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The Challenges of Offering a LARIBA Products and Services Window in an American Bank

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ABSTRACT

Several challenges are met while attempting to own an American community bank in an effort to provide an alternative banking outlet. The bank offers a LARIBA (Islamic) window of banking products and services to meet the growing demands of the 6 million Muslims in the United States. The obstacles encountered included American banking regulators, Islamic legal requirements, and the American Muslim community's reaction to Muslim ownership of a bank offering *ribā* and LARIBA services. Some creative solutions to these challenges are discussed.

I. INTRODUCTION

The American banking system has grown from a community-based banking network to one of the most disciplined and sophisticated banking systems in the world. It offers products and services that meet the traditional needs of the community while at the same time developing new services and products based on technology or focused on expanding the types and quality of financial services and products. The American banking system is going through a revolution such that today's services and products do not resemble those of a few years back. While the American banking system is primarily based upon tradition, to a certain extent it has only recently recognized the financial and banking traditions of a significant segment of the American population—the American Muslim Community. The Community Reinvestment Act ("CRA"), which has played an important part in the American banking system over the last two decades, was originally introduced to allow community banks to gather community savings and reinvest these savings into the community. The CRA has helped communities develop their housing, consumer, and business needs, and has created job opportunities for members of the community.

However, the CRA, as applied by bank regulatory authorities, to a certain extent has missed a major population base in the American society, the American Muslim community. Banking institutions have been unaware of the need to develop products and services geared to this community's needs and beliefs. The American Muslim community has grown over the last 50 years to a current population estimated at 10 million, which is expected to expand to 15 million by 2020, mainly through birth. The community has been endowed with a reservoir of highly qualified professionals, entrepreneurs, business executives, scholars, and students. Due to the unavailability of interest-free banking services, most of American Muslims are compelled to violate one of the most basic requirements of their faith. This paper reviews the experience of the authors in trying to offer an interest-free consumer-banking product through a specialized window in a conventional American community bank.

II. *RIBĀ* VERSUS LARIBA

In today's banking terminology, one can conceptually define *ribā* as unsecured and non-collateralized credit that is not asset- or service-based. In a LARIBA (or NO-*ribā*) setting, the financing activity by a bank is looked upon as an investment by the bank in the individual (or company) in order to help that entity acquire tangible assets and/or services. In this capacity, the LARIBA bank loan officer ensures that the loan has merit and is used for the specified purpose.

Furthermore, an important aspect in LARIBA banking is the absence of a predetermined value measurement for money, which in *ribā* banking is known as interest. In LARIBA banking, the return on investment is obtained as a result of the investment or leasing of the asset in question. That return on investment is the real measure of the value of the investment activity and the location of such an investment activity. The LARIBA banker marks everything to the market instead of utilizing a unified interest rate throughout the country. For

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example, a house rent should reflect the value of that house and not a "cap" rate, as is done in most leases. The rent of two similar homes, one in Alabama and another in California, should be different because of the differences in the costs of living and economies between the two states. This difference should be reflected in the financing process by the lease rate determined by market forces of supply and demand. In other words, LARIBA banking can be defined as a socially responsible and ethical conventional banking service for community economic development that utilizes asset- and/or service-based financing. One way of determining the economic utility of the item to be financed is to look at the lease rate it commands on the market.

Given the extant size and composition, and future growth, of the American Muslim community, the time is ripe for offering a LARIBA banking window as a complimentary banking and financing service to this community. This window should be offered on a stand-alone basis, as an alternative to the prevailing conventional system. The performance of the LARIBA system in a free, competitive market will show its real value to the average consumer of banking services in the United States.

III. BENEFITS OF OFFERING A LARIBA BANKING WINDOW BY A CONVENTIONAL *RIBĀ* BANK

As noted previously, the United States enjoys one of the most well developed financial systems in the world. An advantage of a *ribā* bank's offering LARIBA products and services through a dedicated window lies in the application to the latter of the strict banking, regulatory, and supervisory environment, and competitive practices, enjoyed by U.S. banks. This adds credibility to LARIBA banking and makes its products more reliable and acceptable in the market.

Moreover, such an approach can create a larger pool of bankers of all faiths, training, and experience who are conversant in both conventional *ribā* and LARIBA banking. This can bring a large pool of banking experience, expertise, and creative abilities to manufacture new products and services for the LARIBA banking industry, and can create the foundation for nationwide provision of LARIBA banking services, by a large and sophisticated network of banks, and at the lowest cost. An atmosphere of healthy competition between conventional and Islamic banking products would benefit both the systems and their patrons, who would be offered a choice between conventional *ribā* and Islamically-acceptable LARIBA banking methods. They benefit from the ability to choose from a wider variety of banking, financing, and saving products and services from one organization.

It is also expected that the wider availability of LARIBA banking services would encourage the nation's 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.

IV. COMPARISON BETWEEN THE APPROACHES USED IN *RIBĀ* AND LARIBA FINANCING

In order to contrast *ribā* conventional financing with LARIBA financing, let us consider the following hypothetical situation. A family wants to buy a car for $30,000 but has only $6,000 available at the moment. It approaches a bank to help finance the purchase of the car. A *ribā* banker is likely to go through the following process:

1. Evaluate the application form.
2. Conclude that the family has a steady income and a strong balance sheet; and that its cash flow is sufficient for the purchase of a larger car, or even for a bigger loan on the original car by paying less than $6,000 down.
3. Decide to lend the family the necessary amount at a certain interest rate, payable over a period of time.
4. The repayment period defined by the banker can be longer than necessary because the banker wants to help improve the family's surplus cash flow. In fact, this also helps the bank derive more interest income, as the loan repayment period is extended.
5. In fact, the banker may convince the family to buy a bigger or better-equipped car. The higher amount of the loan will translate into small additions to monthly payments and will be compensated by prolonging the financing period (the term of the loan).

By contrast, a LARIBA banker engages in a distinctly different process:

1. Evaluate the application form.
2. Conclude that the family has a steady income, a strong balance sheet, and good tax returns; and that its cash flow is sufficient to cover the monthly payments for the purchase of the car.

3. Inquire with rental car agencies as well as manufacturers' leasing agencies about the utility value of the car measured by the lease rate.
4. Sign a contract with the family that complies with LARIBA legal requirements. In this agreement:
   a. The family owns 6,000/30,000, or 20%, of the car, while the bank would (temporarily) own 80%. In the same agreement, the family agrees to buy the bank's share of the car for the same value, or $24,000. This way, the bank does not own the asset in order to complies with American banking regulations. The family, based on its cash flow, agrees to pay back the bank's share, interest free, over a period of 3 years, or $8,000 per year. This is the return of capital.
   b. The family and the banker, independently, survey the market to find a fair leasing rate for the car. They negotiate a fair lease and agree on it. Here, the lease is divided between the family (20% in the beginning and rising to 100% over 3 years) and the bank (80% in the beginning and declining to 0% over 3 years). This is the return on capital for the bank. The workings of LARIBA banking mechanically are not much different from a regular amortization schedule. The difference is that the variable in the LARIBA program is the lease rate defined by the market, while the amortization schedule uses the interest rate as the parameter.
   c. The family and the LARIBA banker, in order to satisfy banking laws, sign a promissory note, which documents the repayment of the debt (no time value of money) and the declining lease rate in a total monthly payment. The LARIBA banker uses the monthly payments, representing the lease rate and the return of capital, as variables in a conventional amortization schedule to determine the "implied" interest rate. This rate is disclosed to the client in order to comply with "truth-in-lending" laws.

Note carefully, however, that the resulting "implied" interest rate is not uniformly the same: it differs from one car to another, and differs based on the leasing rate in the relevant market. In a LARIBA environment, the banker encourages the family to pay off its loan as quickly as possible in order to reduce the burden of debt on the family's cash flow.

V. Issues Faced in Offering a LARIBA Financing Window in an American Community Bank

A. Opinion of Jurists about Operating a Bank Using Both *Ribā* and LARIBA Models

The problem of dealing with *ribā* (conventional) and LARIBA financing models in the same institution has troubled many of Muslim jurists and ordinary Muslims. The issue of concern is how one can justify, from a jurisprudential point of view, ownership of a financial institution that deals with forbidden interest and offering a LARIBA banking window through it. In fact, many puritan and strict Muslims believe that this is a clear case of hypocrisy and should never be allowed.

A number of jurists and scholars have investigated this problem at length, first in Malaysia, then in the Middle East. The Central Bank of Malaysia (Bank Negara Malaysia) sought the views of three jurists on the permissibility of establishing a LARIBA banking window as an additional but unique service offered by a conventional *ribā* bank. The jurists involved were Almarhoum Tan Sri Professor Ahmad Ibrahim and Professor Mahmoud Saedon Awang Uthman from the International Islamic University, Malaysia, and Tuan Haji Mohammad Shahir Ahmad from the Department of Islamic Affairs in the Malaysian Prime Minister's office. These scholars stated, "A conventional *ribā* bank, whose operations are conducted on the basis of interest, is not prohibited from operating a LARIBA window." The conclusion was based on the foundation of jurisprudence rule.

Many jurists and scholars around the world have concluded that owning and operating a conventional bank that offers LARIBA products and services, such as lease-to-purchase financing, is not only acceptable but encouraged.[i] Scholars such as Al-Qari and Abdul-Rahman Serri have concurred with this opinion. This, however, does not make *ribā* permissible; the ownership and operation of a conventional bank by Muslims is desirable and encouraged if the intention is to offer LARIBA products as a unique service that can compete with conventional banking products. Such a gradual, clearly planned approach will allow LARIBA banking products and services to be tested by consumers, who make the final decisions about which system they prefer.

B. Concerns Raised by U.S. Banking Regulators Regarding LARIBA Financing Methods

The various bank regulatory agencies responsible for overseeing the American banking system, including the Federal Reserve Board of Governors (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) have only recently begun to address the issues implicated in the provision of LARIBA products and services by conventional financial institutions in the United States. To our knowledge, the FRB and FDIC do not have any interpretive letters concerning LARIBA banking. However, the OCC has been

evaluating LARIBA products by evaluating requests for certain activities by the United Bank of Kuwait in New York City.

OCC rulings forbid a bank from holding title to the property financed. The LARIBA system in fact abides by that rule, for a LARIBA bank holds a lien on the property, like any bank does, in the form of collateral. The question then is whether a national bank can offer residential net lease home finance pursuant to relevant laws.[ii] This question was addressed by the OCC in a study conducted in response to an application made by the United Bank of Kuwait.[iii] The following is an excerpt from the OCC's document.

1. Applicable Laws

The National Bank Act provides that national banks shall have the power to:

> Exercise … all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes…

The Supreme Court of the United States has held that this clause is a broad grant of power to engage in the business of banking, including, but not limited to, five specifically recited powers and the business of banking as a whole.[iv] Judicial precedent reflects three general principles used to determine whether an activity is within the scope of the "business of banking." These principles are:

a. Is the activity functionally equivalent to or a logical outgrowth of a "recognized banking activity?";
b. Would the activity respond to customer needs or otherwise benefit the bank and/or its customers?; and
c. Does the activity involve risks similar in nature to those already assumed by banks?[v]

2. Leasing by Banks

Today, banks structure leases so that they are functionally equivalent to lending secured by personal property. In the M & M case involving a leasing decision, the court noted that in appropriate circumstances, "a lease transaction may constitute a loan of money secured by the property leased."[vi]

The court reasoned, "Because secured lending and personal property leasing are functionally interchangeable, personal property leasing is within the business of banking and is therefore permissible."[vii]

According to the court:

> 1. The business of banking is in constant state of evolution and must be given a broad and flexible interpretation to allow national banks to use modern methods to meet modern needs.
> 2. The comptroller may "look beyond the label given to a certain activity and determine whether or not it is permissible."
> 3. A lease that has the economic attributes of a loan is simply a new way of conducting an activity that is within the business of banking.

The Ninth Circuit Court rejected the "narrow" interpretation of national banks' leasing authority. It stressed that the "functional interchangeability" of leasing and lending was the touchstone of its decision.[viii]

The Court has, nevertheless, laid down several limitations. Only leases interchangeable with loans are allowed. However, a lease, which from its inception inevitably must be repeated or extended to enable the bank to recover its advance plus profit, is not a "loan of money on personal security."[ix] A lease of this type is similar to a rental business. It can expose national banks to risks that they are not permitted to bear.

C. The Human Factor

The human dimension is the most important one facing a LARIBA banker. Individuals in a multicultural and multiethnic society such as that of the United States have different experiences with, varying images of, and possibly unspoken stereotypes toward other ethnic, cultural, and religious groups. This represents a very difficult factor because it cannot be expressed openly and cannot be quantified. That is why we believe that the LARIBA banker should exercise extreme patience, determination, and persistence in order to teach the public and the regulators about the benefits a LARIBA system would bring in its capacity as an alternative to the conventional *ribā* system. It is also important for the LARIBA banker to realize that the United States possesses a deep-rooted policy of separating church and state. Therefore, it would be unwise to present LARIBA banking as an Islamic banking system. While the Islamic faith and principles of just and fair economics inspire the LARIBA system, its benefits

should be made available to persons of all faiths and beliefs. It is the religious duty of every LARIBA banker not to concentrate on labels; the goal, rather, is to bring to participants in retail financial markets the spirit and essence of LARIBA banking.

V. CONCLUSION

The LARIBA (Islamic) banker in the United States must satisfy requirements and rules stipulated by two sources. The first is the body of Islamic jurisprudence, which distinguishes allowable from forbidden financial dealings and transactions. The other source is U.S. banking laws and regulations. The LARIBA banker has to meet and incorporate these requirements in the design of the financing agreement with a client. The LARIBA banker should pay close attention and be extremely sensitive to the important American political principle of the separation of church and state.

The offering of a LARIBA window in a *ribā* bank is not only sanctioned by LARIBA banking scholars, but also encouraged as a duty on responsible community members. The ownership and operation of a conventional bank by Muslims is desirable and encouraged if the intention is to offer LARIBA products and services for those who need them, and to complement what conventional banks provide. This sort of gradual approach will allow LARIBA banking products and services to be tested by the consumers who, in a free market, decide which banking system to patronize.

Finally, a concentrated educational effort is needed to educate several groups. Conventional bankers must be relieved of any fears of the "unknown," their concern about discrimination, and their personal prejudices. Muslim and non-Muslim consumers should understand the spirit of LARIBA banking and the differences in approaches used by conventional *ribā* banking and Islamic LARIBA banking. U.S. bank regulators must be assured that LARIBA banking does not expose the bank providing such services to unnecessary additional risks. As noted, the U.S. Office of the Comptroller of the Currency has sanctioned the lease-to-purchase approach to financing as a legitimate banking activity. The risk of exposing bank capital and bank deposits to market fluctuations in property value is absent because the bank, in a LARIBA contract, does not hold title to the property, but rather holds a first lien on it. This is exactly what happens in a conventional banking situation.

[i] Saleh Malaikah, in a private communication to the authors dated May 17, 1999, noted this. The opinion is based on research conducted by Malaikah.

[ii] 12 U.S.C. §24 (7th) and 12 U.S.C. §371.

[iii] OCC Interpretive Letter #806, December 1997, 12 U.S.C. 24 (7) and 12 U.S.C. 371.

[iv] See National Bank of North Carolina N. A. v. Variable Life Annuity Co., 513 U.S. 251 (1995), 115 S. Ct. 810 (1995) ("VALIC").

[v] See also Merchant's Bank v. State Bank, 77 U.S. 604 (1871); M & M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377 (9th Cir. 1977), cert. denied 436 U.S. 956 (1978); American Ins Ass'n v. Clarke, 865 F.2d 278 (2nd Cir. 1988).

[vi] Id. at 1380.

[vii] Id. at 1382.

[viii] Id. at 1383.

[ix] Id. at 1384.