

# *Islamic Financial Institutions in the United States: Viability and Prospects*

ABDEL-HAMEED M. BASHIR

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## ABSTRACT

*Since the prescriptions of Islam prohibit charging or receiving interest, Muslims in the West, particularly those in the United States, find themselves effectively unable to deal with the interest-based financial institutions. Hence, a genuine need arises for establishing financial institutions that serve a growing Muslim population while at the same time adhering to the rules and regulations of the US financial system. The question now is: How can the Islamic financial institutions bridge the gap between religious constraints and financial regulations?*

## INTRODUCTION

**T**HERE IS CONSENSUS among Muslim jurists and scholars that the interest rate charged by conventional banks is the prohibited *ribā*. While Muslims adhere closely to the directives of the Qur'an and Sunnah, it is sometimes helpful to understand the rationale for these prohibitions. It has been argued by many prominent Western economists that the system based on interest and debt is unstable and subject to financial crises. The 1990s witnessed many debt crises in different parts of the world, including Latin America, East Asia and Russia. The single most common factor of all these crises was bank loans made at excessively high rates of interest. When the indebted companies and currency traders defaulted, the whole financial systems tumbled. The Islamic

financial system, based on participation and risk-sharing offers a viable remedy for the world debt crisis. Under the Islamic modes of financing, the lender is expected to share part of the risk of the investment. Accordingly, Islamic financing encourages active participation and asserts that money borrowed is not entitled to a reward. Thus the system of shared risk is expected to reduce the possibility of financial crises and to be more fair and equitable. Hence, Muslims are encouraged to abide by the tenets of Islam and not deal with interest because of the great torment that awaits those who ignore this Islamic injunction. Therefore, it is imperative that Muslims in the West in general, and in the United States in particular, establish financial institutions that provide them with interest-free choices.

Recently, a survey by the Council on American Islamic Relations (CAIR) and other Muslim organizations, estimated the number of Muslims in the United States and Canada to be over 10 million. The survey went further to conclude that sizeable portions of the Muslim community are middle class professionals with a major savings pool.<sup>1</sup> One major lesson to be learned from this recent study is that the Muslim communities in the West are dynamic and changing over time. During the 1960s and 1970s, the pioneering Muslim emigrants (mainly students) were occupied with organizing themselves on college campuses to preserve their Islamic identity. During the 1980s and 1990s, the process had changed to building local institutions like mosques, schools, and Islamic centers, as well as social, cultural, and professional organizations. Certainly, the urgent challenge facing the Muslims in the twenty-first century is building economic and political bases for empowerment and active participation. In particular, Muslims are faced with urgent needs for financial institutions that conform to the tenets of Islam. The absence of Islamically-oriented institutions has forced Muslims to deal with the interest-based conventional system. Notwithstanding the religious and secular constraints arising when dealing with *ribā*-based institutions, Muslim communities found themselves financially weak and marginalized. Being relatively small communities, large financial institutions were uninterested in serving their needs or catering for their religious restrictions. Consequently, the two groups mostly affected by this situation were Muslim consumers and small businesses for, historically, these two groups relied heavily on local banks for their credit and payments needs.

It is imperative that small businesses are supported, because they play an essential role in the economic prosperity of smaller communities. Hence, for all practical purposes, there exists an indisputable demand for financial institutions providing services and products to satisfy the needs of the Muslim clientele. The question is: Why is the development of Islamic financial institutions in the United States so slow or limited? The purpose of this chapter is to shed some light on the factors limiting the growth of Islamic financial institutions within the US financial system. The second section of the chapter focuses on the constraints facing these institutions and how to overcome them. The third section discusses the current state of the existing institutions, their challenges and potential successes, while the fourth section highlights new opportunities and unsatisfied needs. Some concluding remarks are given in the last section.

#### OBSTACLES AND CHALLENGES

Theoretically, Islamic financial institutions have to overcome many obstacles before they can operate in the US financial system. It is important to keep in mind that some of these obstacles have become less restrictive recently. Islamic institutions have a better chance to succeed, given the profound changes just taking place in the US banking industry; the most obvious being mergers, deregulation, information technology, and financial integration. The implications of these changes for the profitability and safety of banks have been widely discussed. Meanwhile, the implications of these changes for Islamic financial institutions are yet to be examined. One may legitimately argue that the current changes will benefit Islamic finance by relaxing the entry restrictions to the financial markets. If Islamic banks are allowed to operate in the United States, (as community banks or national banks), the Muslim communities will have access to financial services that are compatible with the Shari'ah. Surely, regulations such as the Community Reinvestment Act (CRA), which requires banks to lend in all areas in which they take deposits, would certainly benefit Islamic consumers and small businesses.<sup>2</sup> On the contrary, one might argue that the new changes would not be helpful to Islamic financial institutions for two reasons. First, Islamic financial institutions cannot succeed in a *ribā*-based environment because they have to adhere to regulations. Second, because of their size, Islamic institutions will not be able to compete with large organizations created by mergers. None the

less, for Islamic financial institutions to be able to succeed in the United States, they have to overcome certain impediments. These include regulation, innovation, competition, lack of accounting standards, and the perception of the Muslim communities.

#### FINANCIAL REGULATIONS

Until recently, the primary constraint hindering the growth and development of Islamic banks in the US financial markets is financial regulation. If Islamic banks, for example, were chartered to operate in the United States, they would be required to adhere to the same set of rules and regulations applied to their counterparts, regardless of the nature and scope of their operations.<sup>3</sup> The Banking Act of 1933, which requires the separation of the banking and securities industries, was a major obstacle to operating a bank on an Islamic basis.<sup>4</sup> However, until now, Islamic banks were not able to apply for a charter in the United States, because the Islamic modes of contract (*Muḍarabah*) put the depositors' funds at risk, contrary to the safety measures demanded by regulators. Accordingly, the rapid growth (15 percent annually) and the global success of Islamic banks worldwide have led many traditional banks to open windows for Islamic deposits (Citibank). Another major obstacle to the operation of Islamic banks in the US financial system is the reserves requirement. The equity-like nature of Islamic profit-loss sharing (PLS) deposits makes them different than ordinary deposits in a conventional bank. Many jurists and Islamic economists argue against subjecting PLS deposits to reserve requirements. They argue that since PLS deposits are neither guaranteed nor entitled to fixed returns, subjecting them to reserve requirements will be an extra burden on both the depositor and the institution, since reserve requirements provide no returns.<sup>5</sup> Furthermore, deposit insurance (and insurance in general) could also be considered a barrier, given the controversy over the conventional insurance contract. However, the passage of Grann-Leach-Bliley Financial Services Modernization Act of 1999 (GLBA) has made establishing of an Islamic bank in the United States possible and imminent.<sup>6</sup> In particular, Islamic banks would have to pay more attention to their Camel rating (acronym based on five areas: capital adequacy, assets quality, management, earnings, and liquidity) in order to adhere to the US financial regulations.

## FINANCIAL PRODUCTIONS

Another obstacle hampering the expansion of Islamic financial institutions in the United States is the financial instruments available for mobilizing and utilizing Muslims' savings. The current instruments can be classified under two headings: equity-like and mark-up and debt-like instruments. In fact, there are many types of instruments (contracts) in each category, whereby jurists and financial practitioners have established their validity and conformity with the Shari'ah. None the less, the existing instruments are limited in scope and can hardly cope with the contemporary financial needs. Many Muslims and non-Muslims lack a clear understanding of their applicability to this continually innovative financial environment. Hence, Islamic financial institutions have to develop and innovate (financial engineering) short-term financial instruments that satisfy the Shari'ah requirement while at the same time allowing banks to diversify their portfolios and secure short-term funds if needed. Islamic financial institutions also have to invest heavily in familiarizing their potential customers and clients with these instruments before they can expect to attract new customers or survive the competition.

## ACCOUNTING STANDARDS

Another constraint that could be detrimental for the growth and development of Islamic financial institutions in the US markets is the lack of standard accounting principles that facilitate disclosure and surveillance of bank performance. Standardization of accounting policies is just as important for Islamic financial institutions as it is for conventional ones, and for the same reason: to facilitate meaningful comparisons and analyses of results. In most cases, it is not possible to use the conventional accounting principles and apply them to the Islamic financial concepts because the frameworks of the two systems are different. Recently, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has introduced twelve (12) accounting standards, which precisely cover disclosures and the transparency of the balance sheets and financial statements. It is hoped that, by adopting the AAOIFI standards, the nature of Islamic financial institutions business activities becomes more transparent.

## COMPETITION

For Islamic financial institutions to survive in the US financial system, they should be innovative and have sufficient capital. More importantly, the ability of Islamic institutions to exist in a well-developed and highly innovative system depends on whether they can compete with well-established, well-capitalized institutions. In an environment of financial integration, where the securities and insurance companies have recently been allowed to enter the banking business, Islamic financial institutions will face tough competition in both the deposit and financial service markets. Therefore, Islamic financial institutions should be innovative and aggressive in designing new modes of financing in order to attract deposits and provide financial services for their customers.

On the other hand, financial integration would enable Islamic financial institutions to reduce costs and diversify their portfolios to generate more profits and provide competitive returns. The fact that Islamic banks do not guarantee the nominal values of their deposits and do not provide fixed returns creates a strong incentive for risk taking. Hence, it would be necessary to raise the capital ratio to reduce additional hazards. In particular, enough capital is needed to reduce the risk of insolvency (capital ratio more than 8 percent). In a well-regulated financial system, competition is necessary for efficiency and quality. A certain level of competition is required before these institutions can meet the demands of a growing Muslim population.

## COMMITMENT

For Islamic financial institutions to flourish and expand, we need authentic presence and commitment. Authentic presence requires commitment to the Shari'ah from both the institutions and their clientele. More importantly, the Muslim community's awareness of these institutions and its willingness to patronize them are key ingredients for success. An Islamic bank cannot succeed without clients who are committed to the notion of Islamic financing. Equally, the Islamically committed customers cannot patronize a financial institution unless the institution satisfies their religious and financial needs, that is, unless the institution provides services similar to the un-Islamic alternatives available in the market while satisfying the tenets of the Shari'ah. On the other hand, being socially responsible, Islamic financial institutions should operate as community

banks, mobilizing the savings of the community and reinvesting it in the same community. An Islamic financial institution can effectively and efficiently play a social and religious role by pooling the zakah money and redistributing it in the community. However, these institutions cannot succeed unless they become committed to their mission, abide by the Shari'ah, and provide for the financial needs of their customers. Indeed, the mosque, and other social and educational institutions can play a pivotal role in educating the community about the importance of patronizing the Islamic financial institutions.

#### THE STATE OF THE EXISTING ISLAMIC FINANCIAL INSTITUTIONS

Certainly, the enormous bloc of Muslims in the United States cannot be overlooked in the growth and prosperity of the US economy. The phenomenal surge or fall in the US market (as indicated by various indices like DJIA, NASDAQ, S&P500) in the 1990s has inspired many people, Muslims included, to invest in stocks and other financial assets. Consequently, few institutions have emerged to mobilize Muslim resources and provide them with a bridge to economic and financial security. The bulk of the Islamic institutions operating in the US financial markets today focus on assets management, consumer financing, and non-bank activities. Apparently, the success of some of these institutions has inspired companies like the Dow Jones, International Investor, and the FTSE International to launch global Islamic Index series (DJII, TII Global Islamic Index, and FTSE International) to track the performance of investing in Islamic equity funds. Despite being small and fragmented, some of the existing institutions have made major successes in the areas on which they concentrate. In many cases the annual returns have outperformed both large and small capitalizing stocks in the last few years. For example for Amana Income Fund, the average annual return for the last 10 years was 11.69 percent compared with S&P500's return of 17.43 percent, while Amana Growth Fund averaged 17.81 percent compared with Russell 2000's 10.53 percent for the same period. Between 1996 and 1999, the Dow Jones Islamic Index Fund averaged 27.25 percent, outperforming S&P 500 (24.37 percent) and Russell 2000 (12.86 percent). Furthermore, the NAIT annual returns have averaged 6 percent compared with 5.6 percent deposit rates.

## CHALLENGES AHEAD

The absence of interest-free banks from the US financial landscape can be attributed to the American regulations, as stated earlier, or to simple economics. Whatever the reason, the apparent success of existing Islamic funds has attracted many traditional institutions to consider providing Islamic financing (Citibank, Fannie Mae). Realizing the importance of satisfying the religious needs of the Muslim community, the Office of the Comptroller of the Currency (OCC) is reviewing several applications for a charter by Islamic financial institutions. Moreover, the wide use of the Internet has made it possible for foreign banks to provide their services to Muslims in the United States. Online Islamic banking could benefit consumers by lowering fees or increasing returns on profit-loss deposits.

As we mentioned above, the existing institutions have concentrated their businesses on mutual savings (NAIT), real estate financing (UBK/AL-MANZIL, ISLAMIC CO-OP, MSI), car leasing and home financing (LARIBA), mutual funds and assets management (AMANA, DOW JONES ISLAMIC INDEX FUND, ISLAMIQ.COM), and insurance (TAKAAFUL USA). Obviously, the Muslim financial needs are not limited to what is provided by the existing Islamic institutions. One way to describe the problem is to think of Islamic consumers and small businesses. As consumers, people on fixed incomes cannot invest in stocks, which are the focus of these institutions, because of the high risk associated with them. There is, therefore, an urgent need for institutions specializing in Islamically viable low-risk investments to attract the savings of these groups (an Islamic pension fund?). Muslim students are also not well served by the existing institutions. Institutions specializing in student loans are undoubtedly needed to cater for this group. Institutionalizing zakah and *waqf* could be a viable solution to this problem. Muslim communities also need small business for *halāl* products (stores), professional and specialized services, schools, etc. Because of their vital importance to the communities, these small businesses need specialized funding opportunities. Lastly, but not least, Islamic institutions should establish national foundations that give grants for research and community development.

CONCLUSION

The transformation of the banking system, the change in regulations, and information technology can all benefit the Muslim communities in the United States by allowing Islamic financial institutions to operate under both the American regulations and the tenets of the Shari'ah. The success of the existing Islamic institutions has paved the way for new services, new instruments, and new institutions.