Cite as: 16 MINN. J. INT'L L. 233 (2007)

Islamic Banking: Signs of Sustainable Growth

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INTRODUCTION

The global financial market is dominated by the charging and paying of interest. Banking and financing in the conventional system is a virtual impossibility without interest because the incentive to invest or borrow money is generally driven by potential profit or loss in the form of interest.[1] The interest rate is a powerful tool used by the Federal Reserve to set policy.[2] The mere fluctuation in interest rate poses potentially crippling effects on the capitalist economy.[3]

Islamic banking, on the other hand, has the distinguishing characteristic of banking without interest (*riba*).[4] *Riba* is prohibited under *Shari'a*, or Islamic law, so investors may share in the risk of an investment rather than passively acquire a

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* J.D. Candidate, 2007, University of Minnesota Law School. I am honored to be published in the *Minnesota Journal of International Law* and thank the staff and editors for their time and attention. This Note is also dedicated to Alex Brown, Joe Windler, Beth Duncan and Shaun Pettigrew, all of whom offered no support at all, but a promise is a promise.

1. *See* Hesham M. Sharawy, *Understanding the Islamic Prohibition of Interest: A Guide to Aid Economic Cooperation between the Islamic and Western Worlds*, 29 GA. J. INT'L & COMP. L. 153, 173 (2000).

2. *See generally* Benjamin F. Friedman, *The Role of Interest Rates in Federal Reserve Policymaking* (Nat'l Bureau of Econ. Res., Working Paper No. 8047, 2000).

3. *Id.; see also* Sharawy, *supra* note 1, at 173.

4. While there is rich scholarly debate on whether *riba* includes all interest or just excessive interest commonly referred to as usury, the majority view of Islamic jurists is to condemn *riba* in any form. *See* 6 FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 46–47 (Dr. Mark S.W. Hoyle ed., 1998) [hereinafter *VOGEL & HAYES*].

return on capital.[5] This, along with other *Shari'a* prohibitions,[6] makes Islamic banking seemingly incompatible with, and incapable of growth in, the interest-dominated global financial market. The current state of Islamic banking, which mostly consists of rudimentary banking methods, seems to support this view. [7] The world, however, is witnessing a resurgence of Islamic religious ideals and new demand for more sophisticated *Shari'a*-compliant banking services.[8] Nonetheless, the demand does not change the seemingly irreconcilable differences between Islam and conventional banking. This poses the question: can Islamic banking grow beyond its rudimentary stage and become a competitive market in the global financial system?

This Note explores whether successful growth is possible for Islamic banking and offers ways to measure its growth. Part I introduces the relationship between Islam and finance to provide an understanding of why Islamic finance is different and how religion has affected its growth. Part II explores the Islamic mortgage market and introduces this market as a microcosm for drawing analogies to Islamic banking generally. It looks at the Islamic mortgage market's origins, influential actors in the market, and isolates the important challenges overcome by this market. Finally, Part III applies factors giving rise to growth in the Islamic mortgage market to Islamic banking and looks for evidence that the Islamic financial market can also achieve similar order and scale.

PART I: ISLAM AND BANKING

Islam is a religion that governs life based on moral obedience and compliance with the Qur'an and other sources of *Shari'a*.[9] *Shari'a* permeates every aspect of a Muslim's life by

5. The Qur'an, Sunnah, Ijma, and Qiyas are the main sources of Islamic law. *See* MAWIL IZZI DIEN, ISLAMIC LAW: FROM HISTORICAL FOUNDATIONS TO CONTEMPORARY PRACTICE 36–53 (2004). The Sunnah is a term for practices ascribed to the Prophet Muhammad "in the form of words, actions, approvals or even silence." *Id.* at 38. The Qur'an and Sunnah constitute primary sources of Islamic law. *Id.* at 40. Ijma (consensus of the community) and Qiyas (reasoning by analogy) are secondary sources of Islamic law. *Id.*

6. *See* discussion *infra* Part I.B.

7. *See* discussion *infra* Part I.B.

8. *See* discussion *infra* Part I.B.

9. *See* Dien, *supra* note 5, at 37 (stating that the Qur'an, as composed and given by God, is seen by Muslims as the first source of Islamic law and "to be

acting as a mandate from God on how to live one's life individually and collectively in a society.[10] Notably, Islam does not separate finance and faith. Muslims do not view Islam as existing in addition to economics or any other aspect of society, which subjects the entire area of banking to religious considerations.[11]

A. THE PROHIBITION OF *RIBA*

The Qur'an, or holy book of Islam, is the primary Islamic authority and it prohibits *riba*.[12] The prohibition appears in several passages in the Qur'an.[13] One passage states that God does not view interest as true wealth because it represents unearned income.[14] Another passage condemns Jews for not obeying the Torah's prohibition of interest.[15] A third passage condemns the compounding of interest upon default by stating "O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject the faith . . . ."[16] A final condemnation warns that those who receive *riba* are waging war with God and shall be "inhabitants of the fire and abide there forever."[17] Scholars have noted that the taking of *riba* is on par with repeated adultery and deemed more sinful than

respected more than any human-made law").

10. *Id.*

11. PAUL S. MILLS & JOHN R. PRESLEY, ISLAMIC FINANCE: THEORY AND PRACTICE 2 (1999) [hereinafter *MILLS & PRESLEY*].

12. *See* 1 LAW IN THE MIDDLE EAST 87 (Majid Khadduri & Herbert J. Liebesny, eds., 1955). Muslims believe the Qur'an is the literal word of Allah (God) communicated by the angel Gabriel to the Prophet Muhammad. *Id.*

13. MILLS & PRESLEY, *supra* note 11, at 7.

14. *Id.* (quoting the Qur'an 30:39, which states "And whatever you lay out as [interest/usury], so that it may increase in the property of men, it shall not increase with Allah; and whatever you give in charity, desiring Allah's pleasure—it is these (persons) that shall get manifold").

15. *Id.* (quoting the Qur'an 4:161, which states, "And their taking [interest/usury] though indeed they were forbidden it and their devouring the property of people falsely, and We have prepared for the unbelievers from among them a painful chastisement"). Historically, the levying of interest was not only a prohibited practice in Islam, but also in Judaism and Christianity. *See* Wayne A.M. Visser & Alastair McIntosh, *History of Usury Prohibition: A Short Review of the Historical Critique of Usury*, 8 ACCT. BUS. & FIN. HIST. 175, 179 (1998), *available at* http://www.alastairmcintosh.com/articles/1998_usury.htm. The prohibitions in Judaism and Christianity, however, were abandoned with the growing tide of commercialism in the 15th century. *Id.*

16. MILLS & PRESLEY, *supra* note 11, at 7 (quoting the Qur'an 3:130–1).

17. *Id.* (quoting the Qur'an 2:275, 278, and 279).

maternal incest—two crimes in Islamic criminal law that are punishable by death.[18]

The *riba* prohibition reflects the Islamic view that accumulating wealth through collecting *riba* is not a legitimate mode of "work."[19] Islam values capital when it is the product of labor and risk-taking.[20] When a lender charges interest for capital, he receives a reward without adding his labor and without regard to the success or failure of the borrower's venture. The benefit of the loan to the lender is certain while the benefit of the capital to the borrower is uncertain. Islam views these transactions as necessarily including unfair allocations of risk and justifying reward for a passively acquired return on capital.[21] *Riba* is thus exploitive vis-à-vis the borrower and its prohibition limits the extent to which one party may be disadvantaged by the other party in financial transactions.[22]

Prohibiting economic exploitation is important in Islam because Allah wills his followers to accumulate wealth in a manner that achieves social justice.[23] Social justice, however, should not be mistaken to mean that Allah wanted people to be equal in wealth. Muslims believe that God "deliberately created disparities in the distribution of goods in this world."[24] Rather, social justice supported by legitimate work means that "no one may claim more than he has earned" and may not use wealth to disparage others.[25] This thought, when applied to conventional banking, means that investments cannot be viewed solely through the lens of achieving the highest profit margin. Instead, Islam places accession to wealth in relation to spiritual costs to the individual and social costs to the community.

On an individual level, Islamic scholars have reasoned that prohibiting *riba* is a "divine rule" deployed to avoid commercial

18. *See id.* at 7–8.

19. Sharawy, *supra* note 1, at 161.

20. *Id.* at 166.

21. Ina Burghardt & Carolin Fuß, *Islamic Banking Credit Products in Germany and in the United Kingdom* 2 (EUR. BUS. SCH. INT'L U. SCHLOß REICHARTSHAUSEN, DEP'T. OF FIN., Working Paper No. 12-2004, 2004) [hereinafter *Burghardt & Fuß*].

22. *Id.*

23. Sharawy, *supra* note 1, at 161.

24. VOGEL & HAYES, *supra* note 4, at 56.

25. *See id.* ("Do not covet the bounties which God has bestowed more abundantly on some of you than on others. Men are allotted what they earn, and women are allotted what they earn. Ask God for something of His bounty." (quoting the QUR'AN 4:32)).

exploitation of the poor and weak.[26] Scholars argue that "only a needy person would pay more for a mere extension of time."[27] The rich have a duty in this case "to give charity" and not to take more away.[28] The prohibition, thus, prevents the rich from participating in these exploitative acts.[29] On the community level, prohibiting *riba* ensures that wealth is accumulated for the benefit of the community. This is demonstrated in the *zakat*, a compulsory wealth tax in the Qur'an, which must be paid to the poor annually.[30] The tax deters wealth from accumulating and concentrating in the hands of a small number of wealthy individuals.[31] By limiting hoarding, the Qur'an encourages a "just return to all members of a society from socioeconomic development."[32] Islamic scholars also posit that social justice is served because prohibiting *riba* discourages unequal bargaining by forcing investors to bear direct risks. One Qur'an commentator explains the importance of this check in attaining social justice:

> God forbade *riba* only because it prevents people from busying themselves for gain, because if the owner of the dirham can by means of a *riba* contract gain an additional dirham whether in cash or credit, it becomes easier for him to win the means of subsistence. He will rarely bear the burden of profit, commerce, and arduous crafts.[33]

Outside of social justice, Islamic scholars have also offered economic critiques of interest that support its prohibition. Scholars have argued that the unjust allocation of risk between borrower and lender creates a "penalty upon entrepreneurial initiative."[34] In a truly competitive market, Islamic scholars believe it to be unlikely that an investment could result in gross profits that also cover the interest.[35] Since capital would be unproductive without entrepreneurial input, the disincentive to

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26. VOGEL & HAYES, *supra* note 4, at 82.
27. *Id.*
28. *Id.*
29. *Id.*
30. *See* MILLS & PRESLEY, *supra* note 11, at 4 (stating that *Zakat* is an annual 2.5 percent tax "levied on all marketable wealth, in personal possession for over a year, above specified thresholds" and which is spent on various charities or qualified needy individuals).
31. *Id.*
32. *Id.* at 5.
33. VOGEL & HAYES, *supra* note 4, at 83 (quoting 2 FAKHR AL-DIN MUHAMMAD BIN 'UMAR AL-RAZI, MAFATIH AL-GHAYB 531).
34. MILLS & PRESLEY, *supra* note 11, at 10–11.
35. *Id.* at 11–12.

create wealth hinders economic growth.[36]

B. RIBA-FREE FINANCING TOOLS

The Islamic prohibition of interest does not mean, however, that capital is without cost in an Islamic system or that a party cannot profit from a lending arrangement. Islam recognizes capital as a factor of production and encourages profit when achieved through legitimate means. The following are some examples of Islamic banking techniques that avoid riba and, instead, reward lenders for risk-sharing.

Mudaraba is one form of financing equivalent to venture capitalism.[37] *Mudaraba* allows the entrepreneur who provides the labor, skills, experience and effort to make use of an investor's capital.[38] The investor shares in the profit earned by the entrepreneur while his losses are limited to his capital investment.[39] *Mudaraba* gained acceptance because it was a practice that existed in the time of the Prophet Muhammad and approved by him.[40]

Another form of investment activity is *musharaka*, which is similar to the capitalistic partnership arrangement.[41] Here, the investor and entrepreneur have joint profit-sharing and decision-making powers.[42] Unlike in *mudaraba*, where only the investor provides capital, all parties in *musharaka* provide capital.[43] Banks may use *musharaka* to enter into a "profit and loss sharing scheme" with their customers by using deposited funds.[44]

A third commonly used method of financing is *murabaha*, which is considered financing on a "cost plus basis."[45] Here, the customer approaches the bank and requests that it purchase a good on behalf of the customer.[46] After the purchase, the bank resells the good to the customer for the cost plus a profit

36. *Id.*
37. *See generally* Anita Hawser, *Players Vie for a Prime Slice of a Promising Market*, 19 GLOBAL FIN., Sept. 1, 2005, *available at* 2005 WLNR 15059785.
38. Burghardt & Fuß, *supra* note 21, at 18.
39. *Id.*
40. *See* Sharawy, *supra* note 1, at 170.
41. *Id.*
42. *See* Barbara L. Seniawski, *Riba Today: Social Equity, the Economy, and Doing Business under Islamic Law*, 39 COLUM. J. TRANSNAT'L L. 701, 723 (2001).
43. *Id.*
44. Sharawy, *supra* note 1, at 170 (internal quotes omitted).
45. *Id.*
46. *Id.*

margin.[47] The profit margin is not deemed interest because the bank acquires ownership of the asset before resale, which entails certain risks of ownership such as the goods being damaged before delivery or the client refusing to accept the commodity.[48]

Ijara wa-iqtina' is another commonly used financing tool. *Ijara wa-iqtina'* separates ownership rights of an asset from rights to use the asset.[49] The owner of the asset bears all the risks associated with ownership, such as the duty to maintain and repair the asset, and the user of the asset pays a fixed price for the benefit of using the asset.[50] The user of the asset is considered a lessee and will pay rent on the asset as he pays a sum towards buying the asset.[51] The lessee gains a greater percentage of ownership over the property with each principal payment, which reduces his rent payment proportionally.[52]

The equity-oriented techniques mentioned above form the anatomy of Islamic financing.[53] While these techniques demonstrate that devising *Shari'a*-compliant banking practices is possible, Islamic banking has yet to develop beyond the rudimentary stage. The prohibition of *riba*, along with other *Shari'a* restrictions on how Muslims may invest money,[54] limits

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47. *See* Seniawski, *supra* note 42, at 723.

48. *See* Sharawy, *supra* note 1, at 170; *see also* Mohamed Ariff, *Islamic Banking*, 2 ASIAN-PAC. ECON. LIT. 46 (1988).

49. *See* VOGEL & HAYES, *supra* note 4, at 143–45; *see also* Malcolm Ring, *Islamic Funding and the Effect of Stamp Duty Land Tax*, 15 J. INT'L BANKING L. & REG. 183,184 (2004).

50. *See* VOGEL & HAYES, *supra* note 4, at 144.

51. *Id.*

52. *Id.*

53. Islamic banking has developed other techniques that are outside the focus of this Note. Some of these techniques include *salam* (advanced purchase), *istisna'* (commissioned manufacture) and *ji'ala* (reward). For a full discussion of these and additional techniques, see VOGEL &HAYES, *supra* note 4, at 145–50.

54. Shari'a has many prohibitions in addition to the prohibition of *riba*. Muslims are not permitted to invest in funds or companies that earn income from the production of pork-related products, alcohol, conventional financial services, pornography, gambling, tobacco, arms and other illicit activities. Hawser, *supra* note 37; *see also* QUR'AN 5:90–91. *See generally* Angelo L. Rosa, *Keeping the Faith: The Islamic Prohibition Against Interest and Excessive Risk Can Be Respected with Specially Designed Funding Instruments*, L.A. LAW., Feb. 27, 2005, at 24 (describing how attorneys should advise Muslim clients on *Shari'a*-compliant transactions). Transactions that involve excessive risk also bear too close a resemblance to gambling and are thus forbidden. Burghardt & Fuß, *supra* note 21, at 3. Sales of items whose existence or characteristics are uncertain and upon contractual terms that are ambiguous or unclear are also prohibited. *Id.* This eliminates contracts containing obligations to insure another or to grant future options for purchases. Financing must also be directly tied to tangible assets, making certain securitization

Islamic banking activities to basic service-oriented transactions of depository institutions.[55] On the investment banking side, banks are confined to short-term, low-risk investments with slim profit margins.[56] Islamic banking currently lacks counterparts to sophisticated instruments prevailing in the conventional financial markets, such as products used in project finance and asset management, debt instruments, insurance and hedging.[57]

C. THE CURRENT STATE OF THE ISLAMIC FINANCIAL MARKET

Historically, Islamic banking suffered from insignificant market demand to help develop sophisticated Islamic finance tools.[58] While the economy in the Middle East has grown steadily in recent decades, past activity never formed a critical mass of consumers that could sustain demand for *Shari'a*-compliant financing tools in the global financial market.[59] A recent trend, however, promises a broader consumer base. Islam has now emerged as the world's fastest-growing religion, with more than one billion followers worldwide.[60] At the same time that the Muslim population is becoming more global, it is producing an educated class that accumulates substantial

unacceptable. *See* Rosa, *supra*, at 24. Securitization is a financial technique that pools assets together and, in effect, turns them into a tradable security. *See* STEVEN L.SCHWARCZ, BRUCE A. MARKELL & LISSA LAMKIN BROOME, SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 1–3 (2004). As a result of these prohibitions, mainstream forms of hedging, speculation, swap and derivative transactions, to name a few, are excluded from Islamic banking.

55. VOGEL & HAYES, *supra* note 4, at 292.

56. VOGEL & HAYES, *supra* note 4, at 7–8 (explaining that the "short-term investment strategy of Islamic banks may be a dead-end" because profit margins are too thin to support overhead and produce sufficient profits to satisfy bank owners and depositors).

57. *See* Hawser, *supra* note 37.

58. While Muslim countries have continued to establish financial institutions and built financing tools since the 1960's, these developments were a niche market that operated outside of mainstream financial markets. For a discussion of two large scale investment funds developed by Middle Eastern banks during this time, see Seniawski, *supra* note 42, at 722.

59. *See* discussion *infra* Part III.A; *see also* Mohammed El Qorchi, *Islamic Finance Gears Up*, FINANCE AND DEVELOPMENT, Dec. 2005 (stating that the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 in 2005 and that such institutions have spread to more than seventy-five countries). Islamic financial institutions are also estimated at managing approximately $250B in assets with a fifteen percent yearly growth. *Id.*

60. Marla Dickerson, *The Price of Piety in Islam*, L.A. TIMES, Mar. 17, 1999, at A1.

wealth.[61] This combination is building a consumer base that demands access to financial markets without giving up religious beliefs.[62]

There is little data at this point to accurately measure whether the new consumer base has propelled the Islamic financial market out of its rudimentary stage. Islamic banking is still a niche market when juxtaposed against other markets in the global financial system. The success of a financial market, however, can be measured by certain factors that heavily influence market growth. The next part of this Note uses the Islamic mortgage industry as a case study to flush out these crucial factors.

PART II: ISLAMIC MORTGAGE AS A MICROCOSM OF ISLAMIC BANKING

The Islamic mortgage market is growing rapidly in western nations.[63] While the mortgage market represents a small portion of the finance industry, it serves as an apt example of how an Islamic financial service can develop and become competitive in the broader financial system. The present-day success of Islamic mortgages yields tangible factors for measuring the current growth of Islamic banking.

A. ISLAMIC MORTGAGES IN THE UNITED KINGDOM AND UNITED STATES

Homeownership is the lending mechanism through which consumers participate in financial markets. Half of all homeowners hold at least fifty percent of their net wealth in home equity.[64] Homes generally represent a family's largest investment and form of savings. Homes act as collateral for consumer spending and give consumers purchasing power.

61. *See* Assif Shameen, *Islamic Banks: A Novelty No Longer,* BUS. WEEK ONLINE, Aug. 8, 2005, http://www.businessweek.com/magazine/content/05_32/b3946141_mz035.htm (stating that the organizers of the International Islamic Finance Forum, a semi-annual banking industry conference, estimated that assets invested in compliance with the prohibition of *riba* topped $262B in 2005); *see also* El Qorchi, *supra* note 59.

62. *See supra* note 61 and accompanying text; *see also* discussion *infra* Part III.A.

63. *See* discussion *infra* Part II.A.

64. *See* Freddie Mac Key Corporate Statistics, http://www.freddiemac.com/news/corp_stats.html.

Scholars have also argued that homeownership grounds individuals and their families to their community and reinforces a sense of citizenship to their country.[65] Additionally, the 2005 homeownership rate in the United States was approximately sixty-nine percent, showing that homeownership is an important aspect of American society.[66]

1. *Riba and the Conventional Mortgage Market*

The Muslim population has been severely underrepresented in the homeownership market because conventional home loans require the borrower to pay interest.[67] For a devout Muslim, paying interest puts him at direct odds with the Islamic prohibition of *riba*. Some Muslims opted to violate *Shari'a* and live with the shame of paying interest, but others sought unconventional lending schemes.[68] For example, some communities formed cooperatives that financed local borrowers.[69] These cooperatives resemble limited partnerships and are comprised of Muslim investors living in the community.[70] The cooperative pools money from its member investors and purchases property with the borrower.[71] The borrower then pays back the principal on a monthly basis at the same time that it pays rent to the cooperative for occupying the house.[72] While this system met religious standards, it failed to meet market demand. Cooperatives are not banks and do not

65. *See generally* Yahia K. Abdul-Rahman & Abdullah S. Tug, *LARIBA (Islamic) Mortgage Financing in the United States: Providing an Alternative to Traditional Mortgages*, ISLAMIC FIN. PROJECT (Harvard Law School, Cambridge, M.A.), October 9, 1998, *available at* http://islamic-finance.net/journals/journal2/art3.pdf [hereinafter Abdul-Rahman & Tug] (arguing that homeownership can be a means to strengthen civil society and community).

66. Robert R. Callise & Linda B. Cavanaugh, *Census Bureau Reports on Residential Vacancies and Homeownership*, U.S. DEPT. COM. NEWS, Oct. 31, 2005, at Table 4.

67. *See, e.g.*, Patrick O'Gilfoil Healey, *National Perspectives: For Muslims, Loans for the Conscience*, N.Y. TIMES, Aug. 7, 2005, 2005 WLNR 12419952 (stating that the homeownership rate for Muslim Arab residents "remains 7 percent lower than the overall percentage of homeowners statewide").

68. *See id.* (describing the "shadow of shame" that hovered over a Detroit Muslim who financed his home through a conventional loan).

69. *See* Holden Lewis, Borrowing is Still Possible When Interest is Banned by Religious Law, (July 4, 2000), http://www.bankrate.com/brm/news/mtg/20000714.asp.

70. *Id.*

71. *Id.*

72. *Id.*

have a steady stream of capital. Consequently, cooperatives must wait until loans are paid back before financing new homes.[73] This resulted in backlogs of borrowers who were on waitlists for years.[74]

Other schemes involve making the borrower pay a forty to fifty percent down payment to obtain an interest-free Islamic mortgage.[75] In addition to the substantial down payment, the loans had high fees and closing costs not included in a conventional mortgage.[76] These schemes essentially punished Muslims financially for their religious values.[77]

This hostile borrowing environment resulted in Muslims turning away from lending schemes and renting instead. According to Michigan's census data on its growing Arab-American population, the homeownership rate for Muslim Arab residents are generally "7 percent lower than the overall percentage of homeowners statewide."[78] The low rate of Muslim homeownership exists despite the Muslim population being college educated and making over $50,000 in annual family income.[79] As a state with a large and growing Muslim community, Michigan is a good example of how conventional loans and lack of workable alternatives excluded the Muslim population from the housing market.[80]

2. *Increased Market Demand for Islamic Mortgages*

Beginning in the early 2000's, market demand became a pivotal force in establishing a *Shari'a*-compliant mortgage market in the United Kingdom and the United States. As Muslim populations increased in western countries, Muslims

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73. *Id.*

74. *Id.*

75. Healey, *supra* note 67.

76. *See id.*; *see also* Kim Norris, *Islamic Mortgages: Faith, Finance Forge New Path*, DETROIT FREE PRESS, Aug. 6, 2005, http://www.freep.com/money/business/islamic6e_20050806.htm (describing the 1990s when the United Bank of Kuwait charged Islamic mortgages the equivalent of an additional two percentage points more than conventional mortgages).

77. *See, e.g.*, Norris, *supra* note 76 (reporting that a Muslim borrower in the early 1990s would pay "the equivalent of an additional 2 percent points more" on an Islamic mortgage than on a conventional mortgage).

78. Healey, *supra* note 67.

79. *See* Don Lattin, *Muslim Money Management is Hot Topic at Conference*, S.F. GATE, Sept. 1, 2002, http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2002/09/01/MN147807.DTL.

80. *See* Healey, *supra* note 67.

began to form a critical mass of potential homeowners. The 2001 United Kingdom national census reported that it had a Muslim population of over 1.5 million.[81] Muslims also represented the second largest religious group after Christians.[82] As a result, the potential Islamic mortgage market in Great Britain grew to £9B, or $15.6B.[83] The same growth took place in the United States. The exact figure of the Muslim population in the United States is very difficult to determine, but estimates have ranged from five to eight million.[84]

The growing population focused its attention on *Shari'a*-compliant mortgages. Events taking place in Hennepin County, Minnesota are clear evidence of the power of a critical mass of consumer demand. Due to an influx of Somali immigrants, the Muslim population in the Twin Cities grew to an estimated 130,000 in 2002.[85] Hennepin County, home to most of the state's immigrants, had few rental properties comfortable to accommodate families and the Muslim population generally lacked the income to make large cash purchases or down payments for non-conventional loans.[86] The Muslim population voiced their dilemma to local and state housing agencies,

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81. National Statistics Online, http://www.statistics.gov.uk/cci/nugget.asp?id=954 (United Kingdom) [hereinafter *National Statistics*]. The National Statistics population understates the current Muslim population, which is speculated at 1.8 million. *See* Peter Ford, *"No Interest" Gains Interest with British Muslims*, CHRISTIAN SCI. MONITOR, Sept. 21, 2005, WLNR 14819564; *see also* Maya Imberg, *Onwards and Upwards for Islamic Mortgages*, FIN. ADVISOR, Sept. 8, 2005, WLNR 14227594.

82. *See* National Statistics, *supra* note 81.

83. *See* Imberg, *supra* note 81.

84. *See* The Islamic Project, http://www.theislamproject.org/education/United_States.html (last visited Aug. 23, 2006), which states:

> Because the U. S. Census does not collect information on religious affiliation of residents in the nation, there is no exact figure on the number of Muslims in the country. According to a national poll conducted in 2001, known as the American Religious Identity Survey, approximately 1,104,000 adult Muslims reside in the United States. National Muslim organizations put the total number of all Muslims in the nation at about seven million, based on a survey that determined that two million Muslims regularly attend weekly Friday prayer services, and stipulated that the majority of Muslims do not attend such services. The 2000 Britannica Book of the Year estimate for 2000 states the number as 4,132,000.

Id.

85. *See* Nicole Bennett, et al., *Alternative Financing: Issues and Opportunities for Lenders and Interest-Adverse Populations*, COMMUNITY DIVIDEND (Fed. Res. Bank, Minneapolis, MN), 2002, http://minneapolisfed.org/pubs/cd/02-1/islamic.cfm.

86. *Id.*

requesting information on alternative mortgage products.[87] The large quantity of requests captured the attention of the Federal Reserve Bank of Minneapolis, which worked with the U.S. Department of Housing and Urban Development and other organizations to research and create lending alternatives for Muslims in the Twin Cities Area.[88]

3. Attracting Mainstream Lending Institutions

Like the Hennepin County example, the critical mass of potential Muslim homeowners worldwide and the untapped market they formed captured the interests of local, national and international lending institutions. Originally, lenders in the Islamic mortgage market, like American Finance House–LARIBA, created Islamic loans because they were interested in protecting religious values.[89] American Finance House–LARIBA "wrote the first 'Islamic mortgage' in 1987 for the purchase of a home in Madison, Wisconsin."[90] The company's founders were a group of business people "who believe in the LARIBA system of banking as the true expression of 'halal' Banking and Financing."[91]

American Finance House–LARIBA, however, is now joined by mainstream financial institutions eager to capture the untapped Islamic mortgage market. In the United Kingdom, Islamic mortgage lending increased by an average of sixty-eight percent per year from 2000.[92] In 2004, UK lenders advanced over £164M, or $286M, most of it attributable to large lenders

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87. *Id.*

88. *Id.* Lending alternatives adopted by the working group, among others, include alternative financing contracts used by the Hennepin County and St. Paul's Neighborhood Development Center (NDC) small business financing contracts. The Hennepin County contracts are modeled on monthly installment payment with a fourteen percent mark-up that is considered Hennepin County's profit on the property sale and not interest earned. The NDC financings use buy-sell agreements, lease-purchase agreements, royalty investments and interest-free loans. *Id.*

89. LARIBA is an acronym for Los Angeles Reliable Investment Bankers Association. *See* American Finance House–*LARIBA* Corporate Profile, http://www.lariba.com/company/index.htm.

90. Bill Maurer, *Articulating Islamic Knowledge to an American Dream: Islamic Home Financing Alternatives after September 11, 2001*, 26 POL. & LEGAL ANTHRO. REV. 196, 203 (2003) (describing LARIBA using the "cost-plus model (*murabaha*)" and later also using the *ijara* model).

91. American Finance House–*LARIBA* Corporate Profile, http://www.lariba.com/company/index.htm. It specializes in single family home financing and in small- and medium-size business financing. *Id.*

92. *See* Imberg, *supra* note 81.

like HSBC Amanah and Lloyds TSB.[93] In the United States, international lender HSBC Mortgage Corporation (USA) and community lenders Devon Bank in Illinois and University Bank in Michigan all offer Islamic banking products.[94] Surveys have shown that approximately $300M in Islamic financing was generated in the United States in 2004, and industry analysts predict that this number will increase dramatically in later years.[95] The market demand also sustained specialty finance companies like Guidance Financial Group, which provides only Islamic home financing.[96]

B. MAINSTREAM FINANCIAL INSTITUTIONS HELPING THE ISLAMIC MORTGAGE MARKET GROW

Attracting institutional banks to the Islamic mortgage market was crucial to its growth. Mainstream banks not only bring much needed capital to finance loans, they also bring scale and order.[97] As discussed below, this development created efficient, *Shari'a*-compliant lending products at little or no additional cost to the borrower.

Mainstream banks helped create order and scale because they can affect institutional change. For example, the *murabaha*-based mortgage in England was significantly more expensive than a conventional mortgage because of a double stamp duty.[98] The stamp duty is a tax paid to the British government upon the sale of a home.[99] The amount of the stamp

93. *See id.* (describing the entry of HSBC Amanah Finance, United National Bank and Lloyds TSB into the British Islamic mortgage market in 2003 and 2004 as a "crucial milestone in the development of the Islamic mortgage market" and as evidence of "widespread belief [that] this market is potentially substantial.").

94. *See* William L. Rutledge, Executive Vice President, Fed. Reserve Bank of N.Y., Remarks at the 2005 Arab Bankers Association of North American (ABANA) Conference on Islamic Finance: Players, Products & Innovations in New York City. (Apr. 19, 2005) (speaking on regulation and supervision of Islamic banking in the United States) (transcript available at http://www.ny.frb.org/newsevents/speeches/2005/rut050422.html) [hereinafter *Rutledge Speech*].

95. *See* SHAPE Financial Corp., http://www.shapefinancial.com/aboutus.htm.

96. *See* Guidance Financial Group lending products, http://www.guidancefinancialgroup.com.

97. Abdulkader Thomas, *Methods of Islamic Home Finance in the United States: Beneficial Breakthroughs*, AM. J. ISLAMIC FIN., *available at* http://www.guidancefinancialgroup.com/learn/whitepapers.asp.

98. *See* Imberg, *supra* note 81.

99. *See* Her Majesty's Revenue & Customs, http://www.hmrc.gov.uk/so/so1.htm (United Kingdom).

tax is generally a percent of the home's purchase price.[100] Under the *murabaha* mortgage, the bank purchases the property from the vendor, but it is immediately resold to the customer.[101] This triggered stamp duty twice: once when the bank bought the property and again when the buyer purchased the property from the bank.[102] The stamp duty was generally a significant cost, making Islamic mortgages much more expensive than traditional mortgages.[103] In order to stimulate demand for Islamic mortgages, the Bank of England formed a working group and pushed Her Majesty's Treasury to abolish double stamp duty.[104] As a direct result of its efforts, double stamp duty was abolished in 2003 and Islamic mortgages suddenly became affordable and competitive with conventional mortgages.[105]

In the United States, mainstream lenders pushed for institutional change by successfully selling Islamic mortgages in the secondary mortgage market.[106] Sale of mortgages to the secondary market is essential to originating lenders because liquidity enables the lenders to free up funds and originate more loans.[107] Fannie Mae and Freddie Mac are major players in the secondary market, controlling about ninety percent of the transactions in that market.[108] Fannie Mae and Freddie Mac buy mortgages from lenders, package the mortgages into securities and sell the securities to investors.[109] The two entities are the biggest buyers of home mortgages in the United States and are considered secondary market conduits between mortgage lenders and investors. Freddie Mac alone financed

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100. *Id.*

101. *See Islamic Mortgages: Pillars of Faith*, MORTGAGE NETWORKS (Incisive Media Investments Ltd.), Sept. 20, 2004, http://db.riskwaters.com/public/showPage.html?page=191085 [hereinafter *Pillars of Faith*].

102. *See* Shameen, *supra* note 61; *see also* Pillars of Faith, *supra* note 101.

103. Imberg, *supra* note 81.

104. *Id.*

105. *Id.*; *see also* Shameen, *supra* note 102.

106. Press Release, Fannie Mae, Fannie Mae to Invest $10 Million in Unique Islamic Home Financing Model with American Finance House–LARIBA (Dec. 6, 2002) [hereinafter *Fannie Mae Press Release*].

107. *See* THE IMPORTANCE OF THE SECONDARY MORTGAGE MARKET TO HOMEOWNERS AND LENDERS, THE HOMEOWNERSHIP ALLIANCE (2003) (third series). The Homeownership Alliance is a Washington D.C. coalition of non-profit groups, community bankers, home builders, other mortgage professionals and housing industry organizations.

108. *See* Freddie Mac, http://www.freddiemac.com.

109. *Id.*

over $592B in new mortgages in 2002.[110]

Companies financing Islamic mortgages worked with Fannie Mae and Freddie Mac to develop the Islamic products so that they are eligible for sale in the secondary market. The cooperative efforts resulted in Freddie Mac financing an approximately $11M pool of Muslim home financing contracts in 2001.[111] In December, 2002, Fannie Mae also announced an investment of $10M in Islamic home financing with American Finance House–LARIBA.[112] Though the dollar amount of the investment seems insignificant when compared to the housing market as a whole, working with Fannie Mae and Freddie Mac significantly alleviates the pressure of finding funds to meet high consumer demand for Islamic mortgages.

C. FACTORS ATTRIBUTABLE TO THE GROWTH OF THE ISLAMIC MORTGAGE MARKET

Islamic mortgages have grown from a niche market with cumbersome financing to a viable lending alternative supported by mainstream banks. Several factors contributed to this development. First, the lenders in this market found common ground between *Shari'a* prohibitions and the conventional mortgage system and built lending instruments on these common grounds. Second, *Shari'a*-compliant mortgages gained credibility by joining the conventional regulatory systems and working with influential government and market actors. This process not only fostered cooperation between actors in the Islamic and conventional mortgage markets, it bequeathed benefits on Islamic mortgage consumers that would not have been available otherwise. Finally, Islamic mortgages sustained demand by observing *Shari'a* and not compromising religious legitimacy.

1. Finding Common Ground in Building Lending Products

While Islamic mortgages and conventional mortgages cannot be fully reconciled on their different views of interest, there is substantial agreement between both systems on

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110. *Id.*

111. *See* Press Release, Freddie Mac, Investing in Islamic "Mortgages" from American Finance House–LARIBA (Mar. 28, 2001); *see also* Press Release, Freddie Mac, Standard Federal Bank Announce New Islamic Home Financing Initiative for Michigan Families (Aug. 10, 2001).

112. *See* Fannie Mae Press Release, *supra* note 106.

rewarding a lender for making loans. Interest in conventional mortgage transactions compensates the lender for a time factor, an element of risk and sacrificing liquidity.[113] The time factor supposes that if all things were equal, "a lender would rather have money sooner than later."[114] The lender is foregoing present consumption when he makes a loan and under the discounted cash flow theory, what is consumed in the future is worth less today.[115] Also embedded in this analysis is the erosion of purchasing power due to inflation where cash inflows expected to be received at a later time have reduced value compared to that same cash today.[116] In sum, the time factor dictates that the lender's forbearance from consuming today deserves to be compensated.[117] The element of risk includes the potential of default or unanticipated changes in the economic circumstances of both the lender and the borrower.[118] This calls for compensation to induce the lender to enter into the arrangement despite assuming these risks.[119] The element of sacrificing liquidity argues that the lender is tying up his money and foregoing more profitable investment opportunities that come up in the meantime.[120] The lender is compensated for this loss of liquidity in the form of interest.[121]

Islam disagrees that the time-value element of interest should be rewarded. The objection is that "when time is joined to property—whether cash or in kind—it acquires a legitimate value as part of that single sales transaction."[122] This reasoning is derived from an illustration given by the Prophet using an unborn animal:

> [T]he price of a pregnant sheep should be increased in consideration of what it carries, even though the unborn animal itself could not be sold separately. Thus, time may be considered in setting a price, but it is not separable from the sold article, and the compensation for time is therefore included as part of the price of the article being sold."[123]

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113. *See* Rodney Wilson, *The Issue of Interest and the Islamic Financing Alternatives*, 13 J. INT'L BANKING L. 23, 23 (1997).
114. VOGEL & HAYES, *supra* note 4, at 204.
115. *Id.*
116. *Id.*
117. *See* Wilson, *supra* note 113, at 23.
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. VOGEL & HAYES, *supra* note 4, at 202.

In other words, the time value element cannot be separated from the value of the object, and compensating the lender for this element rewards the lender twice for the same product.

Islam, however, agrees with western economic thought that risk-taking and sacrificed liquidity should be compensated.[124] Islamic finance principles are guided by a desire to control excessive risk, a consideration that is fully consistent with any prudent business practice.[125] The participatory nature of Islamic mortgages, by making banks share in the borrower's investment of his home, reduces risk by spreading it to both parties. This is more stable than in the conventional system where the lender's risk is only limited to the solvency risk of the borrower, but the lender's reward is relatively insulated from loss because the interest payments continue to become due without regard to the borrower's financial position.[126] Under the Islamic economic theory, the lender that participates in risk sharing is not sitting idly while his money accumulates wealth. Instead, the lender is adding labor to the capital.[127] The Qur'an applauds labor from shouldering part of the financial risk and believes it should be compensated. Islamic economists and financiers also recognize that sacrificing liquidity justify a reward to the lender.[128] Depositors with Islamic banks often have their returns determined by the amount of notice they give to the bank before withdrawing the deposits. [129] In practice, Islam recognizes the opportunity cost of sacrificing liquidity.[130]

The two popularly used mortgages, the *murabaha*-based mortgage and the *ijara*-based mortgage, are the products of finding common grounds between Islam and conventional lending theories. These two products justified reward to the lender based on risk-taking and sacrificing liquidity. In the *murabaha*-based mortgage, the bank purchases the home along with a down payment from the customer and takes ownership of it.[131] It then resells the home to the customer at a higher

124. *Id.* at 203.
125. *See* Rosa, *supra* note 54, at 24.
126. *See* Wilson, *supra* note 113, at 23; *see also* Zamir Iqbal, *Islamic Banking Gains Momentum, Expands Market and Competes with Conventional Banking in Arab States*, 21 MIDDLE E. EXECUTIVE REP. 9, 9 (1998).
127. *See* Wilson, *supra* note 113, at 23.
128. *Id.*
129. *Id.*
130. *Id.*
131. VOGEL & HAYES, *supra* note 4, at 141.

price.[132] The mark-up from the original price may look like interest, but there are substantial differences. The lender may not sell the home to the customer before taking title of the home.[133] Taking title entails assuming risks that the home will be destroyed, harmed, develop defect or the seller defaulting on closing obligations.[134] Devon Bank's *murabaha* contract, in particular, has no provision for incurring additional debt upon default; the theory being that the lender has already been compensated for this risk in the mark-up.[135] Most importantly, the *murabaha*-based mortgage does not compensate the lender for the time value of the loan because the mark-up does not increase with the life of the loan.[136] On the basis of these differences, the mark-up is distinguishable from conventional interest and is justified as reward for the lender's risk taking.

In the *ijara*-based mortgage, the customer selects a property and the lender purchases it.[137] The customer and lender enter into two contracts, a promise to purchase contract and a lease contract.[138] Under the promise to purchase contract, the customer agrees to buy the property from the lender for the original purchase price spread over a number of years.[139] Under the lease contract, the customer agrees to pay the lender for occupancy of the property prior to completion of the purchase.[140] The lease payment avoids the time value element of interest because the compensation is based on the customer's use of the

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132. *Id.*

133. *Id.*

134. *Id. Cf.* Vogel and Hayes, *supra* note 4, at 142 (arguing that while the risks exist in theory, lenders have developed a practice that decreases the risks nearly to zero). Lenders generally require the two purchases to take place immediately after each other, making the bank's ownership artificial. *Id.* The customer's down payment towards the initial purchase also reduces the likelihood that a customer will default on the second purchase. *Id. Murabaha* lending has come under severe scholarly criticism as "superficially legal means to attain substantively illegal ends." *Id.* at 143. The practice, however, has survived academic criticism and is still approved by the Islamic Fiqh Academy, the most respected organization that issues legal opinions on *Shari'a* compliance. *Id.*

135. Posting of David Loundy, Vice President of Devon Bank, to EL-Gamal's Challenge http://finance.groups.yahoo.com/group/ibfnet/message/4313 (Aug. 20, 2005, 13:40:00 CST) [hereinafter *Loundy Blog*].

136. *Id.*

137. *See* American Finance House–LARIBA, Overview for Home-Finance Products http://www.lariba.com/home-financing.htm [hereinafter *LARIBA Overview*].

138. *Id.*

139. *Id.*

140. *Id.*

property and not the time value of the principal loan.[141] Because the lender's reward is based on leasing the property, once the customer has purchased all of the property, the lease payments are no longer needed.[142] The lender is the owner of the property during the lease and assumes all the risks of ownership. Such risks include the Islamic requirement that the owner bears the cost of insurance for the leased asset and necessary maintenance and repair.[143]

The *murabaha*-based and *ijara*-based mortgages achieve the same objectives as conventional products even though they are different in lending style.[144] The two products demonstrate that working with the common ground between Islam and conventional practice can result in effective lending tools that both satisfy religious prohibitions and consumer demand.

2. *Establishing Credibility in the Conventional Financial System*

Islamic mortgages also faced the challenge of establishing credibility in the financial system. Mortgage lending is a heavily regulated activity but mortgage laws are generally concerned with regulating interest rates in conventional loans. The differences in the structures of Islamic mortgages are significant enough to bring into question whether the mortgage laws are applicable to Islamic mortgages. Falling outside of a regulatory scheme leaves Islamic mortgages without credibility, which chases away investors and consumers.

The first step in building credibility was making clear that Islamic mortgages should be governed by the same regulatory scheme as conventional mortgages. The General Manager of American Finance House–LARIBA stated this clearly at a presentation at the Second Annual Harvard University Forum on Islamic Finance:

> We . . . strongly urge that in dealing with banking and financing

141. *See* VOGEL & HAYES, *supra* note 4, at 144.

142. *Cf.* Loundy Blog, *supra* note 135 (comparing *ijara*-based mortgages to *murabaha*-based mortgages where the borrower wishing to pay off the principal earlier would still be subject to paying the entire agreed to mark-up).

143. *See* Shameela Chinoy, *Interest-Free Banking: the Legal Aspects of Islamic Financial Transactions*, 10 J. Int'l Banking L. 517, 521 (1995).

144. *See, e.g.*, Robin Matthews, et al., *Islamic Finance*, Centre for International Business Policy, Kingston Business School, *available at* http://business.kingston.ac.uk/research/intbus/islamic_finance.pdf at 9 (comparing Islamic mortgage terms to conventional mortgage terms) (last visited Dec. 2, 2005).

> matters in the United States strict adherence to the letter of the law is required. . . . The Community Re-investment Act (CRA), the laws against usury, the equal lending opportunity laws, the Securities and Exchange Commission rules and regulations, the regulatory functions of the US banking regulators and the laws regarding full and complete disclosures are laws and regulations that reinforce basic human and Islamic values. We also know that the American financial, monetary and banking system is the most sophisticated and reliable in the world. It is our duty to uphold these laws.[145]

If Islamic mortgages are harmonized with conventional mortgage laws, investors and customers may view Islamic mortgages as an alternative lending product and not an entirely foreign and self-regulated lending scheme.

The next step was educating bank regulators on Islamic mortgages and securing their approval that Islamic mortgages were credible products. In the United States, lenders lobbied bank regulators by pointing out that the *Shari'a* element of Islamic mortgages places the same, if not a higher, premium on disclosure and consumer protection, which are the main principles of its laws.[146] The highly regulated real estate process that is layered with a specific flow of paper and documentation designed to present to consumers the cost of lending, the terms of lending and quality of the loan is also approved and encouraged by Islamic jurists and scholars.[147] Lenders showed bank regulators that the risk-sharing component of Islamic mortgages ensures the safe and sound operation of banks by encouraging stable investments. As a result of this cooperation, lenders successfully lobbied the Comptroller of the Currency (OCC) to issue advisory opinions approving Islamic mortgages.[148] These opinions gave investors comfort that Islamic lending products have been reviewed and are safe enough for application by United States banks.[149]

Islamic mortgages also established credibility by doing business with reputable and influential actors in the mortgage market. The secondary mortgage market is the key reason that mortgage markets have thrived in the United States.[150] As discussed earlier, the secondary mortgage market gives banks

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145. Abdul-Rahman & Tug, *supra* note 65, at 4–5.
146. *See* Thomas, *supra* note 97.
147. *Id.*
148. *See* U. Bank of Kuwait, Comptroller of the Currency Interpretive Letter #806 (Oct. 17, 1997); U. Bank of Kuwait, Comptroller of the Currency Interpretive Letter #867 (Jun. 1, 1999).
149. See Thomas, *supra* note 97.
150. *See supra* Part II.B.

liquidity, which in turn allows banks to originate more loans.[151] To enter the secondary mortgage market, financial institutions in the United States must adhere closely to banking and consumer compliance laws. Banks achieve this by using standardized mortgage contracts to document every loan.[152] These standardized contracts make the process of packaging and selling bundles of loans to the secondary mortgage market straightforward for investors because they can easily compare the terms of competing loans.[153] With Islamic mortgages, conventional loan documentation did not correspond to the actual transactions taking place.[154] Lenders faced significant practical challenges with altering standard loan documents to reflect terms and conditions that are not based on interest.[155] Yet, without standardized contracts that investors understood, it was impossible to package Islamic mortgages for resale on the secondary mortgage market. American Finance House–LARIBA and Freddie Mac formed a partnership to address this documentation issue. The partners developed a program that allows Muslim homebuyers to use standard Freddie Mac loan documents which matched other bundled loans sold on the secondary mortgage market.[156] When buyers sign these standardized documents, they also sign a patented American Finance House–LARIBA agreement consisting of a rider that replaces interest-related terminology with language related to mark-ups and installments.[157] This system attracted investors in the secondary market because they can rely on Freddie Mac's reputation and can review and compare yields from the Islamic loans to conventional loans. The form was also adopted later by Fannie Mae and other lending institutions.[158]

Working with the government and influential actors in the market made Islamic mortgages more transparent and reduced risk for investors. In turn, these factors built credibility for Islamic-mortgages and encouraged more lenders and consumers to actively invest in these alternative products.

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151. *See supra* Part II.B.
152. *See* Bennett, *supra* note 85.
153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.*; *see also* Fannie Mae Press Release, *supra* note 112.
158. *See* Fannie Mae Press Release, *supra* note 112.

3. *Maintaining Legitimacy and Observing Shari'a*

Notwithstanding credibility in the conventional mortgage market, Islamic mortgages must comply with *Shari'a* to attract consumers. *Shari'a*-compliant lenders achieved this by working with a supervisory board of religious advisors to review proposed financial transactions.[159] These entities are referred to as *Shari'a* boards and they provide banks with guidance on religious law and certify bank products as *Shari'a*-compliant.[160] *Shari'a* board members are performing due diligence on behalf of the consumers who are without access to the details of what is offered to them and without experience or qualifications to evaluate those details in light of *Shari'a* teachings.[161] In other words, *Shari'a* supervisory boards directly represent the Muslim investor's and consumer's religious interests.[162]

Financial institutions commonly rely on *fatwas* (legal opinion from qualified scholars) derived from a *Shari'a* board.[163] Mortgage lenders have taken special care to fill these boards with impeccable credentials. Generally, the members of *Shari'a* boards have a background in the classical *Shari'a* sciences.[164] In particular, they have studied the *fiqh al mu'amalat* or rules concerning transactions developed by the classical jurists and expanded upon by later generations of *Shari'a* scholars.[165] This background also presupposes facility in the classical Arabic language and the ability to deal directly with legal texts, glosses, and commentaries in that language.[166] Members also have a demonstrated understanding of modern finance, markets, and economics through professorships at respected universities or published academic works in this area.[167]

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159. *See* Burghardt & Fuß, *supra* note 21, at 4–5. A religious supervisory board is also known as the *Shari'ah* committee, *Shari'ah* board or *Shari'ah* supervisory board. *Id.* at 8.

160. *Id.*

161. Yusuf Talal DeLorenzo, *Shari'a Supervision in Modern Islamic Finance* 1, *available at* http://www.guidancefinancialgroup.com/pdf/Shari'ah_Supervision_in_Modern_Islamic_Finance.pdf (last visited Sept. 24, 2006).

162. *Id.*

163. *See* VOGEL & HAYES, *supra* note 4, at 48–49.

164. *See, e.g.*, Guidance Financial Group *Shari'a* Supervisory Board, *available at* http://www.guidancefinancialgroup.com/sharia/shariabios.asp#Usmani; HSBC Amanah Supervisory Board, *available at* http://www.hsbcamanah.com/hsbc/amanah_about/shariah-supervision.

165. *See* DeLorenzo, *supra* note 161.

166. *Id.*

167. *Id.*

The *Shari'a* boards also have progressed beyond providing *fatwas* and are now controlling and auditing lenders for Islamic propriety.[168] Board opinions have become compulsory for the bank, to the extent that if a board rejected a transaction, the transaction cannot be performed without changing the offensive portion.[169] Board members participate in all steps of drafting the loan documents to ensure that it complies with all moral requirements and "reflects in its preamble and body the basic elements of profit sharing, reciprocity between the parties in terms of rights and duties and an equitable manner for calculation of the rates of return and the distribution of profit."[170] Through these strict procedures, Islamic mortgages do not compromise religious legitimacy and can continue to capture the attention of more Muslim consumers.

The Islamic mortgage market has grown from a fragmented niche market to a comprehensive lending system. Mainstream lending institutions were crucial actors in developing this industry by providing capital and expertise. The resources built effective lending products based on common grounds between conventional mortgages and Islamic religious principles. More importantly, lenders built credibility for Islamic mortgages by joining the established legal system, educating bank regulators and cooperating with influential market actors. Through this transition, Islamic mortgages still maintained religious legitimacy by not compromising the authority of *Shari'a* to supervise new lending products.

PART III: APPLYING THE MICROCOSM TO ISLAMIC BANKING

While mortgages represent one part of the financial services industry, it can act as a microcosm for analyzing the industry as a whole. Banking covers a variety of markets ranging from deposits and investments to insurance. Like Islamic mortgages in the early stage of cooperatives, the Islamic financial system has been confined historically to basic retail commercial banking.[171] It lacks sophisticated credit products and is weak in the areas of asset management and investment banking.[172]

168. VOGEL & HAYES, *supra* note 4, at 49.
169. *Id.*
170. Chinoy, *supra* note 143, at 518.
171. *See* VOGEL & HAYES, *supra* note 4, at 292.
172. *See generally* M. Umer Chapra & Tariqullah Khan, *Regulation and*

Research has shown that Islamic banks have a tendency to concentrate on short-term financing with *murabaha* transactions accounting for nearly ninety percent of an Islamic bank's total business.[173] Like the mortgage market, however, the recent trend is moving towards greater consumer demand for more sophisticated *Shari'a*-compliant finance products. Economic growth in the Islamic world has promoted a growing middle class and made banking a necessary service to a larger segment of the population. The surge of Islamic self-identity that supported the mortgage market is flowing into the entire finance industry with the effect of increasing demand to adopt Islamic principles in finance.[174] Although it is difficult to gauge the exact size of the Islamic banking market, current estimates suggest it is between $270B to $500B and growing at a rate of fifteen to twenty percent a year.[175] These estimates came about after 2001, when capital invested by Muslims in the United States began to flow back to the Arab countries after the September 11th terrorist attacks and increased concerns that accounts would be frozen in the United States under accusations of funding terrorist activity.[176] The concentration of capital allowed economists to better measure the value of the Islamic banking industry and helped trigger faster development of Islamic banking.[177]

Like the mortgage market, the steady increase of capital in Muslim finance captured the attention of financial institutions worldwide. For example, Union Bank of Switzerland (UBS), a top wealth management institution, set up a "stand-alone Islamic private bank . . . in Dubai" in 2004 "to cater to its wealthiest Middle Eastern clients."[178] Moreover, 265 Islamic banks and other financial institutions are operating in over forty countries and with total assets that exceed $262B.[179] Financial institutions like ABNAmro, American Express, ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank and

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Supervision of Islamic Banks, 173–252 (Islamic Dev. Bank & Islamic Res. & Training Inst., Occasional Paper No. 3, 2000) [hereinafter *Chapra & Khan*].

173. *See* Burghardt & Fuß, *supra* note 21, at 37; *see also* Iqbal, *supra* note 126, at 2. This reflects the early stages of a financial system's operation because short-term financing is easier to administer, less risky, and has quicker returns. *See* Ariff, *supra* note 48.

174. *See* VOGEL & HAYES, *supra* note 4, at 4–5.

175. *See* Hawser, *supra* note 37; Shameen, *supra* note 102.

176. Burghardt & Fuß, *supra* note 21, at 39–40.

177. *Id.* at 40.

178. *See* Shameen, *supra* note 102.

179. *Id.*

Nomura Securities all now have in-house Islamic units.[180]

A. MAINSTREAM FINANCIAL INSTITUTIONS AND THE ISLAMIC BANKING INDUSTRY

The presence of mainstream financial institutions in the Islamic finance market is a positive sign because, like the mortgage market, they bring order and expertise. Designing sophisticated *Shari'a*-compliant financial instruments is one of the most important challenges currently confronting Islamic finance.[181] Islamic banking has always suffered from a shortage of trained personnel who can manage portfolios and develop innovative products according to Islamic financial principles.[182] Mainstream financial institutions are especially equipped to solve this problem because they have teams of professionals in all areas of the Islamic world.[183]

We can already see benefits to the Islamic banking industry from mainstream financial institution becoming involved in the area of project finance.[184] Conventional project finance puts emphasis on equity participation, which fits well with *Shari'a* principles. In the past few years, financial institutions have designed a form of Islamic bond called the *sukuk*. *Sukuk al-ijara* is one example where a company issues this bond to investors in order to finance a specific project.[185] These bonds are secured by the revenue stream in *ijara wa-iqtina'* structures.[186] Bondholders do not receive a pre-determined profit or interest on their investment. Instead, they own a share of the project's profit that is proportional to the amount of their investment.[187] For example, a *sukuk* can be backed by the revenues from tolls collected from operation of a bridge or

180. *See* Gohar Bilal, *Islamic Finance: Alternatives to the Western Model*, 23 SPG FLETCHER F. WORLD AFF. 145, 148 (1999).

181. *See* Chapra & Khan, *supra* note 172, at 80.

182. *See* Iqbal, *supra* note 126, at 6.

183. For example, HSBC Amanah advertises that it has the support of HSBC Group, one of the largest banking and financial services organizations in the world, which has an international network comprising of 10,000 offices in 76 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa. *See* HSBC Amanah, http://www.amanahfinance.hsbc.com/amanah/hsbcaf.nsf/Pages/GroupStrength.

184. *See* Zamir Iqbal, *supra* note 126, at 4.

185. *See* Reinhard Klarmann, *Construction and Lease Finance in Islamic Project Finance*, 19 J. INT'L. BANKING L. & REG. 61, 66 (2004).

186. *Id.*

187. *Id.*

tunnel, or the production of a power station.[188] The revenue is paid out to the bondholder, which represents a classical profit and loss sharing structure.[189] The Bahrain Monetary Agency has issued *sukuks* to finance several projects that have a total value of almost $1B.[190] Individual bond issues from these projects invested between $50M to $250M each.[191]

There are also products in development to extend Islamic banking to the field of securitization with asset-backed securities. Here, assets such as property are bundled into convertible bonds that morph into shares of *Shari'a*-compliant companies at a given strike price.[192] Large institutional players are also building the Islamic insurance industry through *takaful* contracts, which pools resources from depositors into mutual funds and makes the resources available in the event of casualty or loss.[193] These developments are healthy signs that the Islamic banking industry and institutional actors are working together to join western finance products and *Shari'a*. Continued cooperation to build sophisticated banking tools will further integrate Islamic banking into the global financial system.

B. ISLAMIC BANKING MEETING CHALLENGES

In addition to creating new products to meet investor and consumer demand, there is strong evidence that Islamic banking is meeting the same challenges that faced the Islamic mortgage system. The Islamic mortgage market had to establish credibility and religious legitimacy to grow. These two issues also plague Islamic finance. Until recently, Islamic finance was a relatively vague term for religious financial transactions and had little credibility worldwide.[194] No standards or "best practice" existed for such transactions, which severely inhibited its acceptance into the international financial community.[195] Religious legitimacy was also a roadblock because the sophistication of the financial products tested the financial knowledge of *Shari'a* scholars and their ability to

188. *Id.* at 67.
189. *Id.* at 66.
190. *Id.*
191. *Id.*
192. *See* Shameen, *supra* note 102.
193. *See* VOGEL & HAYES, *supra* note 4, at 151.
194. *See* Klarmann, *supra* note 185, at 61.
195. *Id.*

reconcile religion with finance. The banking industry, however, has taken effective steps to meet these challenges.

1. Establishing Credibility by Meeting the Needs of the Financial Market

Credibility is a significant challenge for Islamic banking because the industry's strength depends on its ability to meet international standards.[196] The Islamic banking industry has a relatively short history and is viewed by many with caution and distrust.[197] Like issues faced under Islamic mortgages, the *Shari'a*-compliant nature of Islamic financial institutions also makes disclosure standards set by the International Accounting Standards Board inapplicable or silent in many areas.[198] As a result, the conventional standards are only partially effective in ensuring appropriate disclosure and good banking practices.[199] This leads investors to view Islamic financial institutions as having higher credit risk, which increases the cost of investing capital in Islamic financial products and makes the products less competitive in today's global marketplace.[200]

Actors in the Islamic banking industry are currently developing a regulatory scheme that will supplement standards missing in the conventional system so that investors may receive relevant and reliable information. This approach seeks to establish more internal controls, risk management and external audit procedures.[201] The Accounting and Auditing

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196. *See, e.g.*, Rutledge Speech, *supra* note 94 (explaining that the international institutions that articulate capital adequacy and risk management standards for Islamic financial institutions are critical in helping regulators make informed judgments on Islamic financial institutions in their country and whether they meet the country's regulatory requirements).

197. Professor Rifaat Ahmed Abdel Karim, Secretary Gen. of the Islamic Fin. Services Board, American Finance House–LARIBA, Global Strategies for Islamic Banking and Finance, Speech at the 10th Annual Symposium on Riba-Free Finance & Banking (Mar. 22, 2003) (transcript available at http://www.lariba.com/symposium2003/abdelKareem/LARIBA%202003%20-%20Rifaat%20Abdel%20Karim%20Pr.htm) [hereinafter *Karim Speech*].

198. *Id.* (using International Accounting Standard No. 30 as an example of a disclosure standard that is ineffective for Islamic banks because much of the regulation for disclosures related to financial statements are not applicable to an Islamic bank).

199. *Id.*

200. *Id.*

201. *See* Chapra & Khan, *supra* note 172, at 56. Controlling bodies that establish international standards include the International Organization of Securities Commissions (IOSCO) and the Bank for International Settlements (BIS).

Organisation for Islamic Financial Institutions (AAOIFI) established in Bahrain in 1991 is a foundation for establishing credibility for Islamic financial institutions.[202] The AAOIFI is an Islamic international, autonomous non-profit body that prepares accounting, auditing, governance, ethics and *Shari'a* standards for Islamic financial institutions worldwide.[203] Islamic financial institutions are currently adopting these standards in increasing numbers.[204] Harmonizing bank accounting standards is pivotal because Islamic banks can now provide information that is comparable to conventional banks, which enables investors to assess the stewardship of the institution.[205]

2. *Protecting Religious Legitimacy*

Islamic banking also faces the difficulty of upholding the religious integrity of innovative banking products. In the mortgage context, lending tools were slight variations of historically accepted transactions. The minor changes that made lending tools *Shari'a*-compliant did not test the limits of a religious scholar's banking knowledge. Islamic banking, however, demands religious scholars with highly technical understandings of the complexities and risks presented in the financial market. Few qualified scholars can take on this task when Islamic banking is still at an early stage of its development.

The Islamic banking industry is confronting this problem by forming a centralized council that defines uniform, cohesive rules for introducing new products into the market.[206] In November 2002, international banking and government authorities including the IMF, AAOIFI, Bahrain Monetary Agency and the Islamic Development Bank founded the Islamic Financial Services Boards (IFSB) to create a centralized *Shari'a* board.[207] Members of the IFSB include major banks and government entities from most of the world's Muslim countries,

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Id.

202. *See* Burghardt & Fuß, *supra* note 21, at 34.

203. *See* AAOIFI Organization Overview, http://www.aaoifi.com.

204. *See generally* Ahmad Mohamed Ali, *The Emerging Islamic Financial Architecture: the Way Ahead*, ISLAMIC FIN. PROJECT12 (Harvard Law School, Cambridge, M.A.), Apr. 6, 2002.

205. *See* Karim Speech, *supra* note 197.

206. *See* Iqbal, *supra* note 126, at 5.

207. Burghardt & Fuß, *supra* note 21, at 34.

as well as the IMF and World Bank.[208] By concentrating global *Shari'a* and banking knowledge in one supervisory entity, the IFSB created the capacity to effectively evaluate new banking products being introduced worldwide.[209] While the IFSB may not interfere with the independent status of *Shari'a* boards existing for particular financial institutions, it offers a benchmark for globally accepted prudential standards that are *Shari'a*-compliant.[210] Banks without their own *Shari'a* board can adopt and operate according to IFSB approved products and standards. The global standard decreases the fragmentation in approving new products and ameliorates the effects of a shortage of knowledgeable professionals in this banking industry.

Though the AAOIFI and IFSB are young institutions, they lay a strong foundation for future growth. The increased market demand for sophisticated Islamic banking products is a catalyst for bringing Islamic banking into the mainstream, but the system must still establish creditability and religious legitimacy to survive in the long run. The AAOIFI and IFSB are squared to meet these challenges by centralizing expertise and defining rules that make investments in the Islamic financial industry more transparent and less risky.

CONCLUSION

Islamic banking has much to contribute to the Western world. It is a financial system that concerns itself not only with profit, but also with the largely ignored benefits of social justice. It acts as a counterweight and possible agent of constructive reform to a system that may have become excessively reliant on debt and interest. It also places a positive emphasis on partnership and profit-sharing investment and offers additional resources of entrepreneurial capital.

Even though Islamic banking has stalled in the rudimentary stage of development, recent revivals of the Islamic faith combined with a growing population of educated Muslim consumers will ensure sustainable demand for banking in accordance with *Shari'a*. Islamic banking must establish credibility and religious legitimacy to be accepted in the global

208. *See* Islamic Financial Services Boards, http://www.ifsb.org/index.php?ch=3&pg=8&ac=11.

209. *Id.*

210. *See* Burghardt & Fuß, *supra* note 21, at 35.

financial market, but these tasks are by no means impossible. As we can see from the mortgage market, Islamic mortgages grew rapidly under a cooperative effort among mainstream financial institutions, banking regulators and influential market actors. The Islamic banking industry is taking these same steps by effectively pooling resources from mainstream international lenders, centralizing expertise and standardizing religious banking principles. Viewing the rapidly growing mortgage market as a microcosm of Islamic banking, we can safely anticipate that the Islamic financial industry will meet the same level of success as the mortgage industry. Despite the fundamental differences between *Shari'a*-compliant finance and interest-based finance, Islamic finance can look forward to rapid growth in the global financial system.