ISLAMIC FINANCE IN THE UNITED STATES: PRODUCT DEVELOPMENT AND REGULATORY ADOPTION

A Thesis
submitted to the Faculty of the
Graduate School of Arts and Sciences
of Georgetown University
in partial fulfillment of the requirements for the
degree of
Master of Arts
in Arab Studies

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Washington, DC
April 21, 2009

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INTRODUCTION

Over the past decade the Islamic finance sector internationally has grown steadily and rapidly, drawing attention from multinational banks and moving into European markets. Although Islamic finance accounts for just one percent of the global finance market, with a yearly value estimated at about $500 billion, over the past ten years the industry has grown at a pace of ten to fifteen percent per year.[1] Islamic banking has been much slower to develop in the United States, due in large part to rigid regulatory standards and lack of legislative accommodations made specifically for the industry. Still, a number of banks and finance companies have dedicated themselves to the legal struggle of developing products and contracts that will comply both with religious law and with US regulations designed with interest-based banking in mind.

This paper examines how Islamic finance has developed in this country, and how the financial regulatory system has treated the new products being offered by Islamic finance providers. The main focus is on how financial organizations offering Islamic finance products (be they banks, finance companies, or non-profit organizations) developed the products they offer so as to adhere to religious law while still complying with existing financial regulation. What is revealed is a willingness on the part of government officials and regulators to accommodate certain Islamic finance forms in order to serve what is perceived to be an "under-banked" population, namely those Muslims who consider conventional borrowing to be religiously prohibited. However, as

[1] Power, "Faith in the Market."

of yet, Islamic contract forms have been adapted to current regulation rather than regulation changing in any way to accommodate Islamic finance. As the industry continues to grow there will arise issues that cannot to be addressed in a manner acceptable under both Islamic and current US law. In these cases, further negotiation between finance providers and regulators will be necessary in order to find a place for Islamic banking under the law, or perhaps providers will have to seek legislative changes that would grant regulatory accommodations appropriate for Islamic finance products.

It is outside the scope of this paper to detail all of the Islamic contract forms the industry has developed in its operations across the globe, nor to record the regulatory regimes governing Islamic finance in the Gulf, southeast Asia, or Europe. This paper specifically looks at the range of Islamic products offered for home finance in the United States, as well as profit sharing deposit accounts offered to retail banking customers. Where providers offer financing products for small business this will also be mentioned, as it is interesting the varying types of contract forms that can be employed for different types of investments. The research considers the legal classification (i.e. bank or finance company) of the entities offering Islamic finance products and the type of products they provide. Interviews were conducted with officials from provider organizations as well as from regulatory agencies and government-backed investors. What emerges is a picture of how providers have worked with regulators and investors to structure Islamic offerings so that they adhere to current US regulation. From this, projections are made about how the Islamic banking sector in the United States might expand, and what future negotiations will have to occur between finance providers and regulators in order to accommodate an expanded Islamic finance product set.

CHAPTER 1: THEORY OF ISLAMIC FINANCE AND ITS APPLICATIONS TO THE UNITED STATES

1.1 Dealing in credit and risk

The difference between Islamic and conventional finance is much more nuanced than the definition often presented in terse media accounts that "Islam forbids interest." Islamic scholars, both today and throughout Islam's theological tradition, have looked to the Qur'an and Prophetic tradition in order to ascertain the divinely prescribed ordering of trade and economic relations within a society. Fuad Al-Omar and Mohammed Abdel-Haq point out how Islamic finance is larger than its prohibition against interest:

> "Islamic banking has been defined as banking in consonance with the ethos and value system of Islam; interest-free banking, by contrast, is a narrower concept, denoting a number of banking instruments or operations that avoid interest. Islamic banking, the more general term, is expected not only to avoid transactions on the basis of interest but also to participate actively in achieving the goals and objectives of an Islamic economy."[2]

Regardless of their stance on the current practice of Islamic finance, both Islamic jurists and economists agree that part of the field's calling should be the establishment of a more just economic order – one that both provides greater security to individuals and also allows more productive use of society's capital.

The cornerstones of Islamic finance theory are the prohibitions on *riba* ("dealing in credit") and *gharar* ("dealing in risk").[3] The Qur'an specifically cites *riba* as being

[2] Al-Omar and Abdel-Haq, *Islamic Banking*, 21.
[3] El-Gamal, "Prohibition of Gharar," and El-Gamal, "Prohibition of Riba"

forbidden for Muslims in their economic transactions,[4] although there is debate whether *riba* in the Qur'anic context is equivalent to interest in modern finance. The prohibition against *gharar* means that one should not try to guarantee a certain outcome.[5] According to Al-Omar and Abdul-Haq: "The rationale of the principle that there should be no profit-sharing without risk-sharing (*al-ghunum bi-'lghurm*) is that the justification for earning profit is having engaged in an economic venture and thus contributed to the economy."[6]

Two oft-quoted hadith used in understanding *riba* show that the concept might not be restricted to a simple analogue of interest or usury. One is the story of Bilal:

> "Bilal visited the Messenger of God (pbuh) with some high quality dates, and the Prophet (pbuh) inquired about their source. Bilal explained that he traded two volumes of lower quality dates for one volume of higher quality. The Messenger of God (pbuh) said: "this is precisely the forbidden *riba*! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other."

The second hadith deals with types of exchange as well:

> "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand to hand, in equal amounts; and any increase is *riba*."[7]

From these two hadith comes the idea that there should not in Islamic finance be an exchange of unequal quantities of the same thing (e.g. money for money) and that money should not be used to make more money without investment in a real asset.

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[4] See verses cited in Maurer, *Pious Property*, 25.
[5] See Iqbal and Molyneux, *Thirty Years of Islamic Banking*, 14.
[6] Al-Omar and Abdel-Haq, *Islamic Banking*, 23.
[7] Both hadith quoted in El-Gamal, "An attempt to understand," 115.

1.2 Is "Islamic banking" really Islamic?

The existence of a global Islamic finance industry, as well as its investors and consumers, indicate many Muslims believe that an alternative form of financing from conventional banking is preferable – and, in the perception of many, required – under Islamic law. A number of jurists, however, had in the past issued fatwas that conventional finance in the United States is permissible on the grounds of legal necessity. One fatwa from prominent Sunni jurist, Yusuf Al-Qaradawi allowed Muslims in North America to finance their home purchases with conventional mortgage in cases of unavailability of Islamic alternatives. Next the question arises when Islamic financing products are robust enough to offer a real alternative. In 2001 jurist Yusuf Talal DeLorenzo issued a fatwa that if terms of an Islamic mortgage were unattainable for a potential homeowner, or the Islamic finance providers were so small that dealing with them would be riskier than dealing with a conventional lender, it is permissible for the Muslim consumer to utilize conventional finance for a home purchase.[8] In 2006, however, the Fiqh Council of North American issued a fatwa saying that "with the advent of Islamic Home Financing companies accessible to most, Muslims must always prefer Islamic Home Financing (with authentic fatwas from reliable scholars), when available, to that of conventional mortgage financing."[9]

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[8] DeLorenzo, "Mortgage for a Home." In the question prompting the fatwa, the available Islamic mortgage alternative required a twenty percent down payment. The prospective homeowner could not afford this, but could afford a smaller down payment for a conventional mortgage.

[9] Siddiqi.

There is a body of theoretical literature, spanning from the 1970s to today, arguing for the necessity of Islamic finance and how it can be structured so as to provide Muslims viable alternatives to conventional, interest-based finance. Conversely there exist criticisms of Islamic finance from scholars who question both its religious justification, in its currently practiced form, and its economic viability. These critics are often idealists who consider an "Islamic economy" one that should be based on maximizing economic productivity to the benefit of society, and consider Islamic finance as it is practiced to fall far short of this calling.

In a speech to a conference sponsored by American Finance House-LARIBA, Pakistani economist Khurshid Ahmed outlined how the Islamic finance industry is far from its idealized form:

> "Now, instead of money being used for production of physical assets, we have created a monetary world where we are creating claims on claims on claims of assets; the financial world has no physical reality. It benefits the rich. In the last few years, how many billionaires have been created? The concentration of wealth and power is taking place. In the twenty-first century, we will have to re-discover the role of money for the creation of physical assets – even Mr. Soros sees this now. Prosperity must go together with equity, toward a redistribution of wealth and income, and a rediscovery of the productive process. Islamic banking can make a singular contribution to this twenty-first century." [10]

In this Ahmed is citing the chasm between the ideal of a religiously organized economy and the current form of Islamic finance, which many claim cleaves close to the forms and substance of the conventional banking system.

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[10] Kurshid, Speech.

Prominent U.S. scholar on Islamic economics, Mahmoud El-Gamal, has been a forceful voice in the field arguing against Islamic finance in its current form. El-Gamal argues that Islamic finance industry practices amount to "Shari'a-Arbitrage."[11] He points out that there is scholarly debate over what exactly constitutes *riba* and *gharar*. Rather than engage this debate theologically and consider its implications for modern times (a process called *ijtihad*), Islamic finance professionals have chosen a juridical approach that insists on developing present-day contracts only by analogy to contracts from medieval times. El-Gamal argues that this process only serves as a re-engineering and misplaced blessing of conventional finance (making it less efficient in the transformation due to increased transaction costs and fees to lawyers and religious jurists), and that it misrepresents the original intent of religious dictates about trade and finance.

In 2005 El-Gamal took his argument against *riba* to the web, where he issued a public challenge on his blog asking: "Is my conventional mortgage *riba*?"[12] In his blog post El-Gamal broke down the structure of signing a conventional mortgage, at a title company, and asserted:

> "While the debt is documented as a 'loan', there was never a money-for-money transaction between me and the mortgagee. In fact, I never received any money from the mortgagee. The only thing I received was the home title (and the right to live in the home), and I paid a certain amount of money to the title company at closing, and then make periodic payments to the mortgagee. So, as far as I am concerned, my transaction has always been one of house-for-money."

[11] El-Gamal, "Mutuality," 2005.
[12] El-Gamal, "Is my conventional mortgage riba?"

Professor El-Gamal has promoted "mutuality" as being the basis for what he would consider truly Islamic finance, rather than "Sharia-arbitrage" that seeks to reconcile medieval Islamic contract forms with current conventional real estate contracts; he argues this is Islamic finance in letter but not in spirit.

El-Gamal points out that the contract forms today's Islamic finance has engineered are the "functional equivalents" of conventional financial forms, except for being less efficient because they add layers of extra transactions. Timur Kuran also criticizes Islamic banking for propagating inefficient economic thinking as it seeks to cordon Muslims off from integration in the global financial system.[13]

Despite the debates about whether Islamic financing truly reflects the economic order required by Sharia religious law, the industry has experienced explosive growth worldwide particularly in the past ten years. Also in the United States the Islamic finance industry, concentrating mainly on home financing, has grown at a modest but steady pace over the past years as providers have refined their product, expanded their market geographically, sought sources of investment, and developed their customer base.

[13] Kuran, *Islam and Mammon*.

CHAPTER 2: HISTORY OF ISLAMIC FINANCE AND ITS PRODUCTS IN THE US

2.1 Key points in the development of Islamic finance in the United States

The history of Islamic finance in the United States began with the grassroots efforts of American Finance House-LARIBA, which in 1987 began offering Sharia-compliant home financing products. LARIBA is a finance lender in Pasadena, California that began using investment capital from individual American Muslims to provide home financing to other American Muslims.[14]

As early as 1993 a major international bank worked with both a US mortgage bank and a key Islamic bank to structure an Islamic home finance program.[15] In 1997 the United Bank of Kuwait (UBK), operating in the United States as a Federal branch under the National Bank Act, applied to the Office of the Comptroller of the Currency (OCC) for guidance on a Sharia-compliant *ijara* (lease-to-purchase) home financing product it sought to offer to US customers. This program was named Al-Manzil. Abdulkader Steven Thomas, who made the request on UBK's behalf, said of its importance: "The pioneering regulatory interpretations obtained by the United Bank of Kuwait have begun to open both the door to scalable funding for Islamic finance in America, the development of securitization, including participation by the government sponsored entities."[16] In 1999 the OCC issued guidance to UBK that approved *murabaha* (cost-plus-profit) home-financing products. Al-Manzil began offering its home financing products in California.

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[14] American Finance House – LARIBA, "Knowledge Center."
[15] Thomas, "Methods of Islamic Home Finance in the United States," 1.
[16] Ibid.

Thomas explained that the program took a longer time than most to become established because there was a lot of "customer training" required to educate customers about the features of the Islamic product, since it was newly developed and unfamiliar to consumers. However after this initial period UBK expanded the Al-Manzil program to eleven states, and financed small ticket commercial properties as well as single-family homes. However in 1999 UBK merged with Ahli United Bank and, because the U.S. operation was the bank's smallest, Ahli made a strategic decision to leave the U.S. market in 2000. At that point Al-Manzil had provided financing for sixty homes.[17] The Al-Manzil program was also in place in the United Kingdom and its operation continues to today under the successor bank.[18]

Since UBK left the market, no bank offering Islamic products has operated under the National Bank Charter or the supervision of the OCC. For this reason the Office has issued no further guidance on Islamic products. However the state regulators that supervise the state-chartered bank providers – Devon Bank and University Islamic Financial Corporation – have followed the guidance of the OCC's interpretive letters on *ijara* and *murabaha* products in granting approval for these financing facilities, since state-chartered banks must comply with national regulations in addition to any further regulations mandated under state law.

On the financing side, one of the most important developments for Islamic finance was Freddie Mac's 2001 decision to buy Islamic mortgages from LARIBA via its cash

[17] Maurer, *Pious Property*, 34.
[18] Thomas, interview.

window.[19] This represented the first type of securitization for Islamic mortgages, and provided a large-scale source of funding for providers. At this time Freddie Mac and Fannie Mae, which began purchasing *ijara* products in 2003[20], are effectively the sole investors in Islamic mortgage products in the United States. As government-backed entities, both invest in Islamic mortgages as part of their mandate to expand access to home ownership to underserved populations. Currently all of the providers of Islamic home financing sell their mortgage contracts to either Freddie Mac or Fannie Mae. These sales also represent the only form of securitization presently available for Islamic mortgages in the U.S. market.

2.2 Types of Islamic financing products offered in the United States

Currently there are three types of Sharia-compliant financing facilities offered by U.S. providers: *ijara*, *murabaha*, and *musharaka*. One company also offers a deposit product on a *mudaraba* model. The specifics of the contracts establishing the products differ among providers, and the provider's legal engineering to make the contract compliant both with Sharia and with U.S. real estate laws are closely kept proprietary secrets. Likewise, many of the providers have developed their own English terminology to refer to their products. For ease of definition, particularly in relating these products to Islamic finance forms found outside of the United States, this paper will refer to the

[19] German, interview.
[20] Miranda, interview.

products principally using their Arabic names. However the terminology used by each provider will be noted in chapter four's discussion of each company.

2.2.1 Ijara: lease-to-purchase

The *ijara* contract, alternately called a lease-to-purchase or net-lease, was the first Sharia-compliant financing form offered in the United States. An *ijara* contract is structured so that the mortgagee purchases the home on behalf of the mortgagor and, in most cases, holds the title in trust over the term of financing. The mortgagor's monthly payment to the provider is divided into two sections: a payment on principal and a "rent" payment which affords the mortgagor exclusive rights to live in the property. The rent portion of the payment can be indexed to a market interest rate (as it is in the case of bank providers) or to the local rental market (as finance company LARIBA does).

The *ijara* form was formally approved by the OCC in December 1997. Subsequent to a request from the United Bank of Kuwait, the OCC issued interpretive letter #806 in which it judged the bank's *ijara* (or "net lease") home financing products to be functionally equivalent to secured real estate lending, and thus permissible for UBK to offer under the National Bank Act. In this letter the OCC points to judicial precedent in establishing three principles to determine the permissibility of new types of banking activities:

1) Is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity?

2) Would the activity respond to customer needs or otherwise benefit the bank or its customers?
3) Does the activity involve risks similar in nature to those already assumed by banks?[21]

The Supreme Court in fact had found in 1978 that "in appropriate circumstances, a lease transaction may constitute a loan of money secured by the property leased."[22] The OCC found that UBK's net lease product satisfied accounting requirements such that it functionally constituted financing rather than leasing. In making this evaluation the Court is looking to the "economic substance" of transactions rather than their form.[23]

A conventional lease agreement would be outside of the purview of a bank, as it would entail the holding of real estate property. In order to structure their net-lease as financing UBK set a number of provisions on the leasing activity:

- UBK did not purchase or maintain an inventory of properties. The property purchase was initiated by the Lessee, who contracted with the Seller to buy a single family residence. UBK did not serve as real estate broker or agent.
- UBK maintained "legal title" to the property, but recorded its interest in the property in the same manner as it would a traditional mortgage.
- UBK conveyed the Lessee occupancy rights in and to the property for a specified number of years. The Lessee had all responsibilities for maintenance and care of the property as would a conventional homeowner.

One very interesting point outlined in the OCC interpretive letter is the manner in which the bank would arrive at an appropriate amount for the "lease" payment. Although the Islamic residential financial products would be kept in a different ledger than the

[21] Cited in Office of the Comptroller of the Currency, "Interpretive Letter #806," 4.
[22] Ibid.
[23] Ibid, 5.

conventional residential mortgage loans, the accounting methodology applied to both was identical and indexed to interest rates:

> "Although the two products will have different documentation, the monthly lease payments will be calculated in the same manner. UBK will add its margin to its cost of funds at the beginning of the lease. The London Interbank Offering [sic] Rate will be used to determine UBK's cost of funds. UBK will then allocate lease payments to mirror the principal and interest breakdown of a conventional mortgage."

It is significant that the product OCC approved is one indexed to interest rates and, by UBK's own definition, structured as an equivalent to a conventional mortgage.

2.2.2 Murabaha: cost-plus-sale

The *murabaha* contract is structured such that the provider purchases a home on behalf of the customer under an agreement that the customer will buy the home back from the provider at a price that includes a pre-arranged profit premium over the original cost of the home. The customer then pays this marked-up price on an installment basis over the term of the financing.

Regulation of *murabaha* products was addressed by the OCC in 1999. This type of facility was approved not only for the purchase of residential property, but also as financing for real estate construction, commercial inventory, and acquisition of commercial equipment. The OCC found that *murabaha* financing is the economic equivalent to either a real estate mortgage transaction or an inventory or equipment loan agreement. "Under the *murabaha* financing facility, [the Branch] will essentially be functioning in a 'riskless-principal'/ quasi-agency capacity."[24]

As with *ijara*, under the *murabaha* facility the customer identifies the property to be acquired, negotiates a purchase price with the seller, and applies to the bank for financing. Again the *murabaha* profit "is typically based on a recognized index such as the London Interbank Offered Rate."[25] In this particular letter, the bank specified a down payment of not less than twenty-five percent, but since that time banks have been able to offer *murabaha* financing with as little as five percent down payment.

2.2.3 *Musharaka*: partnership

The *musharaka* financing form is not approved for use by banks, but is used by the two financial services company providers – Guidance Residential and LARIBA. Guidance uses the contract for home finance, while LARIBA uses it only for business finance.

Musharaka translates literally as partnership and indicates that the finance provider and customer each take a joint stake in the ownership of a business or asset. In the case of Guidance's home financing facility, called "declining balance co-ownership", the company and customer form a corporate partnership that owns the property. The customer's initial down payment determines his share of ownership of the partnership. Over the term of the financing, the customer buys out the company's share in the

[24] Office of the Comptroller of the Currency, "Interpretive Letter 867," 1.
[25] Ibid, 3.

partnership until it is the sole owner of the partnership, and thereby the home. During the term of the financing the customer pays the company a "utility fee" for exclusive use of the home.

In a business venture a *musharaka* financing facility is similar to the concept of joint venture, in which both investor and business operator contribute capital and own a proportionate share of the business. Each of the parties is entitled to a portion of the profits according to its share of ownership. Also in LARIBA's *musharaka* business financing facility, the customer has the option to buy out the company's ownership share over time.

2.2.4 Mudaraba: profit- and loss- sharing

In theory, the *mudaraba* profit- and loss- sharing contract form could be used as a financing facility. This model bears some semblance to a venture capitalism model. In this case the financier provides capital to a business entrepreneur for a product that the financier believes will be profitable. If there are profits, then the financier and the entrepreneur divide them based upon a pre-arranged agreement. However if there are losses, they are borne solely by the financier as the entrepreneur has lost all of the efforts of his labor.[26] This type of Islamic venture capital arrangement is not offered by any of the providers surveyed.

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[26] Al-Omar and Abdel-Haq, *Islamic Banking*, 12-13.

One bank, however, does offer a deposit product based on the *mudaraba* model. In this case the depositors are the financiers, and the bank invests the capital in its Sharia-compliant investments. In order for the product to qualify as a deposit under banking regulations and to carry FDIC protection, the principal deposited by the customer cannot be at risk; so the product shares in bank profits but not in losses.[27] The bank publishes a "profit sharing return" based on the performance of its Islamic home financing portfolio.

The FDIC has approved this product for protection, because it is again a "functional equivalent" to deposits already allowed under their regulation. John Stevens, FDIC chief counsel for the Chicago regional office, explained that banks are allowed to set their rate of return on deposits wherever the bank chooses;[28] if it sets that rate of return based on profits from a certain portfolio, that is the prerogative of the bank.

Being able to offer Sharia-compliant deposit accounts is seen by many regulators and providers as being a required hurdle before the industry in the United States can expand. Three main questions remain about the *mudaraba* deposit product, which will be explored in the final chapter of this work. These questions regard the Sharia-compliance of the product in its current form, use of conventional insurance forms in coverage from the FDIC, and possible securities law implications of the profit-sharing structure.

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[27] University Islamic Financial Corporation, "Deposit Products."
[28] Stevens, interview.

CHAPTER 3: THE REGULATORY CHALLENGE OF ISLAMIC FINANCE

Banking regulation in the U.S. works largely on a market-driven model. This means that it is generally not within the purview of regulators to promote certain types of financial products, but rather they respond to applications and inquiries from banking concerns wishing to offer new products. Regulators at the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, and state regulatory bodies have developed decisions on Islamic banking products on a case-by-case basis as they have been approached by banks or companies seeking to offer Islamic products.

While it is not within the writ of regulators to promote any certain type of financial organizations, it is clear that most of the major regulators have taken proactive steps to educate their employees about Islamic finance to be better prepared to supervise Islamic products as they are offered. This chapter will explore some of the regulatory challenges posed by Islamic finance, and then detail how regulatory agencies have responded to these challenges.

3.1 Regulatory challenges facing Islamic finance in the US

In the late 1990s and early 2000s as Islamic finance was gaining a foothold in the United States, regulators and policy makers identified some fundamental questions raised by Islamic finance in the U.S. context. These were identified by Michael Silva of the New York Federal Reserve as:

1) Bank ownership of real estate;
2) Likelihood of maintaining good programs for anti-money laundering (AML) and Bank Secrecy Act (BSA) compliance; and,
3) Whether deposits can be approved and insured.

Silva reviews these issues and considers the first two items resolved; the OCC has opined that Islamic financing does not violate restrictions on commercial banks owning real property because the transactions are the functional equivalents of secured real estate lending. Also, while some policy makers in the wake of 9/11 questioned whether Islamic financing would be more susceptible to money-laundering abuses, Silva firmly rejects that Islamic finance is more vulnerable than other types of financing and affirms that Islamic banking had no connection to financing terrorist attacks.[29]

3.1.1 Deposit products – approval and insurance

The issue of deposits remains a challenge. As mentioned above, there is one bank that offers a *mudaraba* profit-sharing deposit. Another bank provider questioned the Sharia-validity of this product, citing the "lukewarm" fatwa supporting it. The fatwa says that "such methods as limited by federal law were permissible. We hereby reaffirm our *fatwa*… with the understanding that… the Company and its licensees are working for the implementation of the optimal form of *mudaraba* deposit."[30] Part of the Sharia-compliance problem, as mentioned above, is that while a true *mudaraba* product would share the risk burden between depositor and bank by having the depositor share in both

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[29] Silva, "Islamic Banking Remarks," 204-207.
[30] Yaqubi, DeLorenzo and Shleibak, " SHAPE Profit Sharing Deposit – Profit Sharing Insured Deposit."

profit and loss, the U.S. regulatory structure would not permit any deposit whose principal would be at risk. This means that the depositors only share in profits, and banks are left to "smooth" any losses from their deposit equalization reserves.

This presents another challenge facing Islamic deposits: while the products are insured as bank deposits, they are in some respects functioning as "securities" since they are advertised as paying depositors a portion of profit on a certain portfolio. Whether *mudaraba* products should be classified as investment or deposit products is a question currently under debate by U.S. providers. While classification as investment products would alleviate problems with FDIC insurance, it would also 1) provide less security for the depositor, and 2) require banks to record these funds off-balance sheet,[31] canceling them from the bank's available resources for lending.

Currently the bank that offers this *mudaraba* product publishes its "profit rate" for a given period and the FDIC accepts this method because the FDIC does not regulate what or how a bank pays on a given deposit. However, such a product might be subject to securities laws to regulate that the amount paid to consumers is, as advertised, an accurate reflection of the profit earned on the specified investment portfolio. It will be a challenge to design a *mudaraba* product that provides customers both the principal protection they would receive on a bank deposit product and insures them an accurate investment return on the portfolio in which their deposit is invested.

[31] Shayesteh, "Bullish on US Islamic banking," 3.

3.1.2 Risk profiles

Islamic financing vehicles create somewhat different risk profiles than their conventional analogues. Fiennes outlines how Islamic banks have a different market and operational risk profile than conventional banks. He also highlights that the nature of Islamic finance also offers some inherent mitigating factors to risk, for example because many products are asset based and because in "partnership" models the bank is likely to better know its customer.[32]

The relative infancy of the industry in the US and its small size can similarly be both advantage and disadvantage. To the industry's advantage is that the cumbersome process of going through a lengthy legal argument in order to gain approval of new products means that the industry is slower to innovate; in most cases this would be considered a major disadvantage. However, in the context of the current debt-market turmoil, this means that Islamic banks did not invest in debt-based instruments that subsequently collapsed. But, Standard & Poor's analyst Emmanuel Volland points out: "Islamic banks were not caught by toxic assets as Sharia law prohibits interest. At the same time, you can create and invest in very risky toxic assets and be Sharia compliant."[33] The relative immaturity of the industry means that it was not exposed to some of the riskier assets in the current market, but it does not mean that risky assets do not or could not exist in Islamic finance, particularly as it is currently practiced abroad.

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[32] Fiennes, "Supervisory Implications of Islamic Banking," 248-250.
[33] Quoted in Khalaf, "Islamic finance must resolve inner tensions."

3.1.3 Infrastructure limitations

The immaturity of the industry is also a disadvantage to providers in the United States. In his discussion about the complexities of regulating Islamic finance, Hari Bhambra points out "such institutions may have limited risk management capabilities."[34] Rigorous U.S. regulations regarding consumer banking and real estate origination have meant that this country's Islamic finance providers, who deal almost exclusively with secured real estate lending, have not taken positions with high risk. However the small size of the industry means also that it does not have a developed infrastructure to help in mitigating risk.[35] The sources of liquidity for the industry are very limited, and the only source for securitization is government-backed investors Freddie Mac and Fannie Mae. Likewise the growth of the industry in the United States is limited not only by legal hurdles to prove equivalence to current U.S. regulations, but also Sharia- hurdles inherent in blending conventional and Islamic financing models. Fiennes discusses the operation of Islamic windows in conventional banks and how, for Sharia-compliance purposes, these operations should be kept separate. But in the U.S. much of the infrastructure that brings stability to the banking system works on an interest basis; whether it would be Sharia-compliant for an Islamic bank to borrow from the Federal Reserve's discount window (which is, of course, interest-based)[36] or to benefit from conventionally

[34] Bhambra, "Supervisory Implications of Islamic Finance," 199.
[35] Fiennes, "Supervisory Implications of Islamic Banking," 254-255.
[36] Bell, interview.

structured FDIC deposit insurance[37] is questionable. It would be possible for Sharia-compliant banks to create inter-bank arrangements among themselves to provide that liquidity, but of course this would also require enough Shariah-compliant institutions in the market in order to create an effective network. Here the small size and relative immaturity of the sector presents limitations to growth and, potentially, to bank security.

3.1.4 Insurance

As mentioned before, some Islamic jurists consider conventional insurance forbidden under Sharia. This is based upon the prohibition on *gharar*, or trading in risk, and the judgment that risk should be shared between counter parties. Therefore insurance that guarantees a pre-arranged outcome is not religiously accepted. Conventional insurance is also problematic for Muslims because insurance companies invest policy holders' premiums in a number of ways that run afoul of Islamic law, for example investments in interest-bearing assets, in speculative positions, or in businesses that are themselves not Shariah-compliant (e.g. dealing in alcohol, gambling, pork, etc.).

However there are two salient areas where U.S. regulation effectively requires purchase of insurance. First is the case of real estate lending. In order for Freddie Mac or Fannie Mae to securitize mortgages either a minimum twenty percent down payment must be made, or mortgage insurance is required. When providers began offering Islamic products, they initially required a twenty percent down payment in order to avoid the

[37] Stevens, interview.

question of mortgage insurance, but such a high down payment was unaffordable for many potential clients. For Guidance's *musharaka* product and University Islamic Financial Corporation's *murabaha* a minimum down payment of five percent is accepted. Guidance claims to have developed an "Islamic alternative" to conventional deposit insurance.[38]

Insurance is also implicit in deposit-taking for U.S. banks, in that deposits are insured by the FDIC. The FDIC system is a conventional insurance system, and although it could be possible in the future to offer an alternative Islamic deposit insurance, this does not exist at this time.[39] In approving SHAPE's *mudaraba* deposit product, currently offered by the FDIC insured University Bank, it seems the Sharia board has invoked the law of necessity in saying the product is "permissible" although limited by current federal laws.[40]

3.1.5 Securitization & Investment

Another way in which the limited size of the Islamic finance market in the United States in itself provides a challenge for regulators is that it limits the mechanisms available to Islamic banking concerns to securitize their assets. Currently Freddie Mac and Fannie Mae are the only institutions that securitize Islamic mortgages and are, effectively, the only investors in Islamic mortgages in the United States. While LARIBA

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[38] Gainor, interview.
[39] Stevens, interview.
[40] Yaqubi, DeLorenzo, and Shleibak, "SHAPE Profit Sharing Deposit."

does employ some private investor capital and University Bank can draw from its Islamic deposit program, the size of the industry generally remains limited to the investment that Freddie and Fannie are willing to make in Islamic mortgage products. Potential further sources of capital and investment will be explored in chapter five in considering the U.S. industry's future trajectory.

3.1.6 Sharia regulation

Islamic finance organizations are almost universally structured with a Sharia-compliance board that evaluates new products and approves them as being Sharia-compliant before they are offered to the public. This structure of independent Sharia-boards at each financial institution is used in the Gulf Cooperation Council countries, as well as in Europe and the United States. It surely cannot be within the remit of government regulators, particularly those working within the parameters of the disestablishment clause, to take up the regulation of religious law. As Fiennes points out, this "may give rise to conflicts of interest between religious objectives and financial objectives."[41] However, for Islamic financial institutions there is a Sharia non-compliance risk that amounts to a business risk. Bhambra says, "If customers became aware that the products they have in their portfolio were not *Shariah* compliant, this would seriously undermine customer confidence in the Islamic firm concerned or, on a

[41] Fiennes, "Supervisory Implications of Islamic Banking," 248.

larger scale, in the Islamic financial services industry as a whole."[42] To protect Muslim customers as well as reduce risk to the provider, it would be reasonable for regulators to set some standard for Shariah-compliance review. This could follow the internal and external Shariah compliance requirements as set forward by the international professional oversight organization, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).[43] This type of oversight would not put government regulators in the position of deciding upon issues of Islamic religious law, but rather have a standard for what type of religious certification is required for a product to be considered *halal* under Islamic law. This would be analogous to how kosher food certification is regulated under Truth in Advertising regulations.[44] At this point it is wholly up to the Muslim consumer to determine that the fatwas issued about a particular company's products are authoritative and legitimate, based on their perception of the authoritativeness of the jurist issuing the opinion.[45] While currently government regulators are only concerned that Islamic home finance products comply with standard real estate laws, as the Islamic finance industry in the U.S. expands it may be necessary for regulators to institute standards for Shariah-compliance review (e.g. adhering to the guidance of an institution's independent Shariah-compliance board) to assure consumers that Islamic products have

[42] Bhambra, "Supervisory Implications," 204-205.
[43] Ibid, 205.
[44] Masoudi, "Kosher Food Regulation."
[45] For discussion on how Muslim customers evaluate Sharia certification on U.S. Islamic mortgage products see Maurer, *Pious Property,* 78-84.

been certified Shariah-compliant, and also to protect against business risk to Islamic finance providers that would result from their products being found illegitimate.

3.2 Regulatory bodies involved with Islamic finance in the United States

No U.S. laws specifically accommodate Islamic finance, so the challenge for Islamic finance providers has been to demonstrate to regulators how their products are the functional equivalents of products already offered and permissible under financial regulations. As detailed in chapter two, the OCC approved UBK's *ijara* and *murabaha* financing products because the company demonstrated that its products were the functional equivalent of secured real estate lending.[46] After showing their products are permissible under current regulations, supervisors then examine the safety and soundness of the specific product. This is the same type of review regulators would undertake for any newly proposed product.

This section will review the actions various agencies have taken both in their supervision of providers of Islamic financing and in preparing their personnel to deal with such products in the future.

3.2.1 The Federal Reserve

The Federal Reserve does not currently regulate any banks operating Islamic windows in the United States. Moreover, it is somewhat unlikely that were a fully-

[46] OCC, "Interpretive Letter #806," 1, and "Interpretive Letter #867," 6.

chartered Islamic bank to be established in the United States it would be regulated directly by the Federal Reserve;[47] such a bank would likely seek to operate as a national bank – whether domestic or foreign in origin – and, thereby, be regulated by the OCC. Nonetheless the Federal Reserve, as a bridge between domestic and international banking in the United States, has sought to bring regulators and banks into discussion about the regulatory challenges an Islamic bank would have to overcome, and possible solutions to those hurdles. Federal Reserve officials have published a number of articles and guidances on Islamic banking in the United States, in the broadest terms.[48] Officials regularly take part in conferences and have also offered training on Islamic finance to Treasury Department personnel.[49]

3.2.2 Office of the Comptroller of the Currency, U.S. Department of Treasury

In the late 1990s the OCC was the supervisor for United Bank of Kuwait while it ran its Al-Manzil Islamic home financing program. When UBK merged with Ahli United Bank in 1999, the combined bank left the US market and the Al-Manzil program in the United States was closed. Since this time the OCC has not regulated any bank that offers Islamic finance products in the United States. The OCC does, however, regulate some banks that offer Islamic products in markets abroad. Since 2002 the OCC has engaged in

[47] However, the Federal Reserve does have a role in supervising all foreign banking organizations operating in the United States as a "consolidated supervisor" and under the International Banking Act of 1978 and Foreign Bank Supervision Enhancement Act of 1991. See Federal Reserve, letter.
[48] See Silva; Chiu, Newberger, and Paulson; Moghul.
[49] Treasury, "Islamic Finance 101."

informal talks with a number of organizations interesting in applying to charter a fully Islamic bank under the National Bank Charter. So far, none of these talks have resulted in a formal application being submitted,[50] although SHAPE Financial Corporation was prepared to make such an application before being discouraged by officials at Treasury.

3.2.3 Federal Deposit Insurance Corporation (FDIC)

The banks that offer Islamic finance products – Devon Bank and University Bank – are both FDIC insured institutions. Currently only University Bank offers an "Islamic" deposit. FDIC protection raises the question of whether this type of deposit insurance, offered on a conventional insurance model, is acceptable under Sharia. The FDIC does not dictate the rate nor basis of banks' return on deposits, so a product that pays a return not based on interest is not a problem vis-à-vis deposit insurance. What the FDIC is concerned with is insuring that Islamic finance products on the asset side of a bank's balance sheet do not undermine the bank's overall stability and safety.

3.2.4 State regulatory agencies

Both of the bank providers offering Shariah-compliant mortgage products are state-chartered banks, and thus their primary regulator is the state-level department of financial supervision in their home state. For both the bank and finance company providers, when the company wishes to offer its products in a new state it must apply to

[50] Rushdoony and Maloney, interview.

be a mortgage finance provider to the appropriate regulatory division in that state. While bank providers Devon and University bank are licensed to offer their products in a number of states, because they are state-chartered bank their regulators expect that the majority of their balance sheet will consist of assets in the home state.[51] Illinois's "wild card statute" allows banks chartered in the state to perform any activity allowed by OCC or any other state banking law.[52] Generally banks under state charters are subject to federal regulations as well as any additional regulations imposed by state law. Because of this, the OCC opinions on *ijara* and *murabaha* products have set a precedent for bank providers to offer these products in a number of states.

3.2.5 Attitude of regulators towards Islamic finance

Interviews with representatives from the above agencies, as well as with providers, suggest that regulators generally have been open to working with banks in order to help them gain approval for their Islamic financing products. Part of this stems from regulators' preference to extend banking and access to home ownership to communities who might otherwise be excluded from such services. Michael Silva of the Federal Reserve explained the role of the secular legal system to provide services based on religious practice:

> "A corollary of the principle of religious freedom enshrined in our Constitution is that the secular law should adapt, as much as possible, to accommodate differing religious

[51] Loundy, interview.
[52] Frech, interview. For more on "Wild-card statutes" in state banking see Johnson.

> practices. As public servants, we have a mandate to gain sufficient familiarity with Islamic banking practices to ensure that, as much as possible, our secular law does not burden the religious practice of observant Muslims."[53]

In order to regulate Islamic finance products effectively, regulators must first clearly understand how the products operate. In Bhambra's words: "Effective risk management requires effective risk measurement, and for this regulators must understand the products, contracts, and services offered by Islamic firms."[54] In speaking with officials from a number of regulatory agencies, most agencies are preparing their staff to work with Islamic finance products even though the market at this time is very small. The Federal Reserve has sponsored conferences and written research reports, the OCC holds training on Islamic finance for its officials, the FDIC is sponsoring one official to gain a diploma from the Institute of Islamic Banking and Insurance, and the Illinois Department of Financial and Professional Regulation regularly trains new examiners in Islamic banking in order to fulfill their supervisory duties.

3.3 Government-backed investors: Freddie Mac and Fannie Mae

The main investors into Shariah-compliant mortgages in the United States are government-backed Freddie Mac and Fannie Mae. Because most of the Islamic finance products offered in the United States are mortgages, this makes Freddie and Fannie the primary investors in the industry. Thus, Freddie and Fannie's bureaucratic rules and the

[53] Silva, "Islamic Banking Remarks," 204.
[54] Bhambra, "Supervisory Implications," 202.

details on mortgage reporting paperwork might be even more influential than banking regulation per se in providing parameters for Islamic mortgage products. Because they must arrange for Freddie and Fannie to purchase their products to exist, Islamic mortgage providers must adapt to these investors' reporting requirements.

For the purposes of Freddie and Fannie, the contracts submitted must be standard real estate contracts with standard trustee agreements that would enable the investor to acquire the property in case of default.[55] For the purposes of Shariah-compliance most providers have a set of contracts that outline the Islamic mortgage agreement, and then fill out a second set of standard paper work for the purposes of the government investor. The standard arrangements of real estate law do have some disclosure requirements that are structured in terms of interest. Providers report an annual percentage rate that they calculate from the "implied interest rate" – that rate which would result from the rental or utility fees charged on the Islamic account. Standard real estate purchases also stipulate that the purchaser's down payment be held in an escrow account while the transaction is processed, and that the purchaser be paid interest on this account. Most Islamic providers recommend that the customers donate the yield of this interest to charity. In these ways providers are giving their investors standard real estate contract agreements, while the agreements they write with customers comply with Sharia guidelines.

Freddie Mac began its investment in Islamic products with a $1 million investment in mortgages from American Finance House – LARIBA in 2001. Since then

[55] German, interview. Miranda, interview.

it has grown its Islamic mortgage portfolio by "a few hundred million dollars" per year.[56] Fannie Mae first invested $10 million in Islamic financing contracts in 2003[57], although would not disclose how much the company has acquired since then. However, both Fannie and Freddie have kept pace with their purchases of Islamic mortgages through the 2007-2009 housing market crisis.

[56] German, email.
[57] Maurer, 34.

CHAPTER 4: PROFILES OF U.S. ISLAMIC FINANCE PROVIDERS

In the United States Sharia-compliant home financing products are offered by three types of financial organizations: banks, financial services companies, and non-profit community development organizations. An organization's structure determines what types of financial products it will be able to offer. It is significant to note, however, that the legal process for gaining approval for a product is the same no matter the legal classification of the lending organization or the specific structure of the product. Because there is no legislation or regulation specific to Islamic finance, the providers of Sharia-compliant products submit applications to regulators showing that their product is the "functional equivalent" of an already permissible product. As discussed above, the OCC has opined that *ijara* and *murabaha* financing vehicles are the functional equivalent of secured real estate lending. Likewise the *musharaka* home financing facility used by financial holding companies must be structured to be the functional equivalent of a debt transaction. Profit-and-loss sharing deposit accounts have been found acceptable by state bank regulators and insured by the FDIC because they too were equivalent to products already offered and approved.

4.1 Bank providers

Currently two banks offer Islamic financing products: Devon Bank of Chicago, Illinois and University Bank (and subsidiary University Islamic Financial Corporation) of

Ann Arbor, Michigan. Both banks are licensed to offer their Islamic financing products in several states besides their home states.

4.1.1 Devon Bank – Chicago, IL

Devon Bank is a community bank located in the Devon neighborhood on the northern edge of Chicago. The area is one of the city's most diverse, and as the Muslim community expanded, increasingly customers came to the bank asking if interest-free financing products were available. In the late 1990s, the United Bank of Kuwait was offering Shariah compliant home financing products in the United States. When UBK ended its US operations in 1999, customers again began approaching Devon Bank about offering Shariah compliant products. Responding to this local demand, the bank began product development and, after receiving approval from Chicago-based Mufti Muhammad Nawal-ur-Rahman and the Shariah Supervisory Board of America, began offering Islamic financing products in 2003.[58]

Devon bank offers *murabaha* and *ijara* home financing, although its Islamic portfolio is dominated by residential *murabaha*. This is not only because residential *murabaha* is the product approved in the most states, but is also the type of product supported by Freddie Mac. While residential assets predominate in the number of deals, Devon does offer commercial Sharia-compliant financing in Illinois. These deals are

[58] Loundy, interview.

usually larger than residential deals in size. Additionally *ijara* residential deals tend to be larger than *murabaha* deals.

Devon Bank has sought to gain licensure for its products in as many states as possible. Corporate counsel David Loundy joked, "When the one Muslim in Alaska wants an Islamic mortgage, we will be ready." Devon is currently licensed to offer products to customers in thirty-seven states, although it is currently doing business in only about twenty-five of those. Most of these mortgages are *murabaha* -- *ijara* products are approved in only three states.[59] The bank's business is dominated by deals in Illinois. This is within Devon's nature as a community bank; most of Devon's business comes from the Muslim communities closest to it. Also because Devon is a state bank regulated by the Illinois Division of Banking Regulation, holding a majority of its portfolio capacity for deals out of state would cause complications with its principle regulator.

Interestingly, Islamic finance accounts for the majority of Devon Bank's residential mortgages business. While its conventional banking business comes exclusively from the community where it is based, its Islamic business draws from around the country. As Loundy said, "If you're looking for a conventional mortgage in South Dakota there's no reason to come to us. But if you need an Islamic mortgage, you have fewer choices."[60] In five years of offering Islamic financing products, Devon has not taken a penny of loss to date. Of course the Muslim community is not immune to the

[59] Devon Bank Islamic, "Availability."
[60] Loundy, interview.

effects of the current recession or economy-wide job cuts, and the bank has several homes in foreclosure proceedings due to the homeowners' job loss.

According to Loundy, in general regulators have been open to applications for approval of Islamic financial products: "Regulators like to see the under-banked being served."[61] Devon Bank's primary regulator is the Illinois State Division of Banking Regulation, and the bank is also FDIC insured. While doing business in other states is not particularly difficult, given the modern technology and communication tools, gaining this licensure has involved an arduous state-by-state and at times county-by-county analysis of particular regulations and adapting the products to be compliant with such regulations. Loundy said that while working with state regulators has not been particularly difficult, at times gaining the approval of various Secretaries of State has been more complicated as they are skeptical of these unfamiliar financial products.

4.1.2 University Islamic Financial Corporation – Ann Arbor, MI

University Bank, based in Ann Arbor, Michigan, offers Shariah-compliant home financing through its subsidiary University Islamic Financial Corporation (UIFC). University Bank is, like Devon, state-chartered and FDIC insured. It also offers mutual funds through another subsidiary, University Insurance & Investment Services. The parent, University Bank, offers Sharia-compliant *mudaraba* profit-sharing deposit

[61] Loundy, interview.

accounts, including money market accounts, certificates of deposit, and institutional checking accounts for mosques and other types of Islamic organizations.[62]

UIFC's Sharia-compliant financial products were developed by an independent consulting company, SHAPE Financial Corporation. Currently headquartered in Kuwait, SHAPE is run by Abdulkader Thomas, once head of UBK's Al-Manzil program that gained the decisions on Islamic financing products from the OCC. University offers its Sharia-compliant home financing in eleven states, all with sizable Muslim populations. The *murabaha* product, which the company calls "installment sale," is available with a minimum down payment of five percent and funds properties up to the jumbo mortgage limit of $417,000. The *ijara* product, or "redeemable lease," requires a minimum twenty percent down payment but can be used to purchase properties up to $1.3 million. In this arrangement an independent trust holds the title to the property as the customer buys it back in installments.

4.2 Finance company providers

While none of the companies would release figures about the absolute size of their portfolios, Freddie Mac indicated that a majority of its Islamic mortgage holdings come from Guidance while Fannie Mae's principle relationship is with LARIBA. It seems that the providers operating as finance companies dominate the Islamic finance space. These

[62] University Islamic Financial Corporation, "Deposit Products."

companies have also been in business longer than either of the banks providing Islamic finance products – LARIBA since 1987 and Guidance since 2001.

4.2.1 American Finance House – LARIBA

LARIBA offered the first Islamic mortgage in 1987, using a *murabaha* arrangement. Subsequently LARIBA began offering *ijara* home financing products.[63] The bank began utilizing investment capital from a private group of Muslims. In 2001 LARIBA was the first bank to securitize its Islamic mortgage assets, when it struck a deal with Freddie Mac to sell $1 million of its existing contracts.[64] Today LARIBA offers *ijara* ("lease-to-purchase") products for home, auto, and business financing. It also offers a *musharaka* ("joint venture") for business financing. LARIBA has a relationship with the Bank of Whittier, a community bank chartered in the state of California. LARIBA founder, Yahia Abdul Rahman, wrote a book, *LARIBA Bank*, that sets forth a vision for a worldwide Islamic banking system. It also sets Islamic banking in context within the Western system of interest-based banking and the US regulatory system.[65] The book is an example of the impetus behind Islamic finance "idealists" who see the industry not as a vehicle for earning profit, but rather as an instrument to enact a just economic order:

> "If successful, it [the LARIBA system] will present America and the world with an important contribution towards the happiness and prosperity of all people, Muslims and non-Muslims. And the result will be a closer

[63] Abdul-Rahman and Abdelaaty, "The Capitalization of Islamic Finance Institutions in America."
[64] Maurer, *Pious Property*, 34.
[65] Abdul Rahman, *LARIBA Bank*.

> society which, harmonious in its relationships, fair and moral in its dealings, is most productive because it was done right."

Since it is inspired by religious faith, perhaps it should not be surprising that first entrants into the field such as LARIBA were motivated even more by a sense of mission.

LARIBA's *ijara* product is unlike any other in the U.S. Islamic finance market because it is not benchmarked to an interest rate, but rather to market rents. After a customer selects the home he wishes to purchase, both customer and bank perform a survey of rental rates in the area immediately surrounding the home. It is based on this information that the two companies establish the "rental fee" paid by the customer each month, in addition to the payment on the principal of the home.[66] This is a very interesting model being the only payment structure that is not indexed to interest, but rather to the value of the asset in the real market.

4.2.2 Guidance Residential, Guidance Financial

Guidance Residential, the Shariah-compliant home financing subsidiary of Guidance Financial, was established in 2002. General Counsel Tom Gainor explained that when the group was being established one of the threshold questions was whether to structure their company as a bank or as a mortgage company.[67] Structuring as a financial services company originating home mortgages allowed Guidance to offer a different type of product than those offered by banks – a "declining balance co-ownership", or

[66] LARIBA, "Home financing," corporate website.
[67] Gainor, interview.

musharaka. Gainor cited both business and Sharia-compliance reasons why the firm decided on the *musharaka* model over either *ijara* or *murabaha*. Guidance's *musharaka* model is meant, according to Gainor, as a "re-characterization of the debtor-creditor relationship."[68]

Since 2001 Guidance has continued to refine its business as its portfolio has grown. When the company first introduced its *musharaka* product it was available in only three states. The initial product also required a twenty percent down payment in order to surpass the threshold below which mortgagors must purchase mortgage insurance, since conventional insurance arrangements are forbidden under Islamic law. Guidance passed that hurdle by finding an Islamic solution to private mortgage insurance so that mortgagees could supply at minimum a five percent down payment, making the product accessible to more clients. Initially Guidance Residential would draw upon the resources of its parent company, Guidance Financial Group, to provide liquidity to allow the company to originate loans and hold them on its books until Freddie Mac securitized the mortgage contracts. As the Residential operation grew, the firm established an Islamic funding facility with a warehouse provider in order to increase the originator's liquidity base.

Guidance Residential is headquartered in northern Virginia, but the company offers its product in twenty-four states. Since there is a regulatory burden to gaining approval in each new state, the company is strategic in choosing new markets to enter,

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[68] Ibid.

ensuring that there is enough potential demand to justify the work of making application to the state regulators. The company employs sales representatives to work various geographic regions. These representatives may meet with mortgage applicants, but one of their primary duties is to network with Muslims through programs in mosques and community centers to do grassroots marketing of the company's product. While the company has been contacted by independent mortgage brokers interested in offering a Sharia-compliant product, Guidance has chosen to work only through its own sales representatives.

Brad German of Freddie Mac credited Guidance's "pre-purchase counseling" as a contributor to its mortgages strong performance. When asked about this, Tom Gainor rather characterized the pre-purchase process with the client as one in which the company is explaining the program. Since the product is different from a conventional home mortgage agreement, this might make sense. Gainor: "Our reputation is very much on the line because this whole community is looking to us. We try to have a higher standard than a regular mortgage company; we try to take a more vested interest because the company has a vested interest in the property being co-owners. There isn't any formalized counseling session on the economic side. But we do take our time with people and make sure they feel comfortable."[69]

Guidance's Islamic mortgage performance has been affected by the current recession, although Gainor says its portfolio consistently outperforms the average in the

[69] Gainor, interview.

market. There have, however, been a fair amount of delinquencies and some foreclosures. Gainor explained that for Guidance this was a "good news, bad news" situation. "We wanted to make sure our program worked from A to Z; we weren't looking forward to foreclosures, but dealing with them let us make sure that the program worked as it was intended to even in the case of non-payment."[70]

Although Guidance currently sells its Islamic mortgages to Freddie Mac, the company is looking to develop a fully Islamic security facility. Guidance is moving in this direction through synergies with its parent, Guidance Financial Group. The parent invests through its Fixed Income Fund in securities backed by Guidance Residential's real estate financing assets. These securities are issued by Freddie Mac.[71]

Guidance's marketing is clearly aimed at Muslims, but Gainor highlighted the growth potential for Guidance's products to non-Muslim clients. Particularly in the aftermath of the mortgage market upheavals of the past two years, Guidance's non-recourse mortgage product might appeal to consumers distrustful of entering the home mortgage market. Likewise, because Islamic mortgages can only be sold to Freddie Mac or Fannie Mae, and not further disaggregated or securitized, a *Shariah* compliant product might be appealing to non-Muslim investors wary of their mortgage becoming part of a collateralized debt obligation (CDO).

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[70] Ibid.
[71] Maurer, *Pious Property*, 85.

4.3 Non-profit providers: Neighborhood Development Center – Minneapolis, MN

In Minneapolis/ St Paul another model for offering Islamic finance was pioneered immediately after 2000. Minneapolis is home to a large Somali refugee population whose economic development and integration into the community was limited by the refugees' inability to gain access to financing for personal home purchases as well as business expansion. Because a number of community development organizations worked with the refugee population, it prompted those non-profit organizations to explore Shariah-compliant financing options to aid these populations.

On the residential side, as Somali refugees integrated into the local economy and their incomes increased, they no longer qualified for subsidized housing from local and federal government aid programs. However, while their large family sizes meant that they could not find suitable non-subsidized rental housing, the immigrants were unwilling to purchase homes with interest-bearing loans even within subsidized lending programs. The Minneapolis branch of the Council on American-Islamic Relations (CAIR) worked with Hennepin County, local branches of Fannie Mae and the Department of Housing and Urban Development (HUD) to develop an interest-free alternative for these Somali residents to access government assistance to home-ownership. The partners developed an innovative program whereby the county sold tax foreclosed houses on an installment sales basis.[72]

[72] Thomas, "Methods of Islamic Home Finance in the United States," 4-5.

During the same period the need for Shariah-compliant business financing for the Somali refugee and other underserved Muslim communities emerged. Non-profit organizations that provided financing for small business development were motivated to offer Shariah-compliant financing for these populations. These efforts were couched in the terms of community economic development – in order for the Muslims to expand their businesses and make economic gains they needed an avenue to access business capital.[73]

Muslim leaders in Minneapolis educated government officials, lenders, and civil leaders about Shariah-compliant financing and how it could benefit community economic development. "Nonprofit groups have seen the need for alternative financing during business training classes, especially among Somali immigrants, who tend to be more observant of the Islamic religion. Minnesota has one of the nation's largest populations of Somali refugees, estimated to be as high as 40,000 people."[74]

In 2001 Wafiq Fannoun and Mike Temali established Reba Free Investments, a consulting firm that structured Shariah-compliant business financing products for community development non-profits located mostly in the Minneapolis area.[75] Temali is president and CEO of the Neighborhood Development Center in St. Paul, where Fannoun is also Secretary of the Board of Directors. Other Minnesota non-profits that offered some type of Shariah-compliant financing were: Phillips Community Development

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[73] Jean, "St. Paul, Minn.-Area Muslims Turn to Nonprofits for Loans."
[74] Ibid.
[75] Fannon, interview.

Corporation, Minneapolis Community Development Agency, the Minneapolis Consortium of Community Developers, the Northside Residents Redevelopment Council, as well as the Neighborhood Development Center.

Fannoun said that for this program it was much easier to work with state development agencies than it would have been to work with regulators. In dealing with banks and regulators lawyers are required to advance the work, crafting products that adhere to strict regulations. These community development non-profits were able to work with state funders to adapt programs that are governed mostly by agency rules rather than legal regulatory standards. However, clearly the range of Muslims these programs serve is limited to the lower economic strata, such as new Muslim immigrants. Such government-funded subsidy programs are not adequate to provide services to most in the community, but have been a creative accommodation of economic development programs for those new Muslim immigrants who do not have the economic resources to utilize the commercially offered products.

CHAPTER 5: FUTURE OF ISLAMIC FINANCE IN THE U.S.

While the Islamic finance industry globally is attracting a great deal of interest, investment, and expectations for growth, the story of Islamic finance in the United States is clearly more modest. Some have posited that Islamic finance forms could have helped avoid the current economic crisis, pointing to strong performance among Islamic finance providers. Islamic finance providers worldwide, however, have seen their performance drop along with the general economy. This section will examine how Islamic finance products have performed during the recent recession and consider how the U.S. industry might develop going forward.

5.1 Performance during recession

Since 2007 the U.S. mortgage market has experienced well-reported crisis; at the end of 2008 one in every ten households was in foreclosure[76] and delinquencies have continued despite government programs aimed at helping homeowners.[77] As for Islamic mortgages, however, all of the providers and investors interviewed reported above-average performance of Shariah-compliant products, even during the recessionary climate. Said David Loundy of Devon Bank:

> "In five years we have not taken a single penny of loss to date. I don't know if I'll be able to say that by the end of the year; if a customer loses a job, you have a problem no matter what. But there is a difference in character between an

[76] *Birmingham Business Journal*, "1 out of 10 homeowners facing mortgage woes." Citing Mortgage Bankers Association National Delinquency Survey.
[77] Merle, "Aid to Borrowers Not Preventing Rising Delinquency."

> Islamic customer and a conventional customer similarly situated."[78]

Loundy characterizes Devon's customers as "very responsible" and credits an "immigrant mentality:" they have worked very hard to get to the U.S. and don't want to squander opportunities now here.

Brad German at Freddie Mac reported a similarly strong performance on Islamic products. "Performance has been good, mainly because participants are putting down significant down payments and have significant equity stake in the beginning, twenty percent or more." He also cited strong pre-mortgage counseling as being key. Fannie Mae also reports good performance in their Islamic mortgage portfolio and continues to purchase the products.[79] In the current recessionary market performance of Islamic assets have gone down with the market, but not to a degree that indicates an intrinsic weakness with the product or the Muslim market.

5.2 Chartering a fully Islamic bank

Many of the providers interviewed seemed hopeful that a fully Islamic bank would eventually be chartered in the United States; the regulators, while receptive, seemed less optimistic. The biggest obstacle mentioned by regulators was developing deposit products that were simultaneously Sharia-compliant, eligible for FDIC protection, and did not run afoul of securities regulations.

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[78] Loundy, interview.
[79] Miranda, interview.

Several entities interested in establishing a nationally- chartered Islamic bank have approached the OCC with pre-application questions. However, as Michael Silva of the Federal Reserve pointed out, "Starting a bank, any bank, is difficult… Starting a new kind of bank is even more difficult. The potential market is uncertain and the institution must design novel products that satisfy both profit expectations and the expectations of *Shariah* compliance."[80] Devon Bank is one of these entities that have explored the possibility with regulators. David Loundy cited one of the main issues for any new bank, Islamic or otherwise, is investor support;[81] as the Islamic financing industry in the U.S. continues to mature and prove itself this support might be forthcoming. SHAPE Financial engaged in informal talks with the OCC in 2002 as it prepared to apply for a national charter for a fully Islamic bank. According to CEO Abdulkader Thomas, after his organization had resolved all issues raised by the OCC regulators, he was informally advised by a Treasury official that the application would likely be unsuccessful. Thomas characterized this as illegal discrimination on the part of the official.[82] Although Jonathan Rushdoony of the OCC was not directly involved in these negotiations he said his understanding was that the OCC's reluctance to the application going forward was not due to it being an Islamic bank but rather business concerns about capitalization.[83] For the moment no applications for an Islamic bank are pending before the OCC, despite other entities which have expressed interest.

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[80] Silva, "Islamic Banking Remarks," 204.
[81] Loundy, interview.
[82] Thomas, interview.
[83] Rushdoony and Maloney, interview.

5.3 Securitization and Investment

As mentioned, nearly all Islamic mortgages originated in the United States are purchased by Freddie Mac or Fannie Mae. Some inroads have been made to deepen the securitization market by Guidance Financial's investment through its Fixed Income Fund in Islamic-mortgage-backed securities. Because University Bank offers Sharia-compliant deposit products, these funds are also available for investment in UIFC's Islamic mortgage portfolio. But, generally, sources of investment for the industry are very limited. Expansion of the industry as currently structured would be limited by extent of Freddie Mac and Fannie Mae investment. Structuring alternate sources of investment capital, either through domestic deposit and investment accounts or Islamic investment capital from abroad, will be crucial in allowing the industry in the US to grow.

In the post-9/11 period many investors from the Gulf Cooperation Council were hesitant to make large investments in the U.S., especially following the political backlash over the scuttled Dubai Ports World deal.[84] Now with global financial markets in turmoil, Gulf investors continue to be hesitant to enter the U.S. market. Another potential deterrent for foreign bank investors would be undergoing supervisory review by the Federal Reserve before making an application as a national bank[85]; especially banks owned in part or whole by sovereign wealth funds might find those entities reluctant to disclose their portfolio positions to the U.S. government.[86] Nonetheless, several entities

[84] See Rotemberg, "Dubai Ports World Debacle and Its Aftermath."
[85] As required by the Foreign Bank Supervision Enhancement Act of 1991. See Federal Reserve, 2008.
[86] See Miracky, et al., 2008.

from the Gulf Cooperation Council have expressed interest in opening Islamic banking operations in the United States. Some of these are banks with current Islamic operations abroad that have a deep understanding of the business and products.[87] Two international Islamic bank subsidiaries currently have operations in the United States, although not in the retail financing market. HSBC's Islamic banking division, Amanah, runs asset management operations in the U.S. from its New York office, although it has no retail banking operations in the United States.[88] Additionally, Arcapita, a holding and real estate company wholly owned by the Bahraini Islamic bank of the same name, operates an office in Atlanta. Its U.S. holdings include several commercial and residential real estate developments, manufacturing, consumer, business services, and energy companies. Although these companies are not in the home or business retail lending space, they are strong examples of international Islamic banks bringing investment to the United States.

Until now most Islamic finance providers in the U.S. have emphasized that they utilize American sources of capital. However, as the industry gains more confidence and acceptance in the United States, it might be politically possible and strategically savvy to attract capital from Islamic finance institutions abroad. This could help the U.S. industry expand its liquidity infrastructure while dealing with other Sharia-compliant institutions.

[87] Thomas, interview.
[88] Khan, email.

5.4 Uncertain regulatory landscape

As with the U.S. mortgage market in general, there is great uncertainty about the future of Islamic mortgages because there is great uncertainty about the pace of general economic recovery and how mortgage lending and banking regulation more generally might change as a reaction to the recent crisis. Government-backed entities Freddie Mac and Fannie Mae provided financing for Islamic mortgages under the same rubric they bought some sub-prime mortgages – expanding home financing to "under-banked" populations under provisions of the Community Reinvestment Act.[89] Officials at Freddie and Fannie asserted that because there were no performance problems with Islamic mortgage assets they do not see any reason why purchases of these assets would change.

Nevertheless, regulatory changes in the mortgage market are expected and many potential providers and investors are waiting to act until it is clear what those changes will be. The Obama administration has announced intentions for major overhauls of the regulatory apparatus, although the precise shape of these changes still has not been decided.[90] Professionals in the industry, such as SHAPE's Abdulkader Thomas, expect that the government's response will be an "over-reaction" and have negative externalities for Islamic finance. Thomas: "During the 1990s all you had to do was demonstrate compliance with characteristics of current products offered under the law… It looks like

[89] This is not to assert that the Community Reinvestment Act is responsible for the 2008 financial crisis, as the author is more convinced by Federal Reserve and Bank of International Settlement arguments – that CRA mortgages tend to be better performing than those issued by non-Federally regulated independent lenders – than by critics of CRA in the current crisis. See Ellis, Ergungor, Kroszner, Yellen.

[90] See Nichols and Vekshin, "Obama to Outline Regulation Changes to Avoid Crisis."

we may be going into a period where regulators are more closed. This has nothing to do with Islam or Islamic banking, but all the small businesses like Islamic banking that are not in the focus will run the risk of being affected by changes that are not directed at them."[91] Because of the uncertainties in the future regulatory environment as well as tightness in global financial markets, it is doubtful that providers of Islamic financial products will attract investment from new sources in the near term. This leaves the growth of Islamic finance in the United States limited to the investment contributed by Freddie Mac and Fannie Mae. With the future trajectory of these organizations in flux, it is equally difficult to project how Islamic finance might perform in the future. While a market does seem to exist, and would likely expand as the Muslim demographic in the United States expands and more customers are educated as to the availability and merits of Islamic home finance product, growth in the sector will be constrained by scarcity of capital.

[91] Thomas, interview.

CONCLUSION

Over the past ten years the Islamic finance industry has steadily expanded and developed. While its growth is modest compared to the explosion of the industry abroad, the nascent industry in the United States is beginning to develop the infrastructure that will allow it to expand in more scalable manner moving to the future. This includes developing further avenues for securitization and experimentation with deposit products that could bring the industry greater liquidity and eventually make possible a fully Islamic bank. The industry has also begun to seek alternatives to conventional types of insurance, although sometimes from necessity utilizes conventional insurance where no alternative exists.

As the industry has grown there has been regular contact between providers and regulators. Usually there are just a handful of people at each regulatory agency familiar enough with Islamic finance to work with providers, but the agencies are training more staff and preparing for the industry to grow moving into the future. Historically new products are motivated by market demand at the grassroots – in some cases, Muslims walking into community bank branches and asking for financing that doesn't violate their religious beliefs. Regulators have worked with providers in order to approve products that are the functional equivalents of secured lending or deposit products already offered. Government-backed investors Freddie Mac and Fannie Mae have become the primary investors in Islamic mortgage products, and between them securitize almost all of the Islamic mortgages issued in the United States.

As the industry in the United States has slowly grown and developed over the past decade, it has begun to build infrastructure and develop methods to solve conflicts between Sharia and regulatory demands. Islamic investment funds have purchased interests in securities issued by Freddie Mac and backed by Islamic mortgages. A bank has developed and is offering a deposit product. Even during a recession, Islamic mortgages have maintained strong performance. These slow but steady improvements are a firm foundation upon which the US Islamic finance industry will likely build. In the near term it is difficult to gage how quickly further development will happen, since many actors are holding their current positions while the financial market and regulatory environment stabilizes. It is clear that in order to grow at a faster pace, Islamic finance institutions will need to attract more "capital," either from U.S. Muslim investors and depositors or from Islamic finance concerns abroad. However, strong performance through this recession and increasing infrastructure for the sector might highlight Islamic finance as a strong, if small, section of the U.S. mortgage market.

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