Contemporary Islamic finance is a burgeoning subsector of international finance markets. To properly understand it, one must first understand that the rules of trade and finance are part and parcel of the religion by which Muslims conduct their lives and order their finances and businesses. Although no conclusive data are yet available—a fact reflective of the industry's youth—many observers estimate the global industry has up to $500 billion in managed assets and a growth rate of 15 percent to 20 percent per annum. Some also contend that between 200 and 300 institutions currently contribute to the industry worldwide.

Principled Investing

Islamic finance is in many respects akin to socially conscious investing. It involves what may be called *substantive principles* that speak to the substance of the investment—in other words, the purpose for which the money will be utilized. In practice, substantive principles are applied to the target company's line of business and to the specific activities that the money will advance. Industries such as gambling, pornography, alcohol, tobacco, defense, banking, and insurance are typically prohibited because they involve activities that Islamic law prohibits.

The rules of trade and finance are part and parcel of the religion by which Muslims conduct their lives.

Perhaps the most conspicuous feature of Islamic finance is that the mechanism of financing must also comply with what may be termed *procedural principles.*

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Introduction to Islamic Finance

Definitions and Interpretation

by Samira Saya

Definitions

Islamic banking is a banking system consistent with Islamic law (Shari'ah) principles and guided by Islamic economics. In particular, Islamic law prohibits the collection and payment of interest. Generally, it also prohibits trading in financial risk (seen as a form of gambling). It also prohibits investing in businesses considered *haram* (prohibited, forbidden), such as those selling alcohol or pork.

Shari'ah

An Arabic word for Islamic law, or the Law of Allah, Shari'ah governs both secular and religious life of devout Muslims. It covers religious rituals and many aspects of day-to-day living, politics, economics, banking, and law.

Riba

The meaning of this Arabic word is close to the charging of interest, which is forbidden by the Quran. Riba also connotes a loan in which the borrower makes a return to the lender that is more or better than what was borrowed.

Murabahah (Cost Plus)

Murabahah refers to the sale of goods at a price and includes a mutually acceptable profit margin. The price, other costs, and the profit margin must be clearly stated upfront. As applied to lending, murabahah is a fixed-income loan for the purchase of a real asset (such as real estate or a car), with a profit margin instead of a fixed rate of interest. The bank is not compensated for the time value of money outside of the contracted term (and thus cannot charge additional interest on late payments), however the asset belongs to the bank until the loan is paid in full. The transaction is similar to "rent-to-own" arrangements for furniture or appliances.

Mudharabah (Profit and Loss Sharing)

Mudharabah is an arrangement between a capital provider and an entrepreneur. Profits are shared according to an agreed-upon ratio, but if there are losses, the capital provider must bear them all. The bank is compensated for the time value of its money in the form of a floating rate pegged to the debtor's profits.

Gharar

The underlying principle for the prohibition of *gharar*, which involves the trading of risk or the sale of something that has not yet been obtained, is that one should not profit from another person's uncertainty.

Interpretive Letters

Letter No. 806

In this interpretive letter, the Office of the Comptroller of the Currency approved an arangement proposed by a bank helping Islamic customers purchase residential real estate in conformity with Islamic principles of banking. Leases that were functionally interchangeable with loans were considered to be within the "business of banking." See http://www.occ.gov/interp/dec97/intdec97.htm.

Letter No. 867

In this letter, the OCC concluded that financing products through which the bank acquired property on behalf of a customer and then resold the property to the customer at a mark-up on an installment basis were permissible. See http://www.occ.gov/interp/nov99/intnov99.htm.

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These are the prohibitions against *riba* (commonly but incompletely translated as "interest") and gharar (inappropriate uncertainty). The regulations derived from *riba* and *gharar* control the manner in which financing takes place. Here Islamic law is less concerned with the purposes for which money will be used than with how money is placed in the hands of those who will use it. Procedural principles overlap somewhat with substantive principles in governing how income is generated and how profit and loss must be shared. Additionally, they are concerned with the distribution of wealth throughout society.

In its modern and perhaps most relevant form, the prohibition against *riba* disallows the earning or paying of any benefit, monetary or otherwise, on a loan of money. In Islam, loans are characterized as charitable activities and not profit-making ventures. The prohibition of *riba* also applies to trading that involves certain other commodities, such as gold and silver and particular foods. When these commodities are traded one for another, the trades must be made in equal measure and without deferral. The prohibition of *riba* has been extended by the vast majority of Muslim jurists to include modern commercial bank interest.

Asset sales and leases substitute for interest-bearing loans. Because earning a profit while assuming only credit risk is unlawful, equity arrangements lend themselves more readily to Islamic finance. (See the sidebar "Definitions and Interpretation.") Islamic law demands that the return on capital be tied to the success of the venture, as in traditional venture-capital and partnership-based transactions. But there are important distinctions between conventional equity transactions and Islamic principles. Rules relating to *riba* affect distribution methods and the sharing of profit and loss, so conventional liquidation-preference provisions, for example, are typically prohibited. In Islamic private-equity transactions, simply speaking, equity holders are supposed to bear *losses* on a pro rata basis, but they may share *profits* on a non-pro-rata basis. This places equity holders on a more equal footing.

U.S. regulatory bodies at the state and federal levels have reached out to Islamic bankers to educate and be educated.

As for *gharar*, Muslim jurists generally hold that Islamic law prohibits transactions involving excessive uncertainty. Gambling is the most obvious example of an activity prohibited (at least in part) by *gharar*. A less obvious but arguably more important example relates to conventional insurance. In some policies, there is uncertainty about both the amount of premium the purchaser will ultimately pay and the amount that will be paid out upon realization of the insured risk. Thus some insurance policies are prohibited.

The two prohibitions of *riba* and *gharar* drive the structuring of transactions away from conventional arrangements such as interest-bearing debt and call for creativity. Of course, transactions must comply with local laws and regulations, but contrary to common notions, U.S. laws and financial regulations are not wholly inconsistent with Islamic laws.

U.S. regulatory bodies at the state and federal levels have reached out to Islamic bankers to educate and be educated. In addition, state tax authorities and bank regulators—such as the Office of the Comptroller of the Currency (OCC) and the Illinois Office of Banks and Real Estate—have provided written guidance and comfort, affirming the use of nontraditional structures that otherwise might be technically prohibited.

How It Works Here

The history of contemporary Islamic finance is brief, and its U.S. history is even briefer. U.S. efforts regarding Islamic finance began during the 1980s, at least at an institutional level, and came largely from within the Muslim population. Such efforts, which have increased and gained in momentum and sophistication, have focused mainly on creating retail products.

Some U.S. banks, such as Michigan-based University Bank and HSBC Bank USA, have offered savings accounts, checking accounts, and credit cards that comply with Islamic law. Islamic insurance appeared in the United States during the 1990s but, to our knowledge, is currently unavailable. Some institutions have offered, with varying degrees of success, mutual funds and financing for automobiles and homes. In New England, Chicago-based Devon Bank and American Finance House LaRiba offer Islamic home-financing solutions. Devon Bank also offers commercial real property financing on an Islamic basis.

Local institutions are beginning to notice the demand for small- and mid-size-business financing, commercial real estate financing, and standardized construction-financing products that follow Islamic principles. Efforts toward establishing an Islamic bank or credit union are underway, and some have gained state and federal regulatory approval. University Bank lays claim to being the first bank devoted solely to Islamic finance. Years earlier, Philadelphia-based Muslim Community Credit Union gained certain approvals but was never, to our knowledge, fully operational.

Although most Islamic transactions occur in the Arabian Gulf, there are Islamic finance *windows*, or branches, at international financial institutions. There also are subsidiaries of Islamic investment banks conducting business in America along Islamic lines. In fact, the bulk of Islamic financial activity here comes from major international or foreign institutions transacting for themselves and their non-U.S. investors. Many major Western investment institutions, and recognized European and U.S. broker dealers and investment fund managers have offices both in the Muslim world and here.

In the United States, these institutions structure Islamic investment opportunities in residential and commercial real estate projects and equipment—sometimes as one-off transactions and often as full-fledged investment funds. Profits may result from operating income and sales of the investment assets. The institutions also acquire—and make significant investments in—U.S. companies in the retail, health-care, consumer goods, and technology industries through private equity and, more recently, venture capital arrangements.

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