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The Capitalization of Islamic Financial Institutions in the United States

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ABSTRACT

This paper discusses the experiences of MSI, Albaraka, the United Bank of Kuwait, and American Finance House – LARIBA in the United States. It also covers the sources of capital available to finance the growing needs of those interested in no-interest financing alternatives. The pros and cons of relying on foreign capital as compared to local capital resources in the U.S. are highlighted. Strategies to raise capital to finance and capitalize the extremely under-financed non-interest industry in the U.S. and the rest of the non-Islamic world are proposed. *Sharīᶜa* experts' opinions in light of the conditions and environment prevailing in the United States are documented.

I. INTRODUCTION[i]

Islamic (LARIBA) financing was first offered to the Muslim community in the United States in 1986-87 by two companies in California: Muslim Savings and Investments (MSI, now headquartered in Houston, Texas) and American Finance House – LARIBA (AFH; http://www.lariba.com). Since that time demand for Islamic financing has grown. In response to this growth, new companies came to the scene. The most significant of these was Al-Baraka Bancorp (a wholly owned subsidiary of the Jeddah-based Dallah Al-Baraka), which started in California, and is now headquartered in Chicago, Illinois. Al-Baraka's entry brought additional liquidity to the poorly capitalized private Islamic finance companies. Most recently, in mid-1998, the United Bank of Kuwait (UBK) started financing mortgages using the lease-to-purchase model in a program called Al-Manzil. In early 2000, however, the United Bank of Kuwait decided to terminate its operations in the United States and focus on the United Kingdom and Bahrain. MSI and American Finance House – LARIBA now are the two major companies serving the U.S. market for Islamic financing products.

We believe that the greatest challenge facing these companies in the coming years will be raising sufficient capital to meet the growing demand. While traditional means of raising capital may be employed, they often do not meet *sharīᶜa* standards. The global challenge for Islamic finance thus takes the form of raising capital in a manner that abides by the regulatory standards of various countries, as well as the rules of the *sharīᶜa*. We estimate that to meet Islamic financing demands in the United States alone, the industry needs to raise roughly $2 billion, $1 billion for mortgage financing and another $1 billion for financing automobile, equipment, and other business purchases.

This paper, therefore, reviews conventional capitalization methods, with a view to developing Islamic alternatives. To motivate this review, this paper begins by highlighting the volume of unmet demand for Islamic financial services, and proceeds to discuss capitalization strategies for generating sufficient liquidity to satisfy this demand.

II. A CONSERVATIVE ESTIMATE OF THE AMERICAN DEMAND FOR ISLAMIC FINANCIAL SERVICES

The primary market segment for Islamic finance companies in the United States is the small segment of American Muslims who refuse to participate in *ribā* under any circumstance. Many of those households have sufficient cash savings to purchase an automobile or household appliance, but insufficient to buy a house without resorting to mortgage financing. Consequently, such households are typically debt-free. It is estimated that this segment represents approximately 2% to 5% of the observant Muslim community, and consists mostly of professionals. It is the moral responsibility of Islamic and investment/mortgage bankers to cater to the needs of this "Puritan" segment of the community. The term "Puritan" is used here intentionally, as it conveys the core principles of American democratic participatory freedom and virtue, through industriousness and property ownership.

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A. The Number of Households

A conservative estimate places the Muslim population of the United States at 6 million Muslims, or 1.5 million households. It can be assumed that 50% of those households can afford to buy and maintain a home, thus giving an estimated 750,000 households that either own or may wish to own a home. If assumed that 20% of these households wish to live according to Islamic law; i.e., praying regularly, attending Friday (*jum*^{c}*a*) prayers and ^{C}*Īd* prayers, paying *zakāt*, and performing *®ajj*, then we have 150,000 households that potentially will use Islamic alternatives to conventional mortgage financing. Finally, assuming that 5% to 10% of this number consists of "Puritans," as defined above, it yields a final estimate of 7,500-15,000 households needing an Islamic alternative. Ten thousand households is a very conservative estimate of the minimum market size for Islamic mortgage financing.

This market segment has a unique profile. Such individuals are extremely pious. They run cash-only households, use banks only for safekeeping of deposited funds, and refuse to accept money market interest. They carry no debt, and fulfill their obligations on time. They are honorable, extremely successful, and reputable. They do not boast about their success and accumulated savings, since humility is valued. They are extremely particular about details of *®alāl* and *®arām* (permissible and forbidden actions, respectively). They do not trust easily, but once their trust is earned, it is earned fully. They are the most creditworthy members of the community. Such individuals can only be identified by Islamic bankers through extensive knowledge of the community at the grassroots level.

B. Market Size

The median price of homes in the United States varies widely from one state to another. A conservative estimate of the median house price in California, for example, is $250,000, compared to $150,000 in Texas. For purposes of this analysis a conservative benchmark price of $150,000 per house is used. If one assumes that 70% of the value of the home is to be financed, then the average Islamic financed amount comes to $105,000. A market of 10,000 households thus represents a demand of about $1,050 million. As the Islamic mortgage concept gains credibility and develops a proven track record, the market can be expected to grow further by attracting younger Muslims, and encouraging older middle-class Muslims to re-finance their homes in an Islamic manner.

If it is further assumed that each household buys one car (often a household owns at least two cars) at a median price of $20,000, then the potential market for car leases in the U.S. is approximately $200 million.

It is also important to note that the population of American Muslims is expected to reach around 20 million by 2025, mainly due to the growth in the number of children born to first-generation Muslim immigrants. This new generation will assume better and more affluent positions in the American infrastructure than their parents, which will improve financing prospects. We believe that the market potential for Islamic home mortgages could reach at least $3 billion. This does not include other community Islamic financing needs, such as automobile financing, small-business financing and construction financing.

III. HISTORICAL OVERVIEW

Islamic banking and financing has grown from a small emerging industry serving one village in Egypt (where it was initiated by the late Dr. Ahmad Al-Naggar) in the late 1960s, to a small but important factor in world financial markets. There are many reasons for the phenomenal growth of demand for Islamic banking, of which the two most important are: (1) The vast capital resources available to many Muslim oil-producing countries in the Middle East; and (2) the initiation, in the early 1960s, of a movement to educate Muslims about the prohibition of *ribā*, when many Muslims became aware of the seriousness of dealing in *ribā*. Many Muslims, in India, Pakistan, the Gulf countries, Malaysia, Turkey, as well as other countries, have become adamant about avoiding *ribā*.

Unfortunately, this aversion to *ribā* began at a time when the Islamic banking and finance industry was unable to handle the resulting demand for *sharī*^{c}*a*-compliant financial services, and the vacuum was filled by unqualified and inexperienced marketers and industrialists. A case in point was the movement of pseudo-Islamic "savings mobilization companies" in Egypt like Al-Rayan and Al-Saad. These companies offered higher returns and helped, to some extent, in recycling people's savings in the local economy. However, due to inexperience, domestic and international political considerations, and operating blunders, they quickly faltered. Their failures dealt a blow to the reputation and credibility of the Islamic banking movement. In the late 1970s, the Islamic Development Bank (IDB) was established as an analog of the World Bank for financing Islamic countries' needs. Islamic banking was introduced officially by many governments (most notably, Malaysia in the early 1980s) as well as private Islamic finance companies around the world in the late 1970s and early 1980s.

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Many international conventional banks are now trying to gain a significant share of the Islamic finance market, which has been estimated at $50–80 billion. Most of these funds are now handled in Europe, mainly in the London financial markets. In 1996, Citibank started "Citibank Islamic" in Bahrain to provide marketing of syndicated financing of major projects in many Muslim and non-Muslim countries. Moreover, Citigroup is currently providing limited Islamic financing services to Islamic finance and investment institutions and high-net-worth Muslim investors and entrepreneurs out of its international operations in New York City and San Francisco.

In the 1990s, the Bahrain Monetary Authority started attracting Islamic banks and financial institutions to its shores. Bahrain has since become the international Islamic banking capital of the world. In the process, new steps to regulate Islamic banks and their operations, financing policies, and auditing standards were taken. It is widely believed that Islamic banking will emerge as an important player in the international banking industry in the twenty-first century.

Islamic banking services in the twentieth century focused primarily on institutional financing of large deals. Most of these deals were in the West. The greatest challenge major Islamic banks face today is learning to complement institutional activities with activities that serve Muslims at the grassroots level. Kuwait Finance House is a case in point, but it is unfortunate that this trend did not catch on in the rest of the world. Islamic banks can and will be able to serve communities better, by providing better services, financial products, and instruments to the average Muslim. In doing so, the first steps toward creating a liquid Islamic capital market will evolve.

The historic boom in equities markets in the USA, Europe, and Asia attracted a large portion of the liquidity of many Muslim investors at all levels: institutional, large, and small. This trend was enhanced by the introduction of Islamic mutual funds and stock market indexes such as the Dow Jones Islamic Market Index and The International Investor's (TII) indexes. The marketing expertise of the mutual fund industry and the world investment banking and brokerage industry successfully attracted large sums of money away from the real purpose of and spirit of Islamic banking, financing, and investing. The authors believe that investing in the stock market should never be the *only* investment strategy of a typical portfolio. Investing in the community, while offering lower financial returns on investment, must be included in any well-designed and balanced portfolio. After all, investing in the stock market carries a much higher risk and does not directly impact the economy of the community.

Islamic banks worldwide have not yet been able to provide competitive financial instruments and products to stem this trend. Thus, they have failed to attract a significant portion of funds being invested worldwide by Muslims.

IV. Learning from the Experiences of Others

If Islamic banking is to reach its potential, banks must follow a basic road map similar to the one conventional banks have followed over the past 600 years. The five main steps are:

1. The mobilization of small-scale savings, and their prudent reinvestment in the community. This provides small-scale savers a low-risk vehicle for earning a return on their savings, while encouraging overall community growth and development. In an Islamic framework, such investments will also abide by the *sharīʿa*, further helping support the ethical and social foundation of the community.
2. In its quest to accomplish these goals, the Islamic banking industry must be aware of the competition posed by conventional banks. This will force the nascent industry to develop instruments that not only abide by the *sharīʿa*, but also seem financially attractive to Muslim homeowners, automobile buyers, and professionals seeking business financing.
3. Islamic financial institutions can gain credibility by highlighting the basic structure of asset-based Islamic finance, thus reducing the risk of "runs on the bank" and other financial disasters.
4. The portfolios accumulated during the re-investment of funds in the community, in mortgages, leases, and financing, can be securitized in order to create liquidity to allow the expansion of an Islamic bank's financing portfolio and investment activities.
5. Larger Islamic banks can act as wholesalers for smaller banks. Thus, large banks can capitalize on their high liquidity and potentially lower overhead costs, and small banks can capitalize on their grassroots informational advantage.

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V. A BRIEF HISTORY OF ISLAMIC BANKING IN AMERICA

Muslim Savings and Investments (MSI) and American Finance House – LARIBA offered Islamic financing and investment services for the first time in America in 1986-87 from the State of California. The two companies offered Islamic home mortgages, car leasing, and equipment leasing.

MSI is considered the Islamic investment arm of the Islamic Circle of North America (ICNA), a major national Muslim organization in North America. The company has since moved from California to Houston, Texas. MSI's funding came from ICNA members, who invested by buying shares, or as a liability against the company. MSI was also funded through the use of a set of diversified limited partnerships that are registered with the Securities and Exchange Commission (SEC).

American Finance House – LARIBA was the first company to offer diversified retail financing services to the community in all fields. It first offered Islamic mortgages using the *murāba®a* (cost-plus) model in 1987. It first wrote Islamic mortgages in California and the U.S. in 1987, for a home in Madison, Wisconsin. Company funding is provided by a limited number of successful businesspersons in the community, who own the company and are capable of meeting any unexpected demand for liquidity. A few sophisticated investors fund the rest of the company and receive a distribution based on the return on its portfolio. All funds come from local community resources that have known each other for a long time.

After a brief visit by Shaykh Saleh Kamel (the owner and founder of Dallah Al-Baraka) to Los Angeles in 1987, Dallah Al-Baraka opened a wholly-owned subsidiary called Al-Baraka Bancorp in 1988. The company relied mainly on the financial and capital resources of Dallah Al-Baraka, its parent. The company also provided "warehousing lines" and "take-out" relationships with some Islamic finance companies in the U.S. and Canada. To a limited extent, this helped these companies expand their activities in the areas of Islamic mortgages and automobile and equipment leasing. In early 1989, the new management in charge of Dallah's U.S. operations decided to change its emphasis to focus on investing in large real estate ventures and industrial projects, reducing its original focus on the community. Al-Baraka Bancorp moved to Chicago and invested heavily in overpriced real estate markets around the country.

In mid-1998, the United Bank of Kuwait (UBK), a British-chartered bank owned by a consortium of Kuwaiti banks, started an Islamic mortgage program, Al-Manzil, through its federally licensed branch in New York City. UBK management invested large sums of money on legal fees in order to obtain approval of its business model from United States banking regulators and the Internal Revenue Service (IRS). Intensive, high-profile, and expensive advertising and promotion campaigns were conducted throughout the country, with some success. In early 2000, UBK decided to terminate its U.S. market operations and to focus on Europe and Bahrain. No formal announcement was made as to what happened and how the bank intended to handle the servicing of the lease-to-purchase agreement, although it held title to all the homes it had financed.

Many other smaller Islamic finance and leasing companies tried to start financing operations, but either stayed very small or discontinued their operations because of a lack of capital and experience.

Reflection upon the experiences learned since 1987 reveals the following important lessons:

1. A local Islamic finance company cannot meet its capitalization needs by merely forging a link with a major Islamic organization such as ICNA or ISNA (the Islamic Society of North America).
2. The association of an Islamic finance company with a large organization with an indigenous political culture may be detrimental to its growth and prosperity. In a finance company, decisions must be made on a purely technical and professional basis.
3. Smaller, community Islamic finance companies do not have the large front-end capital resources to support the necessary marketing, sales, and management capabilities and the overhead support that are commanded by large multinational banking, investment, or real estate firms.
4. Community investing might not be as lucrative to large Islamic banks as investing in the stock market or large real estate deals. The large Islamic banking institutions, because of their understandable lack of knowledge and commitment to the local community, opt for higher returns whether or not this benefits the local community.
5. International Islamic banks, like all prudent business entities, seek the highest returns possible. Thus the planning horizon of these banks is very short, which does not meet the long-term requirements for a strategic commitment to develop Islamic capital markets in the United States.
6. International Islamic institutions understandably prefer dealing with a well-established American firm in leasing, real estate, or other financing activities over dealing with a smaller and less experienced community-owned company.

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7. Large international Islamic financial firms compete with community-owned finance companies. The large non-U.S. Islamic bank or finance company is in the business of gathering assets from its local markets to invest directly in the U.S. The community-owned company does the same, but chooses to invest back into the community. If the non-U.S. company invests with a community-owned company, its return on investment will not be large enough to cover overhead and pay a decent return on its investors' money.
8. There is an element of distrust due to lack of knowledge and of familiarity on the part of community-based as well as non-U.S. entities.

VI. The Task Ahead

The authors believe that the capitalization problems of the emerging Islamic financial industry in the United States can be solved if the financial institutions succeed on the following two fronts:

1. Make investing in community-based companies attractive to large non-U.S. Islamic banks.
2. Toward that end, community-based companies need to increase the rate of return generated by local community Islamic finance.

A. Identifying the Needs of Large Non-U.S. Islamic Banks

International Islamic banks can be classified into two groups: banks with excess funds, and banks with limited funds (adequate only for their local needs). This discussion focuses on Islamic banks with excess funds that need to be invested prudently. Many of these are located in the Gulf countries.

The objective of the strategic investment department of the larger non-U.S. Islamic bank is to increase the return on total bank assets without increasing the risk of investing. In this regard, conventional (*ribā*-based) bankers typically diversify investments among: (i) real estate, (ii) business financing, (iii) retail financing, and (iv) fixed-income investments. Many non-U.S. Islamic banks and investment companies have a diversified investment and financing portfolio, with investments in real estate, stocks, and other businesses, and these tend to be long-term investments. These banks, however, need short-term and medium-term investment vehicles that are Islamic and low-risk, and that substitute for the fixed-income investments in a typical portfolio. Small community-based Islamic banks can potentially satisfy this need.

B. Identifying the Needs of Small Community-Based Islamic Banks

Smaller Islamic finance companies in America need to do three things (the third item is discussed below under "Warehousing Facilities"):

1. Expand assets under management to a critical mass of $25-50 million. Such funding may be raised through a private and/or a public offering. A public offering resulting in trading on a U.S. exchange may also allow Islamic mutual funds to include financial services companies in their portfolios.
2. Develop Islamically permissible means of leveraging raised capital. Many conventional means of leveraging invested equity are adaptable to Islamic law, while others require significant adjustments. Yet others are totally inappropriate. Determining which means fits each category requires further analysis that can be left for later discussions.

Capital leveraging is one of the most common strategies employed by Islamic financial institutions to increase capital availability, financing powers, and return on invested capital. Through borrowing, these institutions can, with a limited capital base, increase the volume of financing services provided, thereby increasing return on shareholders' capital. This strategy is very attractive and extremely rewarding under normal market conditions. However, in case of sudden market changes, such as an increase or decrease in interest rates, or a sudden economic slowdown, leveraging can be detrimental to the company. History shows that excess leveraging has bankrupted many companies. Obviously, this practice is not acceptable from a *sharīʿa* point of view. However, several other types of leveraging may be adaptable to Islamic jurisprudence. They include deposits or non-equity investments, interbank borrowing, securitization, and asset sales. The following sections briefly describe each type.

1. Deposits/Non-Equity Investments

The largest type of leveraging is the practice of accepting customer demand deposits or non-equity investments practiced in conventional banks. These funds are placed with financial institutions for the purpose of participating in the returns of the financial institutions' activities. The funds placed constitute a liability against, and

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a claim on, the assets of the financial institutions. The flexibility and return potential of this type of leveraging makes it very attractive for both the depositors/investors and the financial institutions. This practice was further encouraged by regulatory bodies in the U.S. that control and oversee such financial institutions. Examples are the public and regulatory bodies such as the Federal Depository Insurance Corporation (FDIC) and the National Credit Union Share Insurance Fund (NCUSIF) for banks and credit unions, respectively. Those bodies guarantee the principal investment/deposit amount placed in their respective regulated financial institutions.

Unfortunately, most Islamic financial institutions are non-regulated institutions and, as such, are not allowed by U.S. law to take deposits. Moreover, even if they were allowed to accept deposits, they are at a disadvantage in competing with conventional banks because they cannot offer such federal protection to their depositors/non-equity investors. This makes it more difficult to access this source of funding.

Also, for Islamic banks to use this instrument effectively, sufficient consensus needs to be reached among the jurists and the Muslim community regarding the depositary's authorization to invest such deposited funds. Thus, two sets of regulatory frameworks need to be developed for deposits in Islamic banks: one federal, the other Islamic.

2. Interbank Borrowings

Another type of conventional leveraging involves borrowing from other banks or regulated financial institutions. This could include borrowing from and entering into repurchase agreements with local financial institutions. Borrowing from these sources is typically short- to medium-term and can be secured or unsecured. The borrowings can be structured to fit the needs of the borrowing institution. Given the regulated nature of these entities, the cost of borrowing (i.e., the interest rate) is often based on LIBOR (the London Interbank Offering Rate) plus a negotiated margin to reflect the term and the risk of the transaction.

Creative efforts at Islamic financial engineering are needed in order to develop an Islamically permissible analog of this procedure for Islamic financial institutions.

3. Warehousing Facilities

Warehousing facilities are available to such non-bank financial institutions as mortgage banks, credit unions, and finance companies. These facilities are lines of credit limited to funding specific secured financing transactions, primarily home mortgages, and to a lesser degree automobile and equipment financing. These facilities are usually short-term and are drawn upon to fund financing transactions that meet predetermined credit criteria, with the understanding that the facilities will be repaid within 30-90 days. The proceeds used for repayment are usually obtained from the sales proceeds of the papers (portfolios) of the financing transactions. Providers of warehousing facilities include conventional banks and special asset-based lenders such as General Motors Acceptance Corporation (GMAC), General Electric Acceptance Corporation (GEAC), and Countrywide Funding Corporation.

These lines of credit usually carry a variable interest rate equal to LIBOR plus 1% to 4%. They are secured by the underlying financings (e.g., mortgage deed or lien on vehicle registration) as well as by the corporate or personal guarantees of the non-bank financial institutions. The rates charged on these lines of credit are usually equal to or higher than the rates earned on the underlying financing transactions. Hence, they cannot be relied upon as a permanent source of funding. Non-bank financial institutions most often utilize these facilities to increase the volume of business they underwrite in order to increase financing fees.

This type of financing could be available to Islamic financial institutions. However, the interest rates charged would not meet Islamic jurisprudence, and therefore Islamic financial engineering is needed to provide an Islamically permissible analog.

Finally, the smaller Islamic finance company in the United States needs to:

3. Find an Islamic securitization vehicle for the portfolios of small community-based Islamic banks. Such a securitization vehicle could be developed along lines similar to Fannie Mae's and the securitization of real estate portfolios through mortgage-backed obligations (MBOs), collateralized mortgage-backed obligations (CMOs), or collateralized credit card debt securities.

4. Securitization

Securitization involves the packaging of similar fixed-rate obligations (home loans, auto loans, credit card debt, etc.) for the purpose of selling publicly traded securities to individual and institutional investors. The safety and liquidity of these instruments allow the issuing financial institutions to realize a gain on the sale of the underlying transactions. Moreover, securitization helps eliminate the ongoing credit exposure and fluctuation in returns that are characteristic of the original financing transactions. Due to the costs of structuring and marketing

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such transactions, securitization is often available only to financing lenders that operate at very large volumes. Lenders that wish to securitize their assets but are unable to generate the sufficient volume must consolidate their portfolios with others: by selling their financing portfolios to larger lenders; or by acquiring other small lenders' financing portfolios in order to reach the desired volume.

5. Asset Selling

Asset selling is an option embraced by many lenders, particularly small- to medium-size mortgage bankers and finance companies, that are unable to generate the sufficient financing volume. These entities rely on underwriting transactions for the express purpose of selling the transactions to larger buyers, large financial institutions and public bodies such as Fannie Mae and Freddie Mac. Both buyers and sellers agree in advance on the criteria under which the transactions will be sold and the documentation required for the sales. The sale price is a function of the return at the time of the sale on the financing transactions being sold. For example, a transaction that carries a 10% rate of return when the current interest-rate environment would ask for 8% would be selling at a premium (profit to the seller) of approximately 12 to 20%. The opposite is also true: if general interest rates increase after the transaction is booked and before it is sold, the transaction can only be sold at a discount or loss to the seller.

If structured to comply with Islamic law, this option seems to be the most viable alternative for Islamic institutions originating home and auto financing transactions. If small community-based Islamic financial institutions in the U.S. can provide securitization and leveraging instruments that abide by Islamic law and agree with U.S. government regulations, they can provide large non-U.S. Islamic banks the proper incentive and investing vehicle to participate in the U.S. Islamic finance industry.

VII. Guarded Optimism

It is important for Islamic bankers to understand that conventional liquidity instruments were developed over many years to meet specific needs in particular financial settings. Islamic bankers face the challenge of and the responsibility to:

1. Understand the needs for which such instruments were developed.
2. Offer solutions and creative ideas to meet the needs of the market in a *ribā*-free setting.
3. Manufacture and market competitive new Islamic products that meet the market's needs, test the products, and solicit opinions regarding their legality (from the standpoint of the U.S. regulatory framework as well as of Islamic jurisprudence) from lawyers, jurists, and Islamic financial practitioners.
4. Finally, compare products to their conventional counterparts in order to identify useful niches or correct harmful deficiencies.

Unfortunately, this usually is not done. Many Islamic bankers take conventional instruments, dub them "*®alāl*" or "*®arām*," and, in some cases, force an Islamic "dressing" onto them to make them seem acceptable. Islamic jurists label such practices Hiyal (tricks to circumvent Islamic law). Most scholars denounce Hiyal; Imam Ibn Taymiyah dedicated an entire section of his *fatwā*s (Islamic legal judgments) to condemning a variety of their uses. This does not mean that the use of any conventional financial instrument automatically qualifies as Hiyal. Rather, many financial instruments originated by conventional banks can easily be modified to achieve concord with the *sharīʿa*.

Certificates of deposit (CDs) can illustrate this approach. In a conventional bank, one way to manufacture a CD is to consider a portfolio of loans arranged by the bank and then match that portfolio with a portfolio of CDs. The interest rate paid to the CD investor is lower than the average return of the portfolio; this difference is the interest rate spread. The bank gets the liquidity needed to expand its portfolio and makes a profit in the process, while the CD investor is guaranteed a given interest rate and the preservation of his capital.

American Finance House – LARIBA devised "SPIN CDs" (specific investors' CDs). AFH presents the investor with a specific portfolio, such as *ijāra*-based automobile leases, and explains the expected rate of return in order to assure the small investor that the CDs are backed by assets and can be expected to provide a given return. Using this approach, AFH can plan its liquidity because it fixes the maturity. Moreover, the creation of more liquidity allows AFH to finance additional projects in a *ribā*-free manner while preventing any unexpected run on the finance company.

Other such innovative solutions that abide by the *sharīʿa* are needed to solve the liquidity difficulties of Islamic banks in the United States and worldwide.

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VIII. Potential Alliances with Large International Islamic Banks

An alliance between small Islamic finance companies in the United States and large non-U.S. Islamic banks can help develop Islamic capital markets in the U.S. and elsewhere. Marketing alliances between international Islamic banks and U.S.-based investment banks and brokerage houses can provide an important complement to a typical investment portfolio for the corporate cash management that many Islamic businesses need. Such alliances can also provide appropriate vehicles for the retirement planning of Muslims and non-Muslims in an Islamic and socially responsible manner.

The institutional cash management and/or retirement portfolio of a typical Islamic bank would then include:

- cash that can be invested in an Islamic short-term or money market mutual fund;
- stocks and/or mutual funds (such as the Dow Jones Islamic Market Index, the TII Islamic Indexes of America, or custom-built modifications of the S&P 500 index) that comply with the *sharīᶜa*; and
- an Islamic substitute, such as Islamic MBOs, CMOs, and/or securitized lease obligations, for the fixed-income portion of a portfolio. This is a very important and sorely needed substitute because of the difficulties faced by the treasury of an Islamic institution in reducing investing volatility and risk. Islamic bank managers currently must choose between investing banks' idle cash in conventional short-term money market instruments, earning *ribā* returns, or forgoing any returns. In order to circumvent this dilemma, managers resort to one or more of the following options, depending on the institution's *Sharīᶜa* Board:

    1. Refuse to take interest.
    2. Accept interest and use it for charitable purposes. This approach is based on the *fatwā* of some scholars.
    3. Invest in precious metals such as gold in "cash and carry" forward contracts that are based on LIBOR.
    4. Keep track of the lost opportunities for money market interest, and be rewarded by conventional banks with services and interest-free facilities, the economic value of which should balance out the lost interest.

The above is a list of fallback measures taken by many Islamic banks to minimize their losses relative to their conventional counterparts. While some of these measures may not technically be prohibited from a *sharīᶜa* point of view, they should be viewed as but temporary maneuvers that pave the way for genuine Islamic products. The ultimate goal must be for Islamic bankers of the future to follow Islamic law in spirit as well as letter, but without sacrificing competitiveness in financial markets. It is the *duty* of Islamic bankers to develop and/or find such profitable Islamic financial products.

IX. Potential Alliances with Conventional Banks

Forming alliances with conventional banks might become an important strategic option for small Islamic finance companies in case it becomes difficult to form alliances with large Islamic banks. Moreover, such alliances widen the potential reach of Islamic banking services to all members of the community. Numerous synergies could result from alliances between conventional and Islamic institutions, whereby both can ultimately serve all consumers. The time has come to offer an Islamic banking window as a complimentary banking and financing service to the community. This window should be offered on a stand-alone basis, as an alternative to the current conventional system. The free-market system will be the judge of the real value of this *ribā*-free system to the average consumer in America.

Conventional banks that offer Islamic banking windows would:

1. Apply the strict American regulatory and supervisory environment to Islamic banking practices, products, and services. This will add credibility to the Islamic banking approach and will make its products more reliable and acceptable in the market.
2. Create a larger pool of bankers of all faiths and levels training and experience and who are conversant in conventional as well as Islamic banking. This will enlarge the pool of banking experience, expertise, and creative abilities for the manufacture of new products and services for the Islamic banking industry.

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3. Create the foundation for the beginning of a new banking service—"Islamic banking—that is affordably offered nationwide by a large and sophisticated network of banks.
4. Encourage the Muslim community to participate, with its wealth, in the American economic system, without violating its religious beliefs. This will have a great social impact on the growing American Muslim community and encourage savings.
5. Create an atmosphere of healthy competition between conventional and Islamic banking products. This should benefit both systems as well as the consumer.

X. Legal and Juristic Issues Related to Islamic Windows in Conventional Banks

The problem of dealing with conventional and Islamic financing models within the same institution has troubled many Muslim jurists and members of the Muslim community. The issue is how one can justify, from a jurisprudential point of view, owning a financial institution that deals with *ribā* while simultaneously offering an Islamic banking window. In fact, many puritans and strict Muslims regard this a clear case of hypocrisy and believe that it should never be allowed. This problem has been investigated at length by a number of jurists and scholars, first in Malaysia and later in the Middle East. The following paragraph summarizes the opinions rendered by qualified Muslim scholars on the subject.

The Central Bank of Malaysia (Bank Negara Malaysia) sought the views of three jurists on the permissibility of establishing an Islamic banking window as an additional but unique service offered by a conventional bank. The jurists involved were Almarhoum Tan Sri Ahmad Ibrahim, Dr. Mahmoud Saedon Awang Uthman from International Islamic University Malaysia, and Tuan Haji Mohammad Shahir Ahmad from the Department of Islamic Affairs in the office of the Prime Minister of Malaysia. These view of these scholars is that "a conventional bank, whose operations are conducted on the basis of interest, *is not prohibited from* operating an Islamic window." The conclusion was based on a rule in Islamic legal theory (*usūl al-fiqh*).

XI. Conclusion

Even the most conservative estimate suggests that a huge demand for Islamic investment and financial products remains unmet in the United States. This demand is created by the underserved segment of the population that chooses to live in accordance with the requirements of Islamic law. This demand encompasses the most basic needs, such as financing of homes, automobiles, and businesses. The handful of entities catering to this demand is characterized by its local ownership, small size, and limited capacity. These attributes explain their inability to meet this demand. The incidence of local ownership has led to the stability of firms such as American Finance House – LARIBA and MSI. By contrast, larger foreign-owned firms, despite their ample resources and capacity to meet the demand, lack the corresponding commitment to local communities in the U.S. and require much higher returns than prudent investing can generate.

In order to increase the availability of Islamic financial services, local Islamic financial institutions must increase their capacity in one of the following ways:

1. Access the capital markets. This can be done by arranging a private and/or a public offering. The target customers would include local individual and institutional investors and foreign institutional investors.
2. Leverage capital by borrowing. This can be done through creatively structured facilities, from large international Islamic banks or local conventional institutions. Such facilities include warehousing facilities, take-out commitments, and lines of credit with rates of return tied to the returns generated by certain portfolios. The local Islamic financial institutions can provide the lending institutions with avenues for diversification and sources of secured fixed income.
3. Ally with investment and brokerage firms in the U.S. This allows the packaging of similar fixed-rate obligations (home loans, auto loans, credit card debt, etc.) for the purpose of selling publicly traded securities to individual and institutional investors. This would allow the Islamic institutions to originate more financing transactions without having to hold such transactions on their balance sheets.
4. Ally with conventional banks. This includes offering Islamic banking windows, as a complimentary banking and financing service, within conventional banks. Such windows would offer insurance and investment management services similar to those that the conventional banks currently offer.

It is also recommended that Islamic banking and financial institutions cooperate with each other and specialize in specific banking services, in order to strengthen and further develop the industry in the twenty-first

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century. The strengths of each institution would determine their specialties: retail Islamic banks would cater to the financing needs of local communities; wholesale Islamic banks would serve medium-size to large institutions and corporations; and mega-Islamic banks would serve for their smaller brethren as regional banks of last resort.

The authors firmly believe in the viability of and prospects for the fields of Islamic finance and investment. However, in order to reach the full potential for meeting the large demand for such services, it is crucial to restructure and creatively work to attract capital and investment.

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