

# Islamic Finance: Meeting Financial Needs with Faith Based Products

By Shirley Chiu and Robin Newberger

This article explores the demand for and the availability of financial products for Muslims who adhere to religious prohibitions against receiving and paying interest. This is an evolving area of consumer and small business finance, and the goal of this article is to provide an overview of the potential market for Islamic finance, to describe the organizations that currently provide these products, and to highlight some of the challenges of satisfying both religious tenets and government regulations. Two facets of financial products, asset financing, and investments, are addressed. Furthermore, the article identifies three types of organizations that offer Islamic financial products and services: financial entities, nonprofits, and for-profit ventures that sell models of Islamic finance products and consulting services to firms.<sup>1</sup> Drawing largely on interviews with regulators, practitioners, and experts in the field, we find that the few financial entities that offer formal Islamic finance in the United States are often motivated by strong grassroots demand in their local service areas. These entities are often charting new territory in terms of product development and conformity with government regulations. Regulatory issues have not yet been tested on a large scale, and decisions as to whether a bank may offer an Islamic financial product are typically determined on a case by case basis.

## What is Islamic Finance?

Islamic finance is fundamentally different from the conventional finance model as it is based on a profit and loss structure (PLS), which requires that a financial institution invest with a client in order to finance their needs, rather than lending money to the client. Because of the inherent risk involved in an investment, the financial institution is entitled to profit from the financial transaction.

In assuring customers that the structure of the advertised Islamic finance products are compliant with Islamic law, financial institutions employ a panel of Islamic scholars, also known as a *Shari'ah* board, to analyze and approve

of the product's compliance with *Shari'ah*, or Islamic law. If the *Shari'ah* board approves of the product, it signs a certificate called a *fatwa* designating the product *Shari'ah* compliant, which also serves to assure customers of the product's adherence to Islamic law.

Although Islamic finance is relatively new to the United States, various interpretations of this concept are widely practiced in other countries. In Egypt, Indonesia, Malaysia, Sudan, and the Gulf States, Islamic banking coexists with conventional banking. In many cases, international banks have established Islamic finance windows, or branches of their bank that specifically offer Islamic finance products and services. In countries such as Iran and Pakistan, Islamic banks are the only type of financial institution. Islamic finance is also offered in Europe by a small number of conventional banks and through the recently established Islamic Bank of Britain. Over the past ten years, the global Islamic finance industry has grown significantly and today has between \$200 billion and \$300 billion in assets.<sup>2</sup>

A fundamental distinction of an Islamic Bank is the lack of deposit insurance common in conventional banks. The PLS structure permits receipt of money by depositors where deposits invested have incurred a profit, but they must incur losses in situations where deposit investments incur losses to comply with *Shari'ah*. Deposit insurance defeats the purpose of PLS because the depositor does not incur any risk. This very fundamental aspect of an Islamic bank runs contrary to the standards of western banking regulations. In fact, rather than overcome this hurdle, the Islamic Bank of Britain's *Shari'ah* board, finding in the end that this was the only remaining obstacle faced, allowed for the deposit insurance as long as customers were made aware that deposit insurance was not *Shari'ah* compliant.

The U.S. does not currently have an Islamic bank. Prior to 1997, no bank in the U.S. offered formally structured

Islamic financing that was both publicly approved by a U.S. regulatory agency, and approved by a board of Islamic scholars. In the late 1990s the New York branch of the United Bank of Kuwait (now closed) paved the way for financial institutions that currently offer Islamic financial products. In 1997 and 1999, the Office of the Comptroller of the Currency issued two interpretive letters permitting a New York branch of the United Bank of Kuwait to offer its Islamic home financing products to Muslim customers. The interpretive letters have since been the premise for determination by certain regulatory agencies whether an Islamic finance product is compliant with U.S. banking regulation and can be offered by a financial institution.

## Demand for Islamic Finance Products

The U.S. State Department notes that Islam is one of the fastest growing religions in the U.S. Most of this growth is due to immigrants and descendants of immigrants. Immigrant Muslims are mostly from Iran, Iraq, Somalia, Sudan, Afghanistan, and the former Yugoslavia. In the past few decades, the number of Pakistani and Indian Muslims living in the U.S. has also grown significantly. More recently, the number of Muslims from Indonesia and Malaysia has been increasing.

These demographic trends are useful for estimating the demand for Islamic finance in the U.S. According to the U.S. State Department, there is no official count of Muslims in the United States. The analysis here draws on data from a number of sources, including the *American Religious Identification Survey* by the City University of New York; the Department of Homeland Security; the U.S. Census Bureau's *Current Population Survey*, March Supplement; and the U.S. State Department. The *Current Population Survey* (CPS) shows 2.1 million people in the U.S. who emigrated from countries where Islam is the dominant religion or are children of such emigrants.<sup>3</sup> This value is close to the 2.2 million Muslims identified by the *American Religious Identification Survey*.<sup>4</sup> Some leaders of the Islamic community put the number of Muslims living in the U.S. as high as 9 million. According to data from the Department of Homeland Security, Muslims made up about 4 percent of new immigrants in 1990 and 7 percent of new immigrants in 2000, representing about 72,000 new arrivals that year. Between 1995 and 2003, the percentage of immigrants in the United States who came from a country where Islam was the majority religion increased from 10 percent to 14 percent.

In addition to immigrants and their descendent children, nonimmigrant Muslims are comprised mostly of African Americans and are estimated to make up more than one quarter of the U.S. Muslim population.<sup>5</sup>

Another factor in estimating potential demand is degree of religious observance. Experts identify three distinct levels of observance in the Muslim community. The first

level comprises the most observant Muslims who do not use conventional financing. This group represents the core market for Islamic financing arrangements. The second level currently uses conventional financing, but might switch to Islamic financing if it were available. This group often consists of U.S.-born children of immigrants, rather than the immigrant parents themselves. The final level comprises the least observant Muslims, who currently use conventional financing, and would likely continue to use it even if a religiously compliant alternative were available.

Although mosque affiliation does not necessarily imply a demand for Islamic finance, financial institutions assume that mosque attendees would form the basis of their Islamic market and have concentrated their outreach efforts on this population. Several surveys collect information on membership at mosques to provide a greater understanding of the Muslim presence in the U.S.<sup>6</sup> In 2001, there were 1,368 mosques in the U.S. The states with the greatest number by rank were California, New York, New Jersey, Michigan, Pennsylvania, Texas, Ohio, Illinois, and Florida. Between 1986 and 2001, California, New York, New Jersey, Michigan, and Pennsylvania experienced the greatest growth in the number of mosques. Of the 2.2 million self-identified Muslims living in the United States, 62 percent are members of a mosque. Between 1990 and 2001, the number of self-identifying Muslims increased by 50 percent.

Another way to think about demand for financial products is in terms of the socio-demographic status of Muslims in the United States. National data sets show that immigrants from predominantly Muslim countries, and the children of these immigrants, have relatively high levels of education and income. An estimated 46 percent of Muslims have at least a college degree, compared with 23 percent and 25 percent of all immigrants and natives, respectively. Similarly, Muslim immigrants and their descendants have median incomes closer to natives than to those of immigrants overall. So too, the Muslim population has the highest proportion of young adults under the age of 30 as compared to any other religious group.

## Islamic Financial Transactions

U.S. financial institutions that offer Islamic finance products typically offer *Murabaha*, *Ijara*, and *Musharaka* financing for purchasing homes, cars, and small businesses. In a typical *Murabaha* transaction, the financial institution acts as an agent and purchases a good requested by a customer; the financial institution, in turn, sells the good to the customer at the acquisition cost plus the profit over a stated period of installments. If the customer defaults, they are only liable to the financial institution for the contracted sale price. The key requirement of *Murabaha* is that the financial institution

must own the good before transferring it to the customer. The financial institution justifies its profit based on the risk it assumes from buying the asset.

The *Ijara* is a leasing agreement where the financial institution purchases an asset and leases it to the customer. The financial institution, or a subsidiary of the financial institution, owns the asset throughout the lease period and the customer pays the financial institution a rental fee each month during the leasing period. The customer may purchase the asset in its entirety either during or at the end of the lease period, but is not required to do so. The typical *Ijara* asset financing models offered in the U.S. are lease-to-own in nature. Until the buyout is consummated, the investor is the owner of the asset and is responsible for any taxes and risks associated with the ownership.

The *Musharaka* is a declining balance or shared equity purchase. Typically, the financial institution provides a percentage of the capital needed by its customer in a business undertaking, with the understanding that the financial institution and customer will proportionately share in profits and losses in accordance with a formula agreed upon before the transaction is consummated. In the case of home financing, the homebuyer makes monthly payments to the investor such that each month less of the total payment goes toward the actual use of the property and more toward building the buyer's equity. The *Musharaka* is a legally binding contract to form a partnership to buy the property. That agreement allows the homebuyer exclusive use of the whole property and extracts a morally binding promise from the buyer to purchase the property from the investor in the future.

A much less common method of Islamic finance in the United States is the *Mudaraba*. The *Mudaraba* is an agreement between an investor and an agent, where the investor provides capital for the project and the agent invests the funds according to the investors' instructions. The investor provides the capital, entrusting the agent for his expertise and experience. Profits from the investment are shared between the two parties at a predetermined ratio, and losses are borne by the investor.

## Islamic Finance Providers in the United States

A small number of entities formally offer Islamic financing products in the United States. Other banks might customize loan products for Muslim customers on an as-needed basis, but do not offer a formal Islamic finance product and book these transactions as traditional loans. We identify seven institutions below that currently advertise formal Islamic finance products and two for-profit organizations that offer models of *Shari'ah* products to entities.<sup>7</sup>

LARIBA and Guidance are finance houses – institutions that offer asset financing, but cannot hold deposits. Established in 1987 by business people who believe in *Shari'ah* compliant financing, LARIBA is the oldest of the organizations listed in Table 1, and is currently owned by members of the American Islamic community. It is based in Pasadena, California, and licensed to sell its *Shari'ah* financing products in 49 states. LARIBA offers a lease-to-purchase model with terms up to 30 years, or a variation of the *Ijara* model to finance homes, automobiles, and medical clinics and equipment. LARIBA also offers leasing with declining equity for construction of single-family homes and finances small business and trade.

Guidance Financial Group also has origins in the Muslim community and has been offering products since April 2002. Guidance is based in Virginia, and currently licensed to sell its products in 18 states. The organization offers home financing through its declining balance co-ownership program, or a variation of the *Musharaka*. In addition to offering home financing products, Guidance is currently looking to securitize its home financing contracts so that they are *Shari'ah* compliant for purchase by Islamic investors.

Devon Bank in Chicago and University Bank in Ann Arbor, Michigan are privately owned community banks. Their involvement in Islamic finance has developed largely as a result of their locations in multi-ethnic neighborhoods with high concentrations of Muslims. Devon Bank offers its products both inside and outside of Illinois. It offers Islamic home, construction, and small business financing. Home financing is offered through either the *Murabaha* or *Ijara* model. Devon Bank offers commercial *Murabaha* and *Ijara* transactions for real estate acquisitions to business customers.

University Bank started offering Islamic finance products in July 2003 when brokers and real estate agents made them aware of this niche market. In an effort to expand its Islamic home finance business nationwide, University Bank in December 2005 created a subsidiary, University Islamic Financial Corporation, to focus solely on selling its line of Islamic home finance products, profit sharing deposit accounts, and shares of Islamic mutual funds. University Islamic Financial Corporation uses home financing and deposit product patents from SHAPE Financial Corp. It currently offers the *Ijara* home-lease financing model and interest-free deposit accounts. The money from these deposit accounts is invested in the bank's *Ijara* home financing contracts, and in return, the deposits receive a net yield calculated from profit-sharing in the home-lease financing products.

HSBC, the only large bank offering Islamic home financing and other *Shari'ah*-compliant products in the United States, focuses its Islamic finance activity in

**Table 1: Islamic Finance Providers**

Name of institution	Location	Type of institution	Islamic financial products offered
LARIBA Finance House	Pasadena, CA	Finance house	Home, auto, and business financing
Guidance Financial Group	Reston, VA	Finance house	Home financing
Devon Bank	Chicago, IL	Bank	Home and business financing
University Bank	Ann Arbor, MI	Bank	Interest-free deposit accounts, home financing
HSBC	New York, NY	Bank	Home financing, interest-free checking accounts, credit/debit card
Neighborhood Development Center	Minneapolis/St. Paul, MN	Nonprofit	Small business financing and training
World Relief	Nashville, TN	Nonprofit	Small business financing
SHAPE Financial Corp.	West Falls Church, VA	For-profit wholesaler/consultant	Home financing, savings accounts, and consulting services
Reba Free	Minneapolis/St. Paul, MN	For-profit wholesaler/consultant	Small business financing models, and consulting services

the state of New York. Since 1996, HSBC has offered Islamic finance products and services in offices in its global Islamic services division overseas in the UK, Saudi Arabia, Malaysia, Bangladesh, Indonesia, Singapore, and Brunei. In the United States, HSBC offers *Shari'ah* home financing, deposit accounts, and credit cards. HSBC utilizes an *Ijara* lease-to-own home finance model. The deposits from interest-free deposit accounts are invested as capital for the *Shari'ah*-compliant home financing products. The specified percentage of the profit collected from the home financing models is then distributed at a specific rate across the deposit accounts. The money in the interest-free accounts is segregated from investment in "interest-based" funds.

Home financing is the most important source of business for each of these institutions. Each tends to serve socioeconomically diverse customer bases, although some recognize particularly strong growth potential among Muslims in professional occupations.

In contrast, the Neighborhood Development Center and World Relief are nonprofit, small-volume lenders that offer Islamic small business financing mainly to Somali refugees in Minneapolis/St. Paul, Minnesota, and Nashville, Tennessee, respectively. While these states do not have large Muslim populations overall, the nonprofit

organizations serve communities with large concentrations of Muslim refugees.

Since 2001, the Neighborhood Development Center (NDC) has partnered with Reba Free, an organization which develops *Shari'ah* approved Islamic financing products, to finance small business entrepreneurs. Most of the NDC's customers are Muslim, particularly Somali refugees, but the program is open to anyone who is looking for an alternative method of financing. NDC offers a buy/sell agreement, which is very similar to that of a traditional *Murabaha* agreement, where NDC purchases the asset and resells it to the client at a predetermined profit rate. NDC also offers a royalties agreement that is similar to the traditional *Musharaka* agreement, in that both the client and the NDC put a certain percentage of capital towards the asset.

World Relief offers micro-financing to Nashville refugees with small businesses. Funding comes from the Office of Refugee Resettlement in the U.S. Department of Health and Human Services. In addition to offering Islamic business financing through a *Murabaha* model, World Relief also provides technical assistance and training.

In addition to these entities, SHAPE Financial Corp. and Reba Free are for profit ventures founded by experts in Islamic finance that supply pre-designed *Shari'ah*-

approved products and consultations to financial institutions. SHAPE offers asset financing and deposit account products to institutions in the United States, Canada, Singapore, and Lebanon. Reba Free offers small business finance products and consulting services within the Minneapolis/St. Paul, Minnesota metropolitan area.

## Islamic Investment Products

Another set of institutions that offer financial products for Muslims in the U.S. is asset management companies. The main companies are Assad Asset Management, Allied Asset Advisors, and Saturna Capital's Amana Income and Amana Growth funds.

Most have their own *Shari'ah* board that oversees the portfolio to ensure compliance. Compliance relates both to a purification standard that ensures money is not invested in non-*Shari'ah* compliant businesses, and to a speculative uncertainty standard that ensures the fund is not using financial derivatives or debt products. Globally, 95 percent of investment funds perform their own investment research with their own *Shari'ah* boards. In the U.S., as an alternative to conducting their own investment research, investors and fund managers can purchase a license to the Dow Jones Islamic Index (DJII), an Islamic equity benchmark index comprised of companies that have already been *Shari'ah* approved. The DJII screens out non-*Shari'ah* businesses, which include producers of alcohol- and pork-related products, providers of conventional financing (banks, insurance, etc.), and providers of entertainment services.<sup>8</sup> The DJII then evaluates financial risk by excluding remaining companies with unacceptable financial ratios.

To date, demand for Islamic investment products in the U.S. has been small compared to that for home financing. The U.S. Islamic investment market is estimated to be \$112 million.<sup>9</sup> While that number is only a fraction of the total assets of all mutual funds, U.S. based Islamic investment firms have recorded strong annual growth since their creation in the late 1990s. An often cited reason for the smaller demand in the U.S. is that the investment portfolios of Islamic investments focus on returns for the short run, which results in portfolios more liquid and volatile than the conventional long-term retirement portfolios typical of this group. The main challenges to the Islamic investment industry include a lack of understanding by investors as to the particular function of *Shari'ah* funds, high fees, and limited distribution channels.

## Debt Investment Products on the Horizon

Within the last four years, tradable Islamic bonds or *sukuk*, have made their way into investment portfolios and mutual funds, particularly outside of the U.S. Governments in Bahrain and Malaysia spearheaded sovereign project

financing with *Shari'ah*-compliant transactions and securitized these contracts in the form of *sukuk*. To date, the primary issuers of *sukuk* are government sovereigns or sub-sovereigns, mainly Malaysia, Bahrain, Qatar, Dubai, Germany (Region of Saxony), and Pakistan, as well as a small number of corporate entities and the Islamic Development Bank, an international financial institution. *Sukuks* are the fastest growing form of Islamic financing worldwide. In the last two years alone, the global *sukuk* market amassed about \$5 billion. Fifty percent or more of *sukuk* investors are in the Middle and Far East, while another 30 to 40 percent are in Europe. The largest investors are mostly nonbank financial institutions and private investors. In the United States, investments in the *sukuk* market have been limited but growing. Because it is the only type of bond product that is *Shari'ah*-compliant, investors are hard pressed to relinquish *sukuk*, resulting in little liquidity in the overall *sukuk* market.

## Challenges Facing the Industry

Organizations that offer Islamic finance in the United States face two principal challenges. One is offering products that conform not only to Islamic religious doctrine, but also to state and federal regulation. For example, the National Bank Act of 1864 prohibits banks from the purchase, holding of legal title, or possession of real estate to secure any debts to it for a period exceeding five years. This would seem to prohibit many Islamic home finance products. However, in two interpretive letters, Numbers 806 and 867, the Office of the Comptroller of the Currency (OCC) concluded that particular versions of *Ijara* and *Murabaha* transactions can be considered exceptions to the prohibitions of the National Bank Act if they meet the standards for functional equivalence to conventional asset financing. The specific standards that must be satisfied are that: 1) the underwriting standard used in these models must incur the same risks as that of a conventional loan; 2) the risk incurred by the bank if a customer defaults on payments must be the same as that of a conventional loan; and 3) the risk from the bank's holding of legal title to the property must be the same as that of a bank providing a conventional loan. In their application of these standards to United Bank of Kuwait's *Ijara* and *Murabaha* models, the OCC determined that the risks incurred by the bank in offering these models are equivalent to those of a conventional loan. The OCC specified that the standards set forth in the two interpretive letters, including the detailed structure of the particular *Ijara* and *Murabaha* models, must be strictly observed in order to receive approval. At this time, no other agency rulings have been made.

The second challenge involves the added costs of offering products that have little precedent in the United States. Some of these costs stem from research required to develop new methods of financing; designing and

producing new financial documents to accompany the products; consultations with religious and regulatory experts; and the training of staff in different home purchase procedures. Additionally, banks face the “typical” initial set-up costs related to financial transactions, regulatory capital, and compliance costs from offering new products. Islamic small business products offered by nonprofit institutions tend to generate lower costs than home financing products because they raise fewer regulatory issues. Often the additional costs associated with Islamic finance are passed on to the Islamic banking customer.

The treatment of certain real estate transactions within individual states can also result in higher costs of Islamic finance products. For example, a bank in New York that offered a regulatory and *Shari’ah*-approved *Ijara* model found that its lease to purchase nature resulted in double real estate transfer taxes under the New York real estate code – once during the initial transfer from the original seller to the bank, and again when the property is transferred to the lessee at the end of the lease term. However, this double-taxation does not occur with the *Murabaha* when there is both a transfer and acquisition of property during the same transaction.

A further cost relates to limited opportunities for selling Islamic financial products in the secondary market. To date, three of the institutions that formally offer Islamic finance products have sold their specialized “mortgages” to Freddie Mac. Fannie Mae is looking to establish a similar program by creating standardized documentation for financial institutions that are looking to sell Islamic home finance transactions in a secondary market. In order for Freddie Mac and Fannie Mae to give their appraisal to financial institutions, the transactions must fall within the scope of their charter and meet the standard requirements of qualified conventional loans.

Opportunities for selling assets to private secondary market purchasers in the U.S. are few. According to bankers, traditional bondholders are unfamiliar with the underlying structure and risks of these transactions. Some of the purveyors of Islamic finance have sought to build more complex financial products that would be marketable to Islamic investors domestically and internationally. Guidance Financial Group’s motivation to enter the Islamic finance market was to be the first in the industry to build financial instruments from Islamic home financing contracts that would allow Islamic investors to invest in mortgage-backed securities. Meanwhile, religious experts are still debating whether all models of Islamic financing can be sold on the secondary market. *Shari’ah* law permits a bank to sell a note only if it represents an interest in the property by the bank. At present, only the *Ijara* model is structured this way. The approval of such products

by religious authorities is likely to affect their appeal to Islamic investors.

## Conclusion

Islamic finance is thriving at a small, local level, where interest from Muslim communities has prompted financial institutions to offer products that comply with state and federal regulations, as well as with *Shari’ah* law. In efforts to expand their customer base, many of these financial institutions are also licensed to offer *Shari’ah*-compliant home financing in states outside of that which they are located. As a result, religiously observant Muslim families who previously thought they were unable to purchase a home are now able to become homeowners. Islamic finance is sometimes better understood by banks and finance houses that have developed and marketed the Islamic finance products than by regulators whose approval they need. However, regulatory agencies are interested in building their knowledge in this area. For example, the U.S. Treasury currently hosts an in-house Islamic scholar, so that its staff can better understand the issues as part of an international effort to design a regulatory framework for Islamic finance.

Although the Islamic finance industry has grown in the U.S., there are many questions that remain unanswered. One question is the scope of national demand for Islamic finance. This may be a less pressing concern for individual banks that are responding to abundant demand in specific areas. Another question for financial institutions is how strictly Islamic finance products have to adhere to *Shari’ah* principles before a Muslim individual will become a new customer or switch from conventional to Islamic finance products. Islamic scholars would argue that even the most *Shari’ah*-compliant products in the United States have their limitations. This raises the concern for U.S. financial institutions to determine to what extent their customer base is religiously conservative before deciding to proceed with creating *Shari’ah*-compliant products. Finally, a key issue for regulators involves understanding the risks associated with Islamic finance products. Currently, both banks and their regulators assess risk according to the “functional equivalent” standard established by the OCC. Federal and state regulatory agencies have stated their intention to hold regional discussions with financial institutions aimed at developing regulatory standards that take into account the institutional and systemic risks of Islamic financial products.

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## Notes

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- 1 Financial entities denotes primarily those entities that sell products for personal financing.
  - 2 Under Secretary of the Treasury John B. Taylor's keynote address at the Forum on Islamic Finance at Harvard University, May 8, 2004.
  - 3 In the CPS data, we define Muslims as those who were born in a country where Islam is the major religion or have a parent from such a country. These countries are defined as those where more than 50 percent of the people are Muslim according to the CIA World Fact Book.
  - 4 The American Religious Identification Survey asks Americans to identify their religious affiliation. It finds between 2.2 million and 2.8 million Muslims in the United States, including African-American Muslims.
  - 5 Council on American-Islamic Relations (CAIR).
  - 6 City University of New York, American Religious Identification Survey; Hartford Seminary's Hartford Institute for Religious Research, as reported by the U.S. State Department.
  - 7 Information is collected from interviews with officers of each of these organizations and from each of the organization's financial literature.
  - 8 Tobacco manufacturers and defense and weapons makers, although not strictly forbidden for investment under Islamic law, are also excluded from the index.
  - 9 Conversation with Monem A. Salem, Director of Islamic Investing, Saturna Capital, March 19, 2005.
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