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I. INTRODUCTION

For many citizens of the United States homeownership is an important part of the American dream. [1] Homeownership is also encouraged by society because it is common for homeownership to increase the sense of belonging in a community and pride in citizenship[2] Homeowners are more involved politically and socially, and produce higher neighborhood property values.[3]

In the United States owning a home is often accompanied by a mortgage obligation. Over 60% of homes in the United States are currently subject to a mortgage obligation.[4]

When a mortgage is signed, the mortgagor is agreeing to make payments to the lender according to an amortization schedule.[5] The basics of this amortization schedule are that the mortgagor is agreeing to pay more than they originally borrowed over a period of time.[6] The amount over the borrowed amount is interest.[7] The lenders charge interest in order to compensate themselves for the time value of the money they are sacrificing to the borrower.[8]

The requirement of interest in conventional mortgages has

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[1] Scott Griswold, *A Redeeming Interest in Religious Freedom: Are Islamic Mortgage Alternatives Clogs on the Equitable Right to Redemption?*, 13 FORDHAM J. CORP. & FIN. L. 419, 420 (2008).

[2] Chian Wu, *Islamic Banking: Signs of Sustainable Growth*, 16 MINN. J. INT'L L. 233, 242 (2007).

[3] Roberta F. Mann, *Is Sharif's Castle Deductible?: Islam and the Tax Treatment of Mortgage Debt*, available at http://works.bepress.com/roberta_mann/4, 6 (last visited April 11, 2009).

[4] U.S. Census Bureau, *Residential Finance Survey- Detailed Regional Tables: 2001*, http://www.census.gov/hhes/www/rfs/2001detailedtables/tab1_1a.html, (last visited March 1, 2009).

[5] MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE, at 3 (Cambridge University Press 2006).

[6] *Id.*

[7] *Id.*

[8] Wu, *supra* note 2, at 249.

caused an underrepresentation of homeownership among Muslims. [9] Conventional mortgages are incompatible with Islamic concepts and principles.[10] The interest component of a mortgage is problem for many followers of Islam because the payment of interest, also known as *riba*, is forbidden.[11]

Unfortunately the cost of this *riba*-free Islamic financing is greater than a conventional mortgage.[12] However, certain Muslims are willing to pay what some have called a "piety premium" to acquire *riba*-free financing.[13] The Islamic finance transactions cost more themselves, and there may be tax consequences.[14] The additional costs are felt both immediately and into the future.

The limited demand and supply of Islamic financing keeps the initial cost of obtaining financing high.[15] In some Islamic financing arrangements the borrower does not receive a benefit for early retirement of the debt.[16] Additionally, because there is no interest payment in the *riba*-free loan, the borrower is not entitled to deduct home financing interest from their income for tax purposes.[17] However, there are arrangements and options allowing the borrower in an Islamic financing arrangement to deduct an interest amount attributed to the financing of their home from their income for tax purposes, but that poses a moral dilemma for many Muslim borrowers.[18] Therefore *riba*-free or approved financing alternatives are being sought by many Muslims today.

II. HISTORY OF ISLAMIC FINANCE

The underlying principles of Islamic banking go back 1,400 years.[19] However, European colonization and the creation of Western finance caused early Islamic finance to be abandoned.[20] Islamic banking was first publicized in modern times by Muslim Brotherhood[21]

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[9] Wu, *supra* note 2, at 249.

[10] Hjh Siti Faridah Abd Jabbar, *Islamic Finance: Fundamental Principles and Key Financial Institutions*, Company Lawyer 2009, v. 30(1), pg 23-32.

[11] *See* Wu, *supra* note 2, at 242.

[12] *See Islamic Finance: Savings and Souls*, THE ECONOMIST, Sept. 4, 2008. [hereinafter *Savings and Souls*].

[13] *See id.*

[14] *Id.*

[15] *See id.*

[16] *See* Griswold, *supra* note 1, at 440.

[17] Mann, *supra* note 3, at 2.

[18] *Id.*

[19] Thomas K. Grose, *The Rise of Islamic Banking*, U.S. News & World Report, Dec. 10, 2008, at 41-42.

[20] Jabbar, *supra* note 10.

[21] John Walsh, *Egypt's Muslim Brotherhood: Understanding Centrist Islam*, 24 HARV. INT'L. REV. 4 (2003) (noting that the Muslim Brotherhood's long term goal is to implement *Shari'a* as the basis for national law. The Muslim Brotherhood officially renounces violent tactics of other Muslim organizations).

founder Hassan al-Banna in the 1920's.[22] Hassan al-Banna's stated goal was to penetrate Western financial systems and corrupt them from within.[23] The hope was that a parallel system would be created and lead to the establishment of a global Islamic empire governed by *Shari'a*.[24] Though Islamic finance reappeared in the 1920's, it did not become prevalent until the 1970's.[25]

The recent growth in Islamic banking is not driven by al-Banna's desire to corrupt the Western financial system from within, but is instead the industry is driven by prohibition or *riba* and *gharar*.[26]

A. *Shari'a*

Islamic law is known as *Shari'a* and governs not only a person's religious life but also their secular life.[27] That means the business life of a follower of Islam is also governed by *Shari'a*. An example of business life being governed by *Shari'a* is the prohibition of *riba*, *gharar* and *maisir*.[28] The concern for ethics, fairness, good-measure in transactions, social justice and spiritual values override the freedom of contract in Islamic finance.[29]

According to *Shari'a* making money from money, or interest, is known as *riba* and is prohibited.[30] The prohibition of *riba* prevents the wealthy from hoarding wealth for their personal uses.[31] Benefitting the community is the reason *riba* is forbidden. It is believed that only the poor would pay for the extension of time for repayment and the wealthy have a duty to 'give charity.'[32] Interest attained by the lender is forbidden because it is seen as profiting unduly from the hard work and risk bearing of others.[33]

Therefore, many *Shari'a* scholars believe the payment of interest is the equivalent to paying *riba*.[34] Furthermore, the entire interest based conventional banking industry is taboo according to Islam.[35] However, not all Islamic scholars agree that interest is a prohibited form of *riba*. Nevertheless, the traditional mortgage makes many Muslims uncomfortable.[36]

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[22] Rachel Ehrenfeld and Samuel A. Abady, *Op-Ed: Islamic Banking*, WASH. TIMES, Dec. 11, 2008.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] El-Gamal, *supra* note 5, at 8.

[27] Michael Silva, *Islamic Banking Remarks*, 12 AM. LAW & BUS. REV. 201, 202 (2006).

[28] *See* Jabbar, *supra* note 10.

[29] *Id.*

[30] *Id.*

[31] Wu, *supra* note 2, at 237.

[32] *Id.*

[33] Schehrazade S. Rehman, *Globalization of Islmaic Finance Law*, 25 WIS. INT'L L.J. 625, 631 (2008).

[34] Silva, *supra* note 27, at 202.

[35] Jabbar, *supra* note 10.

[36] Mann, *supra* note 3, at 9.

Gharar is also prohibited by *Shari'a*.[37] *Gharar* transactions have an "unacceptable" level of risk or uncertainty.[38] However, what is considered "unacceptable" is fact specific and determined on a case by case basis.[39]

An example of excessive *gharar* is when the purchase price is not definitively stated in the contract, making the purchase price unknown to the buyer and seller.[40] Furthermore, contracts for the sale of things that do not yet exist are also prohibited, such as the sale of a crop that has not yet been planted.[41]

Speculation and gambling is known as *maisir,* and is also forbidden by *Shari'a*.[42] The rule against *Maisir* only allows the accumulation of value through productive efforts; not through betting or gambling.[43] Undertaking a risk that allows you to profit only at the expense of another party is the type of transaction that is forbidden.[44] However, transactions that involve general commercial speculation, such as opening a business or purchasing *Shari'a* compliant securities are allowed.[45]

Shari'a also forbids investment in morally questionable companies.[46] Industries and investment in those industries involving alcoholic drinks and pornographic materials are also against the tenets of Islam.[47]

Although *riba* and *gharar* are prohibited, making a profit is not.[48] Unless a clear reason for prohibition exists, commercial transactions and contracts are permissible.[49] Islam encourages profit when the investor takes a calculated risk.[50] Profit is seen as proof of successful entrepreneurship and the creation of additional wealth for the individual and the community.[51] Therefore, industries such as banking are encouraged as long as they stay *Shari'a* compliant.

B. Islamic Banks

The main differences between Islamic and conventional

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[37] Kimberly J. Tacy, *Islamic Finance: A Growing Industry in the United States*, 10 N.C. Banking Inst. 355, 357 (2006).

[38] *Id.*

[39] *Id.*

[40] Umar F. Moghul, *Separating The Good From The Bad: Developments In Islamic Acquisition Financing*, 23 Am. U. Int'l L. Rev. 733, 737 (2008).

[41] Theodore Karasik, Frederic Wherey, and Steven Strom, *Islamic Finance in a Global Context: Opportunities and Challenges*, 7 CHI. J. INT'L. L. 379, 382 (2007).

[42] Jabbar, *supra* note 10.

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] Carla Power, *Faith in the Market,* Foreign Policy, January/February 2009.

[47] *See* Jabbar, *supra* note 10.

[48] Rehman, *supra* note 33, at 631.

[49] *See* Jabbar, *supra* note 10.

[50] *Id.*

[51] *Id.*

western banks is the absence of interest, or *riba*, and the fact that Islamic banks pay *zakat* from their profits.[52] *Zakat* is religiously mandated alms.[53] The objective of Islamic financing is to transfer funds from areas of surplus to areas of deficit that provide the best yield or return.[54]

The depositors in an Islamic bank act as investors and the bank acts as an entrepreneur investing the depositors' funds with borrowers.[55] The profit or loss from the business funded by the banks investment is shared between the bank and borrower.[56] In turn, the bank shares the profit with the depositors.[57] Since gain or loss is shared, neither a profit nor the depositors capital is guaranteed.[58]

For those depositors who do not want to share risk with the bank, many Islamic banks operate '"two-windows."[59] The depositor may choose to deposit their funds into an on-demand account that does not yield a return nor bear the risk of loss from the bank investing the deposited funds.[60]

C. Shari'a Supervisory Boards

To determine if a bank or a transaction is *Shari'a*-compliant a *Shari'a* supervisory board must be consulted.[61] *Shari'a* supervisory boards are composed of Muslim jurists who issue edicts or *fatwas* regarding the permissiveness of a transaction or practice.[62] Because there is no central authority dictating *Shari'a,* there are many different interpretations depending on the scholar and the country or region the scholar is in, or from.[63] For example, Malaysian *Shari'a* scholars tend to be more flexible in their interpretations of *Shari'a* than other *Shari'a* scholars around the world.[64]

With the increasing number of Islamic financial institutions there is an increased need for *Shari'a* scholars.[65] Specifically there is particular need for *Shari'a* scholars with a background in finance.[66] This need for finance savvy *Shari'a* scholars is worldwide.[67] The

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[52] *Id.*

[53] Bill Maurer, *Pious Property- Islamic Mortgages in the United States*, Russell Sage Foundation, at xiii (2006).

[54] Jabbar, *supra* note 10.

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*

[60] Jabbar, *supra* note 10.

[61] Rehman, *supra* note 33, at 628.

[62] *Id.*

[63] *Savings and Souls, supra* note 12.

[64] Grose, *supra* note 19.

[65] Gordon Platt, *Islamic Finance Is No Longer For Muslims Only*, Global Finance, Vol. 21, Issue 7, July/August 2007.

[66] *Id.*

[67] *See* Karasik, *supra* note 41, at 390.

shortage of *Shari'a* scholars has made it common for the same scholar to be on many different *Shari'a* boards.[68]

Additionally, this increased demand for *Shari'a* scholars gives a benefit to the larger banks.[69] The larger banks are able to afford well-known Muslim jurists whose *fatwas* and opinions carry more weight with Muslims regarding the suitability of that bank's financial services.[70] Islamic banks have begun to fund programs to train *Shari'a* scholars in finance.[71] For example, a $53 million endowment was created by Malaysia's central bank and Saudi-based Islamic Development Bank to promote *Shari'a* scholarship.[72]

Shari'a scholars are individuals and may have differing views on *riba*. They may also have differing views of *gharar*. Some *Shari'a* scholars believe interest is a completely forbidden type of *riba*, while others believe it is permissible.[73] Additionally, *gharar*, as explained earlier, can be looked at as excessive risk. Since all contracts inherently have some risk, a certain level of risk is considered a necessary evil.[74] The prohibited level of *gharar* is usually seen in those contracts and transactions that are considered risky, but the definition of risky is open to interpretation.[75]

Shari'a boards for financial institutions are important today because of the *riba*-free financing alternatives that are becoming increasingly prevalent. Each institution offering Islamic financing must maintain one of these boards to determine if the proposed transaction is *Shari'a* compliant.

Fortunately, there are efforts underway to create international regulations and standards in Islamic Finance.[76] One such organization is the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).[77] A second global standards organization is the Islamic Financial Services Board (IFSB).[78] The IFSB is composed of international regulatory and supervisory agencies.[79] The IFSB is dedicated to ensuring the soundness and stability of the Islamic financial industry.[80]

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[68] Power, *supra* note 46.
[69] Rehman, *supra* note 33, at 628.
[70] *Id.* at 628-29.
[71] *Id.*
[72] *See Id.*
[73] Maurer, *supra* note 53, at 41.
[74] El-Gamal, *supra* note 5, at 58.
[75] *Id.*
[76] *See* Power, *supra* note 46.
[77] *Id.*
[78] Tacy, *supra* note 37, at 362.
[79] *Id.*
[80] *Id.*

III. MOST COMMON TYPES OF ISLAMIC MORTGAGE FINANCING

In an answer to many Muslims' problem with obtaining a conventional mortgage, a variety of different financial arrangements have developed. These alternatives are often called *riba*-free financing.[81] The three main mortgage alternatives in use today are *Murabaha*, *Ijara*, and *Musharaka*.[82]

A. *Murabaha*

Murabaha contracts can be referred to as a cost-plus model.[83] With a *Murabaha*, the homebuyer identifies the home and negotiates a price. The financial institution then buys the home and sells it to the homebuyer at a marked-up price.[84] The homebuyer then pays for the home in deferred payments over a stated installment period.[85] The marked-up price is not called interest, and is justified by the risk that the homebuyer might back out of the deal and the financial institution may need to find a new buyer.[86].

Since the marked-up price is already determined and includes the interest component, lenders as opposed to borrowers receive the windfall from early retirement of the debt.[87]

B. *Ijara*

Ijara financing is essentially a rent-to-own transaction.[88] The financial institution purchases the home and the client pays the bank rental payments.[89] The duration and amounts of rental payments are fixed at the beginning of the arrangement,.[90] The bank owns the home until the end of the lease transaction when the lessee has the option to purchase it.[91]

C. *Musharaka*

The *Mushraka* transaction is probably the most interesting of these arrangements because of the relationship it creates between the lender and borrower. It creates a partnership between the borrower and

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[81] *See* Wu, *supra* note 2, at 238.
[82] Mann, *supra* note 3, at 10-11.
[83] Maurer, *supra* note 53, at 33.
[84] Mann, *supra* note 3, at 10.
[85] Tacy, *supra* note 37, at 358.
[86] *Id.*
[87] *See* Griswold, *supra* note 1, at 439-40.
[88] Mann, *supra* note 3, at 10.
[89] Tacy, *supra* note 37, at 358.
[90] *Id.*
[91] *Id.*

the bank.[92] A *Musharaka* creates joint ownership where both owners are entitled to revenues derived from the jointly owned property.[93]

The first step occurs when the homebuyer and the financial lender create a partnership. The partnership purchases the home.[94] The homebuyer makes monthly payments to the lender. Those payments are used partially to purchase the financial lender's share of the home, and as rent to the partnership.[95] The homebuyer and the financial lender share profits and losses in a proportion agreed upon at the agreement's outset.[96] The profit the bank receives is the bank's proportional share of the rent paid to the partnership.[97]

Not only do the partners share profits and losses, but also; the risk that the property value may decrease. Therefore, M*ushraka* transactions are riskier for banks than M*urabaha* or *Ijara* transactions.[98]

IV. SOURCE OF FUNDING FOR HOMEBUYERS

The source of funding for conventional mortgages comes from a well established market. Conversely, the market for funding Islamic mortgage alternatives is relatively new and under-developed.

A. Conventional Sources

The secondary mortgage market puts private investor capital to work for homebuyers.[99] In the secondary markets, the mortgages are bundled and sold to investors.[100] The investors that have purchased shares of the bundled mortgages are entitled to the principal and interest payments made by borrowers on the loans.[101] Because these secondary markets are based on interest payments, this traditional source of funding for mortgages is prohibited by *Shari'a*.[102]

The payment of interest is not the only thing prohibiting Islamic financing alternatives from being financed through the bundling of mortgages. Additionally, most *Shari'a* boards also prohibit the sale of bundled mortgages because it constitutes the sale of debt.[103]

As a result, Islamic mortgage alternative providers have had to find different sources of funding.

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[92] *Id.* at 359.
[93] Moghul, *supra* note 40, at 749.
[94] Mann, *supra* note 3, at 11.
[95] *Id.*
[96] Tacy, *supra* note 37, at 359.
[97] Moghul, *supra* note 40, at 749.
[98] *Id.*
[99] *Id.* at 23.
[100] *Id.* at 21-22.
[101] *Id.* at 86.
[102] *Id.*
[103] Moghul, *supra* note 40, at 751.

B. Funding Alternatives

Cooperatives have been used to finance home lending but are only useful when there are funds available.[104] Without the influx of additional capital, cooperatives must wait until loans are paid back before financing new home purchases.[105] Therefore, the cooperative can only finance a limited number of Islamic mortgages.

However, there is an increasing amount of capital available for Islamic financing due to a surplus of funds available from the Persian Gulf Oil producers, often referred to as petrodollars.[106] Investors in the Middle East have amassed so much wealth through the production of oil that they have no choice but to look for opportunities in other parts of the world.[107]

Muslim investors may seek to invest these excess funds in the *sukuk* market.

C. Sukuk Financing

Sukuk financing arrangements are similar to asset-backed certificates.[108] In *Sukuk* arrangements, investors contribute capital in exchange for an ownership share of the asset being financed.[109] This ownership entitles the investors to a share of the revenue generated by the financed asset.[110]

Sukuk is a relatively new financial instrument that is generally used in project financing and other large-scale industrial contexts.[111] The use of *Sukuk* in the United States in private equity financing is limited and almost nonexistent.[112]

However, as of June, 2008, the *Sukuk* market was growing at a rate of about 35% a year[113] and is expected to reach $200 billion by 2010.[114] The *Sukuk* market offers the important liquidity and avenue for investment needed in the market.[115]

V. INTERNATIONAL ISLAMIC FINANCING

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[104] Wu, *supra* note 2, at 243

[105] *Id.*

[106] Grose, *supra* note 19, at 41.

[107] *Id.* at 42.

[108] Moghul, *supra* note 40, at 749.

[109] *Id.* at 750.

[110] *Id.*

[111] *Id.*

[112] *Id.*

[113] Gordon Platt, *Islamic Fiancial Instituions Awards 2008*, Global Finance, Vol. 22 Iss. 6, June 1, 2008.

[114] *Id.*

[115] Tacy, *supra* note 37, at 364.

Britain's stable political environment, historical links to the Middle East, and their strong pool of financial talent are attracting investors with large amounts of petrodollars.[116] The increase in Islamic finance is being supported by the British government who see it as an opportunity instead of a threat.[117]

London's first Islamic financing company opened in 2004.[118] That number has grown to 25 today, and is expected to double in five years.[119] Muslim financial institutions are not the only place you can find *shari'a*-compliant products in Britain today. Most of Britain's western banks have opened "Islamic windows" offering *shari'a*-compliant products.[120]

France is also trying to become a hub for Islamic Finance.[121] One report suggests that France could possibly attract $100 billion from Islamic financial institutions.[122]

Unlike these new ventures in Europe, Malaysia has a tradition of Islamic financing dating back to the 1960's.[123] In 1963, the Muslim Pilgrims Savings Corporation was created as a way to assist the Muslim population in saving for Hajj, the once-in-a-lifetime pilgrimage to the Muslim holy cities.[124] More recently Malaysia reentered Islamic banking in 1983.[125]

VI. Tax Consequences And Regulation Of Islamic Financing

A. Deductibility Of Interest From Income

In the United States homeowners are allowed to deduct interest on the debt used to purchase their home from their taxable income.[126] To obtain the deduction, the payment needs to be in the form of interest.[127] However, since Islamic mortgage alternatives do not have an interest component those borrowers are losing out on the deduction.

Many of the Islamic mortgage alternatives appear to have the same economic substance as conventional mortgages.[128] The substance-over-form principle established by the U.S. government allows the IRS

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[116] Grose, *supra* note 19, at 42.

[117] *Id.*

[118] *Id.* at 41.

[119] *Id.*

[120] *Id.*

[121] Emma Vandore, *Crisis Widens Appeal Of Islamic Finance*, INT'L HERALD TRIBUNE, (Dec. 24, 2008).

[122] *Id.*

[123] Rehman, *supra* note 33, at 639.

[124] *Id.*

[125] *Id.*

[126] 26 U.S.C. § 163(h)(3).

[127] Mann, *supra* note 3, at 2.

[128] *Id.* at 12.

to tax a transaction according to its substance.[129] However, this substance-over-form principle is not a two-way street.[130] The taxpayer is bound to the consequences of the form they have chosen for a transaction.[131] Accordingly, it follows that since the taxpayer has chosen a form of financing that does not have an interest component they are not allowed to look to the substance of the transaction and subtract the financing cost as an interest deduction.

Despite this notion, University Islamic Financial leaves it to their customers to choose to deduct, suggesting that the government recognizes Islamic mortgage programs the same as traditional programs.[132] According to University Islamic Financial's FAQ section on their website, as a financial institution they are "only able to show profit on the financing of a home in one fashion."[133] Therefore the bank issues their *Murabaha* customers 1098-INTs stating the relative interest amount paid.[134] The customer must then search their conscience to determine if it is permissible to deduct the interest amount from their taxable income.[135]

The home interest deduction is intended to promote the purchase of homes.[136] The importance of home ownership is still recognized today as seen in the Executive order that directed the President's tax reform panel in 2005.[137]

Even though homeownership is encouraged among all income brackets, the interest deduction benefits those people in higher income brackets most[138] and has the second highest cost of all tax preferences.[139] The cost of the home interest deduction falls between the cost of retirement savings incentives and health cost deductions.[140] Will the Internal Revenue Service make changes to allow income deductions for the holders of Islamic loans?

B. Tax Changes In Britain

Those who bought homes in England using *Murabaha* also encountered negative tax consequences.

When a home is sold in England it is subject to what is called a stamp duty.[141] Since in a *Murabaha* transaction the home is bought by

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[129] *Id.*
[130] *Id.*
[131] *Id.*
[132] *Id.* at 13.
[133] University Islamic Financial, FAQs, http://www.universityislamicfinancial.com/faq.html.
[134] See *id.*; *see also* Mann, *supra* note 3, at 13.
[135] Mann, *supra* note 3, at 13.
[136] President's Tax Reform Panel, pg 25 available at http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_1_11-1.pdf.
[137] *Id.* at 41.
[138] *Id.* at 25.
[139] *Id.* at 27.
[140] *Id.*
[141] Wu, *supra* note 2, at 246.

the bank and then sold to the homebuyer, the stamp duty was imposed twice on essentially one purchase by the homebuyer.[142]

To remedy this unfair double taxation and stimulate demand for Islamic mortgages, the Bank of England formed a working group to study alternatives.[143] The result of this working group was that the double stamp duty was abolished in 2003.[144]

This is an example of Britain's encouragement of and involvement in the regulation of Islamic finance.[145] Regulation of Islamic finance is important to its development because regulation is valued by investors.[146]

Malaysia has also undertaken regulation of Islamic finance and has arguably the world's best developed legal framework for *Shari'a*-compliant products.[147] For example, in 2005 Malaysia banned *Shari'a* scholars from serving on more than one *Shari'a* supervisory board at a time.[148]

Similar regulatory changes in the United States may be slow coming. Consumers, in an effort to comply with regulations, simply designate the series of transactions involved in some Islamic mortgages as a single transaction, thereby creating more favorable tax consequences.[149] Agreements that negate the tenor and structure of a transaction can make *Shari'a* boards quite uncomfortable.[150]

VII. U.S. REGULATION OF ISLAMIC FINANCE

The Federal Reserve of the United States does not have an official stance on *Shari'a*-compliant financial services.[151] The Federal Reserve's regulation of financial innovation is not dependent on any ethnically or religiously defined group.[152] The Federal Reserve views itself as a watchdog whose duty is to prevent problems from developing in the market.[153] Furthermore, they have made it clear that Islamic finance's religious foundation , is irrelevant to the oversight of the industry.[154]

To date, the Federal Reserve's involvement in the regulation of Islamic finance has been limited.[155] The Federal Reserve still views the number of providers as too small and too limited scope to warrant

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[142] *Id.* at 247.
[143] *Id.*
[144] *Id.*
[145] Grose, *supra* note 19, at 41.
[146] *Id.*
[147] Power, *supra* note 46.
[148] *Id.*
[149] Moghul, *supra* note 40, at 748.
[150] *Id.*
[151] Rehman, *supra* note 33, at 646.
[152] *Id.*
[153] *Id.* at 646-47.
[154] *Id.* 647.
[155] *See id.*

much involvement.[156]

However, the United States Office of the Comptroller of the Currency, by which all banks in the United States are supervised, has issued two interpretive letters concerning Islamic Banking.[157] The two interpretive letters issued in the late 1990's discussed both *Murabaha* and *Ijara* transactions.[158] The first letter was issued in 1997 regarding *Ijara* financing.[159] The letter essentially said that the *Ijara* arrangement was within the business of banking and put the lender in a position as a secured lender.[160] The letter stated the "Net Lease proposal is consistent with the well-established public policy of encouraging homeownership."[161]

The second interpretive letter on Islamic financing, issued in 1999, discussed *Murabaha*.[162] It explained that lending can take many forms and that *Murabaha* financing was functionally equivalent to secured real estate lending.[163] The letter stated that the lender was essentially functioning as a "riskless principal;" or a quasi-agent.[164]

By no means did these interpretative letters solve all of the regulatory difficulties faced by the Islamic financial market. An example of a problem still facing the industry is whether state law requires the financial institution to qualify as a licensed leasing company.[165]

Although it is clear that differences exist in the treatment of homebuyers utilizing Islamic financing, it is not clear when, or if, these differences will be eliminated. To see changes that have any notable impact, regulations must be issued and to do this the size of the Islamic banking lobbying in the United States would need to increase.[166]

VIII. ISLAMIC FINANCE AND THE CURRENT FINANCIAL CRISIS

Much of the damage from the financial crisis could have been avoided by Islamic banking requiring that strict adherence to principles laid out in the *Qur'an*.[167] Important parts of the subprime crisis, including repackaging and trading debt along with credit-default swaps, would have been avoided because they are forbidden under

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[156] *See id.*

[157] El-Gamal supra note 5 at 15.

[158] *Id.*

[159] *See id.*

[160] *See id*; *see also* Office of the Comptroller of the Currency, Interpretive Letter #806, Dec. 1997, available at http://www.occ.treas.gov/interp/dec97/int806.pdf.

[161] *Id.* at 9.

[162] *See* Griswold, *supra* note 1, at 432.; El Gamal, *supra* note 5, at 15.

[163] *Id.*; *see also* Office of the Comptroller of the Currency, Interpretive Letter # 867, Nov. 1999, available at http://www.occ.treas.gov/interp/nov99/int867.pdf.

[164] *Id.* at 1.

[165] Rehman, *supra* note 33, at 649

[166] *Id.* at 652.

[167] *Crisis Widens appeal of Islamic Finance supra* note 121.

Shari'a.[168]

One proponent of Islamic banking says *Sukuks* would have prevented the subprime crisis.[169] However, this idea is not reflected in *Shari'a* compliant stocks. Non-*Shari'a* compliant stocks lost 25% of their value in the first three quarters of 2008 compared to a 23% loss in value for *Shari'a* compliant stocks.[170]

Luckily, most Islamic banking institutions did not have the "toxic assets" that led to big write-offs during the financial crisis. [171] An example of this is University Bank in Michigan, which operates University Islamic Financial. According to Amjad Quadri, assistant vice president of development and new markets at University Islamic Financial, University Bank has not seen the kind of defaults other financial institutions saw during the housing market collapse because overall they have made very safe investments.[172]

Bank officials are quick to point out that University Bank has not been immune to problems in the Michigan economy.[173] The Bank has taken back two homes from the Islamic portfolio, which is comparable to the number of defaults on the conventional side.[174] However, they claim "the Islamic portfolio has performed much better than the conventional."[175]

However, Islamic banks may face problems that that do not dramatically affect Western banks.[176] Islamic banks depend on short-term deposit funding.[177] A liquidity freeze could cause greater damage to Islamic banks than Western banks.[178]

Islamic banks are also forbidden from investing in certain assets.[179] The limits on investments may concentrate the Islamic bank's risk more than a conventional bank's risk.[180]

IX. OPPOSITION TO ISLAMIC FINANCE

There are those who oppose Islamic financing. Some believe that the aspiration of Muslims promoting Islamic finance is to replace

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[168] *See* Power, *supra* note 46.

[169] *Id.* Yusuf Talal DeLorenzo, quoted above, serves as an advisor to international hedge-fund mangers, bankers, and asset managers and is one of the world's leaders in the fast-growing Islamic finance market.

[170] Power, *supra* note 46.

[171] Grose, *supra* note 19.

[172] Lara Mossa, *University Bank of Ann Arbor Expands Muslim Lending Unit*, ANN ARBOR BUS. REV., Apr. 10, 2008, *available at* http://www.mlive.com/business/index.ssf/2008/04/university_bank_expands_muslim.html.

[173] *Id.*

[174] *Id.*

[175] *Id.* (quoting Stephen Ranzini, Chairman of University Bank).

[176] *See Savings and Souls, supra* note 12.

[177] *Id.*

[178] *Id.*

[179] *Id.*

[180] *Id.*

man-made laws with *Shari'a*.[181] These people may even believe Muslims are paving the .way for the establishment of a universal caliphate under which everyone would be governed.[182] For most non-Muslims and even many Muslims this theory is unacceptable because it denies choice.[183]

This theory of establishing a universal claiphate may have its roots in the 1920's.[184] Muslim Brotherhood founder Hassan al-Banna's stated the purpose of Islamic finance was to corrupt the Western financial system.[185] For most non-Muslims, and even many Muslims, this theory is unacceptable because it denies choice.[186]

Still, others believe that Islamic banking will lead to the funding of terrorist groups.[187] Most Gulf banks dealing in Islamic financing, however, have fairly sophisticated monitoring systems in place to ferret out money laundering, terrorism, or other abuses.[188] For example, the September 11[th] terrorists did not use Gulf banks; they used Western banks to finance their operations.[189]

Some people even disapprove of the seminars the U.S. Treasury Department has held promoting Islamic banking.[190] Such critics claim that Islamic banking enables the illegal Arab boycott of Israel.[191]

Opposition is not limited to non-Muslims; it is also coming from Muslims themselves. One scholar of Islamic jurisprudence opposes Islamic mortgages because they are merely interest-bearing debt in disguise.[192] Some critics feel that much of today's Islamic financial instruments do not meet the intentions of *Shari'a*.[193] The critics argue that combining *shari'a*-compliant contracts to produce interest bearing loans is the heart of the problem with Islamic finance today.[194] They complain that banks are following the letter of the law, and not the spirit of the law.[195]

The lack of regulation also creates problems with Islamic finance. In conventional banking, investment and banking services are separate.[196] This is not the case in Islamic banking, where the same personnel may be acting as an entrepreneur for the bank and may also

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[181] Rodney Wilson, *Islamic Banking: Opportunity or Threat*, Common Grounds News Service (Jan. 2007), available at http://www.commongroundnews.org/article.php?sid=1&id=20262 (last visited June 6, 2009).

[182] *Id.*

[183] *Id.*

[184] *See* Ehrenfeld, *supra* note 22.

[185] *Id.*

[186] *Id.*

[187] Grosè, *supra* note 19.

[188] *Id.*

[189] *Id.*

[190] *See* Ehrenfeld, *supra* note 22.

[191] *Id.*

[192] Power, *supra* note 46.

[193] *See id.*

[194] Rehman, *supra* note 33, at 636.

[195] *Id.*

[196] Jabbar, *supra* note 10.

be investing the depositors' funds, creating the possibility of insider dealing.[197]

Additionally, the legal relationship between an Islamic bank and its depositors is unclear.[198] The depositor is neither a creditor nor a shareholder.[199] Instead, the depositor is known as an Investment Account Holder (IAH).[200] Investors may be discouraged from becoming an IAH of an Islamic bank because they do not have the legal and regulatory rights of a creditor, nor representation on the board of directors, because they lack shareholder status.[201] This lack of legal responsibility and accountability to IAHs leaves the allocation of profits and losses from the bank's investments completely at the discretion of bank management.[202] In response to this lack of accountability, the AAOIFI and IFSB have issued standards for reporting and transparency.[203]

Unfortunately, the AAOIFI and IFSB standards protect IAHs only through uniformity of reporting and transparency standards.[204] Furthermore, compliance with these standards is not strictly enforced and only a few countries have adopted these standards.[205]

X. FUTURE OF ISLAMIC FINANCE

The facts and figures about Islamic finance are constantly changing. Current estimates show the global market for Islamic finance to be between $500 billion and $1 trillion.[206] Additionally, these figures are expected to grow at a rate between 10 and 15 percent annually.[207]

These numbers may seem large, but Islamic finance still only accounts for about 1 percent of the global financial market.[208] However, one Islamic finance insider says he expected the Islamic finance market to account for 12 percent of the global financial market by 2025; but with the current economic situation now expects to meet that point much earlier.[209]

It is possible, although unlikely, that Islamic finance could become more prevalent than Western finance.[210] The reason for this

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[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *Id.*
[201] *Id.*
[202] Jabbar, *supra* note 10.
[203] *Id.*
[204] *Id.*
[205] *Id.*
[206] Grose, *supra* note 19.
[207] *Id.*
[208] Faiza Saleh Ambah, *Islamic Banking: Steady In Shaky Times*, WASH. POST, (Oct. 31, 2008).
[209] *Id.*
[210] *Savings and Souls, supra* note 12.

possibility is that Islamic finance can service the entire population.[211] Conversely, those seeking *Shari'a*-compliant options cannot use Western financing.[212] Some customers may also see Islamic financing as a safer way of doing business than conventional Western banking systems.[213].

The additional costs, or "piety premiums", of Islamic mortgages will decrease as more Islamic mortgage transactions take place.[214] Lenders are trying to bring the cost of these transactions down. One way money has been saved is by reusing contract templates originally drafted as aircraft leases.[215]

Funding for Islamic mortgages is limited because of the setbacks the Islamic capital market is suffering.[216] Generally accepted *Shari'a* principles allowing for wide spread acceptance by Muslim investors do not exist.[217] Additionally, a number of accounting issues need to be resolved to clarify what an investor is paying for when he invests in Islamic financial instruments.[218] This regulation gap must be bridged to allow for the growth of the industry.[219]

XI. CURRENT ISLAMIC FINANCE OFFERINGS IN THE U.S.

Polls show that about 30% of Muslims would choose Islamic banking based on their personal principles. [220] Some banks are taking advantage of this by offering American Muslims specialized services.[221]

The growth of this industry is evident at Devon Bank in Chicago. Devon Bank began offering Islamic home financing in June of 2003 and Islamic financing now makes up more than half of the bank's mortgage portfolio.[222]

Devon Bank in Chicago offers two different forms of *Shari'a*-compliant home loans: *Ijara* and *Murabaha*.[223] If the *Ijara* method is chosen, Devon bank sets up a trust to purchase the home.[224] The cost of setting up the trust is approximately $500.[225] Over time the customer pays off the purchase price while at the same time paying rent, which is based on interest rates.[226]

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[211] *Id.*
[212] *See id.*
[213] Platt, *supra* note 65.
[214] *Savings and Souls, supra* note 12.
[215] *Id.*
[216] Jabbar, *supra* note 10.
[217] *Id.*
[218] *Id.*
[219] *Id.*
[220] Rehman, *supra* note 33, at 644.
[221] *Id.* at 645.
[222] Katherine Glover, *How Banks Make Islamic 'No Interest' Rule Work*, DAILY HERALD ARLINGTON HEIGHTS, April 22, 2007.
[223] *Id.*
[224] *Id.*
[225] *Id.*
[226] *Id.*

A *Murabaha* financing arrangement at Devon Bank is straightforward.: Devon Bank buys the house and sells it back to the client over time at a mark-up.[227] The cost to the homebuyer in both the *Ijara* and *Murabaha* methods is comparable to the cost of a conventional mortgage.[228]

At University Islamic Financial in Michigan, the down-payment requirements vary depending on the type of financing chosen.[229] *Murabaha* financing at University Islamic Financial requires 5 percent down, and issues financing up to $417,000.[230] However *Ijara* financing requires a larger down payment, 20 percent but also offers larger financing amounts up to $1.3 million.[231]

XII. CONCLUSION

As in every new industry, caution must be exercised in Islamic financing. Some Western bankers may view Islamic finance simply as a business opportunity.[232]

Additionally, to maintain a positive reputation, the Islamic finance industry must be wary of unscrupulous newcomers.[233] These unscrupulous newcomers could easily harm the reputation of the entire industry while still in its infancy.[234]

The future of Islamic banking may be uncertain. It may not replace conventional banking, but will likely stay around.[235] Islamic banking will most likely remain as a specialized form of banking serving only a segment of the population.[236]

Global standards and regulation would encourage the development of Islamic finance globally.[237] For Islamic finance to bring the equity, prosperity, and stability it promises, more needs to be done to standardize the industry.[238]

Islamic banking and finance provide opportunities for many, but those opportunities currently come with costs and a lack of regulation and uniformity.

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[227] *Id.*

[228] Glover, *supra* note 222.

[229] *See* University Islamic Finance, Home Finance, http://www.universityislamicfinancial.com/homefinance.html

[230] *Id.*

[231] *Id.*

[232] Wilson, *supra* note 181.

[233] *Savings and Souls,* supra note 12.

[234] *Id.*

[235] Rehman, *supra* note 33, at 650.

[236] *See id.*

[237] *See id.*

[238] Jabbar, *supra* note 10.