹²¹ University Islamic is the first subsidiary of its kind in the United States and plans to offer mortgage products nationwide.¹²² As a result of the new subsidiary, University Bank president and chairman Stephen Lange Ranzini believes the bank can double its assets, which were listed at \$56.5 million on September 30, 2005.¹²³

Home financing is the primary source of business for many institutions that offer Islamic financial services,¹²⁴ providing an option to Muslims who wish to adhere to the principles of their faith and purchase a home in the United States.¹²⁵ National lender, Freddie Mac, has offered home financing compliant with Shari'ah guidelines since

110. Located in Reston, VA. *Id.*

111. Located in Chicago, IL. *Id.*

112. Located in Ann Arbor, MI. *Id.*

113. Located in New York, NY. Chiu et al., *supra* note 8, at Figure 1.

114. Located in Minneapolis/St. Paul, MN. *Id.*

115. Located in Nashville, TN. *Id.*

116. Located in West Falls Church, VA. *Id.*

117. Located in Minneapolis/St. Paul, MN. *Id.*

118. Ben Jackson, *In Brief: Mich. Bank Forms an Islamic Lender*, AM. BANKER, Jan. 3, 2006.

119. Stefanie Murray, *Bank Forms Subsidiary for Muslims*, ANN ARBOR NEWS, Dec. 31, 2005, available at <http://www.mlive.com/business/aanews/index.ssf?/base/business-4/113602744499430.xml&coll=2>.

120. *Id.*

121. Jackson, *supra* note 118.

122. Murray, *supra* note 119.

123. *Id.*

124. See Chiu et al., *supra* note 8.

125. Karen Dybis, *Banks Offer No-interest Options for Muslims*, DETROIT NEWS, Dec. 21, 2004, at 1B.

2001 through LARIBA.¹²⁶ Institutions licensed to offer Islamic home financing products typically offer a mortgage alternative loan transaction (MALT) program to Muslims who want a Shari'ah-compliant loan.¹²⁷ The MALT program replaces a traditional home loan with a redeemable lease using an ijara wa iqtina model.¹²⁸ Karen Dybis with Detroit News describes the MALT program offered by University Bank:

The bank holds the home in trust, and [the client] makes monthly payments to that trust. Each rent payment includes a set amount of savings, which builds [the client's] equity in the home. Once that savings account equals the home's original purchase price, [the client] will own it, free and clear.¹²⁹

The bank earns its profit from the rent.¹³⁰ The Internal Revenue Service (IRS) recognizes these MALT programs as a traditional mortgage, and therefore, the client gets the tax advantages of a traditional mortgage.¹³¹

In contrast to providing home financing, the Neighborhood Development Center and World Relief offer Islamic small business financing, mainly to Muslim refugees.¹³² The Neighborhood Development Center works with very small business owners in Minneapolis/St. Paul, Minnesota, while World Relief works exclusively with refugees, typically from Somalia, in Nashville, Tennessee.¹³³

SHAPE Financial and Reba Free work with financial entities, providing pre-designed Shari'ah-compliant products along with consultation for their implementation.¹³⁴ SHAPE Financial has provided its services to institutions in the United States, Canada,

126. *Id.*

127. *See id.*

128. *Id.*

129. *Id.* This type of ijara wa iqtina transaction is subsequently described in further detail. *See infra* Part III.B.

130. Jackson, *supra* note 118.

131. Dybis, *supra* note 125.

132. Chiu et al., *supra* note 8.

133. *Id.*

134. *Id.*

Singapore, and Lebanon.¹³⁵ Reba Free provides its products and services mainly within the Minneapolis/St. Paul, Minnesota area.¹³⁶

There are also a number of Islamic investment firms, including Saturna Capital, Azzad Asset Management, and Allied Asset Advisors.¹³⁷ These firms offer Shari'ah-compliant mutual funds, such as Amana Funds and the Dow Jones Islamic Fund,¹³⁸ growth funds, and income funds.¹³⁹ These funds must invest only in pre-approved businesses that do not engage in or endorse conduct prohibited by Shari'ah law.¹⁴⁰ Therefore, these funds avoid businesses such as casinos, tobacco manufacturers,¹⁴¹ producers of pork-related products, producers of alcohol, and providers of conventional financing.¹⁴²

Responding to clients' increasing needs for more complex Islamic financial transactions, the law firm King & Spalding LLP formed the Middle East-Islamic Finance and Investment Practice Group (Islamic Finance Group), dedicated to the development of numerous finance and investment structures that comply with Shari'ah law.¹⁴³ This group pioneered the first mortgage financing provided by a U.S. bank for commercial real estate in the United States,¹⁴⁴ the first leveraged-buyout financing provided by a U.S. commercial bank for a U.S. corporate acquisition,¹⁴⁵ and the first construction financing provided by a U.S. commercial bank for real estate in the United States.¹⁴⁶ The Islamic Finance Group focuses on eight primary areas: real estate investment, corporate acquisitions, investment funds, financial products and structures, project development and finance, construction finance, trade and manufacturing finance, and leasing finance.¹⁴⁷

135. *Id.*

136. *Id.*

137. *Id.*

138. Dybis, *supra* note 125.

139. Chiu et al., *supra* note 8.

140. *See id.*; *see also* Dybis, *supra* note 125.

141. Dybis, *supra* note 125.

142. Chiu et al., *supra* note 8.

143. King & Spalding LLP, http://www.kslaw.com/practice_areas/practice.asp?practice_id=141 (last visited Jan. 18, 2006).

144. Using an ijara wa iqtina structure. *Id.*

145. Using an ijara wa iqtina structure. *Id.*

146. Using an istina-ijara structure. *Id.*

147. *Id.*

A. *Shari'ah Requirements for Conventional Financial Institutions*

In order for conventional financial institutions to comply with Shari'ah requirements, they must: completely segregate their funds; establish a Shari'ah supervisory board; have management that is committed to Islamic financial concepts; safeguard Muslim investors' funds from negligence, trespass, and fraud; and comply with the standards of the AAOIFI.¹⁴⁸

1. Complete Segregation of Funds

Funds that are used for Islamic investment products must be completely segregated from the financial institution's funds that are used for purposes not Shari'ah-compliant.¹⁴⁹

2. Shari'ah Supervisory Board

There must be a Shari'ah supervisory board made up of scholars who are trustworthy and highly qualified to issue religious rulings, or "fatawa," on financial transactions.¹⁵⁰ Members of the board should also have a considerable amount of knowledge and experience in modern dealings and transactions.¹⁵¹ The rulings of the Shari'ah board should be binding upon the financial institution's management.¹⁵²

3. Managerial Commitment

The entire management of a financial institution providing Islamic financing should be fully committed to compliance with the governing teachings of the Koran and Muhammad.¹⁵³ It is acceptable to start with one senior executive member of management who implements resolutions and trains the other members to adhere to these guidelines.¹⁵⁴

148. Yaquby, *supra* note 7.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. Yaquby, *supra* note 7.

154. *Id.*

4. Safeguarding Muslim Investors' Funds

While financial institutions cannot guarantee Muslim investors' accounts,¹⁵⁵ they can provide a guarantee that the accounts will be protected against trespass, negligence, and fraud.¹⁵⁶

5. Compliance with AAOIFI Standards

Financial institutions offering Islamic services are required to conform to AAOIFI standards in order to avoid confusion, misunderstanding, and ambiguity, as well as to seek sound business practices.¹⁵⁷

B. Regulation of Islamic Banking Services in the United States

In general, Islamic methods of financing are more complex than conventional financing and may require financial institutions to perform activities with which they are unaccustomed.¹⁵⁸ This may be problematic for U.S. banks, which are limited in their powers to engage in "non-banking" activities.¹⁵⁹ Therefore, a principal challenge facing Islamic finance providers in the United States is offering products that conform to both Islamic religious doctrine and state and federal banking regulation.¹⁶⁰ The same high licensing and supervision standards that apply to conventional financial institutions will also apply to financial institutions that offer Islamic services.¹⁶¹

A provision in the National Bank Act of 1864 that prohibits banks from the purchase, holding of legal title, or possession of real estate to secure any debts due it for a period exceeding five years appears to present an obstacle to U.S. financial institutions wishing to

155. See Sabahi, *supra* note 4, at 13.

156. Yaquby, *supra* note 7.

157. *Id.*

158. Sabahi, *supra* note 4, at 13.

159. *Id.*

160. Chiu et al., *supra* note 8.

161. William L. Rutledge, Executive Vice President, Fed. Res. Bank of N.Y., Regulation and Supervision of Islamic Banking in the United States, Remarks at the 2005 Arab Bankers Association of North America (April 19, 2005), available at <http://www.ny.frb.org/newsevents/speeches/2005/rut050422.html>.

offer Shari'ah-compliant services.¹⁶² Although it seems to prohibit many Islamic home finance products, two letters issued by the Office of the Comptroller of the Currency (OCC) have settled the potential conflict.¹⁶³ Interpretive Letter 806, issued in 1997, approved a proposal by the United Bank of Kuwait (UBK)¹⁶⁴ for a particular ijara transaction – a residential net lease-to-own home finance product (ijara wa iqtina).¹⁶⁵ In the letter, the OCC described the circumstances under which such a transaction would be permissible. The lessee contracts with the bank to purchase a single-family home and is required to pay a down payment toward the purchase.¹⁶⁶ After the bank and lessee enter into a net lease agreement and a separate purchase agreement, the bank pays the remainder of the purchase price and holds legal title to the property.¹⁶⁷ The bank records its interest in the property in the same way that it would a traditional home mortgage.¹⁶⁸ The net lease conveys property rights in the property to the lessee for a specified number of years and requires the lessee to pay the costs necessary to maintain the property, along with any other costs that an owner or purchaser would otherwise pay.¹⁶⁹ The lessee makes monthly payments to the bank sufficient to cover principal and interest,¹⁷⁰ as well as property taxes and insurance.¹⁷¹ Upon final payment, the bank transfers legal title to the lessee, who then owns the property free and clear.¹⁷²

Interpretive Letter 867, issued in 1999, permitted a bank to offer certain murabaha-based financing products to accommodate the acquisition and construction of Islamic schools, mosques, community

162. See 12 U.S.C. § 29 (2000).

163. See Chiu et al., *supra* note 8.

164. See O.C.C. INTERPRETIVE LTR. 806 (Dec. 1997).

165. Rutledge, *supra* note 161.

166. O.C.C. INTERPRETIVE LTR. 806 (Dec. 1997).

167. *Id.*

168. *Id.*

169. *Id.*

170. Islamic law technically disbars charging interest. Thus, while the OCC refers to the payments as principal and interest, under Islamic law, the payments are for rental dues, part-payment towards the final purchase, and a pre-determined profit. Islamic Economics, <http://islamic-world.net/economics/ijara.htm> (last visited Jan. 28, 2006). The predetermined profit is justified because of the risk the bank assumes in the transaction. See *supra* note 27 and accompanying text.

171. O.C.C. INTERPRETIVE LTR. 806 (Dec. 1997).

172. *Id.*

centers, and businesses.¹⁷³ In this transaction, the client identifies the property, inventory, or equipment to be purchased, negotiates the purchase price with the seller, and applies to the bank for financing.¹⁷⁴ If the ordinary credit underwriting criteria is satisfied, the client and the bank simultaneously enter into a purchase agreement and a murabaha agreement, where the bank agrees to purchase the asset and immediately sell it to the client at cost plus markup.¹⁷⁵

In determining that an activity is within the “business of banking,” and therefore permissible,¹⁷⁶ judicial precedent outlines three guiding principles: (1) the activity is functionally equivalent to or a logical outgrowth of a recognized banking activity; (2) the activity responds to client needs or otherwise benefits the bank or its clients; and (3) the activity involves risks similar in nature to those already assumed by banks.¹⁷⁷ The OCC recognized that the activities discussed in their interpretive letters were the functional equivalent or logical outgrowth of secured lending, and that they were in response to the special needs of Islamic clients who otherwise would be forced to choose between adhering to their religion and owning a home or business.¹⁷⁸

In the residential net lease-to-own home finance product, the OCC said that the net lease proposal would pose essentially the same risks as those associated with a traditional home mortgage loan.¹⁷⁹ The bank’s decision to accept the credit risks are determined by the branch’s underwriting standards, and in the case of a default under the lease, the bank has remedies similar to those under a traditional nonrecourse mortgage.¹⁸⁰ The bank provides notice of default and an opportunity for

173. See O.C.C. INTERPRETIVE LTR. 867 (Nov. 1999).

174. *Id.*

175. *Id.*

176. See 12 U.S.C. § 24 (Seventh) (2000) (allowing banks to exercise the use of incidental powers that are necessary to the business of banking).

177. See, e.g., *Am. Ins. Ass’n v. Clarke*, 865 F.2d 278 (2d Cir. 1988) (holding that municipal bond insurance was part of the business of banking because it was sufficiently similar to a standby letter of credit); see also *M & M Leasing Corp. v. Seattle First Nat’l Bank*, 563 F.2d 1377 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978) (authorizing certain lease transactions, even if the lessor bank does not recover all of the property and financing costs during the initial lease period, because the risks assumed are similar to those a bank already assumes in secured loan transactions).

178. See O.C.C. INTERPRETIVE LTR. 806 (Dec. 1997); see also O.C.C. INTERPRETIVE LTR. 867, (Nov. 1999).

179. O.C.C. INTERPRETIVE LTR. 806 (Dec. 1997).

180. *Id.*

the lessee to cure it.¹⁸¹ If the lessee cannot cure the default, then the bank will treat the property as if it had been acquired in foreclosure.¹⁸² Moreover, the bank can pool and securitize its leases and sell them on a secondary market, just as home mortgage loans can be pooled and securitized.¹⁸³ In regards to a murabaha financing transaction, the OCC said that the bank functions like a “riskless principal” because it will not purchase the real estate, equipment or goods until requested to do so by the client, who agrees to immediately purchase the property from the bank at the original purchase price plus markup.¹⁸⁴ The bank therefore assumes no greater risks than it already assumes in a conventional mortgage or loan transaction.¹⁸⁵

In its analysis in Interpretive Letter 806, the OCC separately addressed 12 U.S.C. § 29, which provides that national banks may not hold legal title to or possession of real estate for a period exceeding five years.¹⁸⁶ The OCC broadly interpreted this provision, stating that “a narrow view of the statute would elevate form over substance because, in this case, having legal title is largely cosmetic and the actual indicia of ownership are borne by the Lessee.”¹⁸⁷

The Branch does not, and will not, actually hold real estate. It will not operate the property, pay taxes, insurance, and other charges, maintain upkeep of the premises, make repairs when necessary, assume liability for injuries or other accidents on the property, or otherwise exercise dominion and control over the property. The Lessee, and not the Branch, will bear these responsibilities. Although the Branch will have legal title to the property, it will not take actual possession of the property at any point during the lease term. The Branch will only take possession of the property if the Lessee defaults or upon termination of

181. *Id.*

182. *Id.*

183. *Id.*

184. O.C.C. INTERPRETIVE LTR. 867 (Nov. 1999).

185. *Id.*

186. 12 U.S.C. § 29 (2000).

187. O.C.C. INTERPRETIVE LTR. 806 (Dec. 1997).

the lease. If the Branch does take possession of the property, it will take the property as OREO [other real estate owned] within the meaning of 12 U.S.C. § 29.¹⁸⁸

Thus, the OCC concluded that the UBK proposal did not violate the policies behind 12 U.S.C. § 29.¹⁸⁹

These OCC interpretations demonstrate how the U.S. regulatory framework can accommodate Islamic finance by allowing for significant flexibility in how compliance with general objectives can be met.¹⁹⁰ This is encouraging to financial institutions that want to enter the Islamic finance market and to those that want to expand the Islamic finance products that they offer.¹⁹¹

Furthermore, financial institutions other than banks may prove to be consistent with Islamic financial frameworks, such as credit unions and saving associations.¹⁹² Because credit unions follow a communal/partnership model, the operational philosophy of Islamic banking may easily transfer to such an institution, though the interest-free transactions will be limited in much the same way as they are limited in a commercial bank.¹⁹³ Savings associations are able to enter into joint ventures and own property through subsidiaries.¹⁹⁴ Therefore, institutions that wish to offer Islamic services aimed at real estate financing should be able to easily adapt a savings association to its purposes.¹⁹⁵

Regulatory challenges remain, however. For example, deposits fully structured according to profit- and loss-sharing are not permitted in the United States.¹⁹⁶ Because under Islamic principles, the financial institution is in a type of joint investment with the depositor, under the profit/loss-sharing framework, if the financial institution loses money, so does the investor.¹⁹⁷ This is contrary to the Western framework,

188. *Id.*

189. *Id.*

190. Rutledge, *supra* note 161.

191. *See generally id.*

192. Taylor, *supra* note 1, at 412-13.

193. *Id.* at 412.

194. *Id.* at 413.

195. *Id.*

196. Rutledge, *supra* note 161.

197. *Id.*

where the certainty of the deposit principal is a given.¹⁹⁸ SHAPE Financial Corporation has modified the deposit product it proposed to offer through University Bank so that principal is guaranteed, and the deposit-holders share only in bank profits, not losses.¹⁹⁹ While this adjustment fits within the strictures of U.S. regulation and practice, a client who accepts full repayment in the case of a loss may not be in compliance with Shari'ah law.²⁰⁰

The restrictions placed on the range of permissible investments that commercial banks may hold is another regulatory challenge faced by institutions that offer services to Muslim clients.²⁰¹ To avoid unnecessary risk, banks must limit their investments to fixed-income, interest-bearing securities,²⁰² which are prohibited by the Shari'ah.²⁰³ In addition, in order to comply with consumer credit laws, commercial banks must make numerous disclosures in a manner that does not always fit within the principles of Islamic finance.²⁰⁴ For example, The Truth in Lending Act²⁰⁵ requires that banks make advance disclosure of annual percentage rates (APR). These rates are inapplicable to Islamic financing due to the prohibition against interest.²⁰⁶ Moreover, a financial institution that wants to finance the purchase of a car or home under murabaha or ijara structures may face additional hurdles if state law requires the institution to qualify as a licensed leasing company or auto lender.²⁰⁷

C. *Supervision of Islamic Banking Services in the United States*

In addition to the legal issues regarding permissible bank activities, bank supervisors must consider how to assess the safety and

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *See* 12 U.S.C. § 24 (Seventh) (2000); 12 C.F.R. pt 1 (2005) (detailing permissible investments for national banks).

203. Rutledge, *supra* note 161.

204. *Id.*

205. A federal law that requires credit card companies and other lenders to disclose the terms of a loan, including interest rates and payment due dates, to the borrower. *See* 15 U.S.C. §§ 1601-1666 (2000); 12 C.F.R. pt. 226 (2005).

206. Rutledge, *supra* note 161

207. *Id.*

soundness of individual banks offering Islamic financial instruments.²⁰⁸ Many Shari'ah-compliant financial structures involve high risk because of the nature of the profit/loss-sharing structure.²⁰⁹ Bank regulators must evaluate the specific risks and risk-management practices of individual institutions and may need to "allow for an accommodative approach to Islamic banking that is based on its unique structure and related risks."²¹⁰

Much of a U.S. bank examiner's risk assessment is specific to an individual institution; how the particular institution manages and controls the risk that results from its business strategies.²¹¹ As William L. Rutledge, the Executive Vice President of the Federal Reserve Bank of New York, explained,

We seek to understand each individual institution – what is its business strategy; what risks arise from that strategy We then ask such questions as: how well does management understand, measure, and manage those risks? and how sound is the overall governance and control structure of the firm? We look to train and develop our examiners so that they can make the necessary case by case judgments in a rigorous and fair way. What we include in our broad framework of approach and how we train and develop our examiners to make these individual judgments is, of course, strongly influenced by supervisory practices developing around the world.²¹²

As previously mentioned, the Islamic financial community has been working to confront the challenges that Islamic financial institutions face and has adopted prudential standards on capital

208. *Id.*

209. Sabaha, *supra* note 4, at 14. "[T]he bank, especially in *mudharaba* (trust financing), has no practical means to control the agent/entrepreneur, because in *mudharaba* (unlike *musharaka*) the bank only provides the capital, and the agent is responsible for the management, which creates a moral risk." *Id.*

210. Rutledge, *supra* note 161.

211. *Id.*

212. *Id.*

adequacy and risk management for Islamic financial institutions.²¹³ While these standards pertain to Islamic financial institutions, as opposed to conventional financial institutions that offer Islamic financial services, they will nonetheless help regulators in the United States to understand, supervise, and manage risk in the latter.²¹⁴

IV. CONCLUSION

Over the past three decades, and especially in the past few years, Islamic financial institutions have seen significant growth and have developed and improved upon the range of investment products available to match those offered by conventional financial institutions.²¹⁵ This growth has caused many financial institutions in the United States to establish Islamic financing units that offer Shari'ah-compliant services to their Muslim clients,²¹⁶ and has led one bank to establish a subsidiary devoted entirely to Islamic financial services.²¹⁷ Although challenges remain,²¹⁸ it is clear that market participants are up to the task and dedicated to investing the time and resources needed to overcome these challenges.²¹⁹ With efforts such as those by the AAOIFI and the IFSB, the willingness of Western markets to resolve conflicting issues,²²⁰ the innovativeness of new Shari'ah-compliant products, and the growing investor demand for such products, there is significant potential for continued growth of the Islamic financial industry in the United States.²²¹

KIMBERLY J. TACY

213. See *supra* notes 74-84 and accompanying text.

214. Rutledge, *supra* note 161.

215. See, e.g., Shameen, *supra* note 3.

216. Sabahi, *supra* note 4, at 17.

217. See *supra* notes 118-23 and accompanying text.

218. See, e.g., Box & Asaria, *supra* note 64.

219. *Id.*

220. See Rutledge, *supra* note 161.

221. Box & Asaria, *supra* note 64.

