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Islamic Banking Remarks

*Michael Silva**

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WHILE I have served as a central bank lawyer and official for years, I have had little exposure to Islamic finance until recently. In this respect, I believe I am typical of most U.S. bank supervisors, who have had, for the most part, few opportunities to evaluate Islamic financial products to date. While some Islamic products are offered in the United States, there is currently no Islamic bank per se. But this appears to be changing. The demand for *Shariah*-compliant products is growing in the United States, in response to the demands of Muslim consumers. With that growth, it is imperative that U.S. supervisors understand and adapt as well. As public servants, we have a constitutional responsibility to ensure that our regulations and practices accommodate religious practice to the greatest extent that is possible consistent with our statutes, regulations, and other supervisory objectives.

In this paper, I will review some of the regulatory challenges that an Islamic bank might face in the United States, and also attempt to evaluate these challenges—to gain a view as to the challenges that are significant

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and those that are not as hard as they appear. To a supervisor used to conventional Western-style financial institutions, Islamic banks can, at first, seem difficult to comprehend and understand and perhaps even exotic. At first blush, Islamic banks look to turn conventional banking practices on their head, especially with respect to their prohibition of interest. But in order to serve the needs of the Muslim banking public, regulators must work through their initial perceptions of the exoticism of Islamic financial institutions. When they do, I think that they will find that Islamic banking practices, much like other sophisticated financial practices, can be made compatible with secular law. The regulatory challenges facing Islamic banks are complex, but I think in the end that they will prove soluble.

An understanding of the main principles and practices of *Shariah*-compliant finance is important to better comprehend Islamic banking and financial services. *Shariah* is the Arabic word for Islamic law, also known as the Law of Allah. My understanding is that Islam draws no distinction between religious and secular life. Hence, *Shariah* covers not only religious rituals, but many aspects of day-to-day life, politics, economics, banking, business or contract law, and social issues. Our focus is banking and finance, so I will focus on some of the main *Shariah* principles concerning those areas. The first and foremost such principle is that a person should not make money from money. This restriction is classically manifested as a prohibition against paying or receiving interest, or *riba*. It is also manifested in the concept of shared risk between a depositor and a bank and between a bank and what we would call a borrower. A depositor's fortunes should track the bank's fortunes, and a bank's fortunes should track a borrower's fortunes. Other important *Shariah* principles applicable to finance include prohibitions against speculation, or *gharar*, and prohibitions against investments that might involve substances or activities that are contrary to Islam, such as alcohol or gambling.

In short, Islamic banking is a form of banking with a conscience. Islamic banks each have a *Shariah* board of *Shariah* scholars as well as financial experts who are responsible for determining what activities are and are not *Shariah*-compliant. One of the many challenges Western regulators face in understanding Islamic financial institutions is that the *Shariah* board of one institution may determine that an activity is permissible while the *Shariah* board of another financial institution may determine that it is not.

Turning now to the status of Islamic finance, this has been a period of great growth for Islamic finance worldwide. Some have estimated that there are more than $200 billion in deposits in Islamic financial institutions worldwide, with growth at about 15 percent a year.[1] Much of that growth has occurred on the wholesale investment level. But there has been notable growth in retail banking as well, especially in the Middle

1. Nigel Dudley, *Islamic Finance Needs Solid Foundations*, EUROMONEY, Jan. 2004.

East and Southeast Asia.[2] In the West, we have taken special note of the chartering of the Islamic Bank of Britain last year as the first stand-alone Islamic bank in Europe–a landmark event in the emergence of Islamic banking.

Islamic financial services are expanding in the United States as well, although still on a much smaller scale than in some overseas markets. Again, much of this has occurred in the wholesale market, but a small number of U.S. financial institutions offer products to retail consumers as well. *Shariah*-compliant products have been provided both by conventional banks, such as HSBC, Devon Bank, and University Bank, as a component of their business, and also by non-bank financial institutions, such as Guidance Financial and LARIBA Finance House. These institutions have been particularly successful at introducing home finance products by using Islamic structures that are the functional equivalent of residential mortgage loans.

Despite these noteworthy developments, as of yet, there is no Islamic bank in the United States per se. That is, there is no stand-alone institution that is dedicated to *Shariah* compliance and that provides a full range of banking services–checking accounts, deposit accounts, consumer loans, etc.?to observant Muslims. At the Federal Reserve Bank of New York, we have dedicated ourselves to keeping our ears to the ground on this issue by co-sponsoring and/or attending a number of conferences and meetings on Islamic banking. In this process, we have heard rumblings of potential applications, but still have not seen anything concrete manifest itself yet. Why not? I can only speculate. But U.S. demographics may play a part. Since the census does not survey residents for religious preference, it is hard to quantify the number of Muslims in the United States with any confidence, much less the number of Muslims whose religious observance will motivate them to seek out *Shariah*-compliant financial services. Published figures range from approximately 1 million to 7 million, or roughly three tenths of 1 percent to 3.4 percent of the population.[3] Moreover, the United States is a big country. The Muslim community is more dispersed in the United States than it is in the United Kingdom, for example, where cities such as London and Birmingham contained large, relatively concentrated populations.

Probably more important, however, is that starting a bank, any bank, is difficult. Organizers of a new bank must identify a market in need of their services, develop a profitable business plan, obtain financing, attract and train competent staff, draft procedures and documentation appropriate to their business, and they must undertake the often time-consuming process of gaining regulatory approval.

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2. Nigel Dudley, *Shariah-Compliant Banking Takes Centre Stage*, EUROMONEY, Sept. 2003.

3. Thomas C. Baxter, Jr., Gen. Counsel, Fed. Reserve Bank of N.Y., Welcome Speech at Seminar on Legal Issues in the Islamic Financial Services Industry (Mar 2, 2005).

Starting a new kind of bank is even more difficult. The potential market is uncertain and the institution must design novel products that satisfy both profit expectations and the expectations of *Shariah* compliance; arrange financing; contract an appropriate religious supervisory board; and convince regulators to play along. Most of these challenges are inherent in the process of starting a new kind of bank and must be left to market participants to address. As bank supervisors, we are required to follow the mandates of statute and regulation in evaluating the safety and soundness of a financial institution, and an Islamic bank will be no exception from this principle.

That being said, I believe that regulators also have a constitutional duty, within that statutory framework, to accommodate the free exercise of religion to the maximum extent possible. The First Amendment contains two principles affecting religion: that there neither be a government establishment of religion nor a law prohibiting the free exercise thereof. A corollary of the principle of religious freedom enshrined in our Constitution is that the secular law should adapt, as much as possible, to accommodate differing religious practices. As public servants, we have a mandate to gain sufficient familiarity with Islamic banking practices to ensure that, as much as possible, our secular law does not burden the religious practice of observant Muslims.

It is my impression, from my discussions with other U.S. bank supervisors about this topic, that they accept this. In general, I sense a great enthusiasm and curiosity about Islamic banking practices. Still, along with this enthusiasm, it has also been my sense that many misconceptions persist about what Islamic banks do: what they forbid, what they allow, and how they differ from conventional banking organizations.

It is easy to be overwhelmed by the multitude of issues that Islamic banks may seem to present. Some of the most frequently mentioned include:

(1) their ownership of real estate;
(2) their likelihood of maintaining good programs for anti-money laundering (AML) and Bank Secrecy Act (BSA) compliance; and
(3) whether their deposit products can be approved and insured.

Upon closer inspection, I believe the real estate and anti-money laundering issues are less challenging than they first appear, and may require no greater flexibility than supervisors have shown themselves willing to exhibit in the context of other types of finance. But the provision of *Shariah*-compliant deposit products presents more complex issues that will require further thought and creativity from regulators and market participants.

Let's take a closer look at each of these three areas, starting with ownership of real estate. One of the most frequent issues raised in respect of the potential for Islamic banks to operate in the United States regards whether they would violate restrictions on real estate ownership by banks. Commercial banks in the United States are generally restricted from owning real property, apart from their own premises and parcels they may have acquired through foreclosure proceedings. The latter must generally be sold as soon as practicable.[4] These restrictions have potential implications for some of the most common *Shariah*-compliant, asset-backed loan products, such as *ijara* and *murabaha.*

In general, an *ijara* is a contractual arrangement comparable to a sale/leaseback, where the bank buys and then immediately leases an asset to a consumer for a fee. The duration of the lease and the fee are set in advance, and are in many ways comparable to the terms that might apply to a conventional loan. But paying a fee to occupy a home owned by the bank instead of repaying a mortgage on a home owned by the occupant avoids violating the *Shariah's* prohibitions against the occupant paying interest and against the bank receiving interest. Similarly, a *murabaha* is a cost-plus sale type of arrangement, where a bank purchases an asset on behalf of a customer with the understanding that the customer will purchase the asset back from the bank. The bank's price to the customer includes a stated profit known to both parties, and the payments are amortized across a payment period, similar to a traditional secured loan.

Ijara and *murabaha* techniques have been fruitfully used to finance the purchase of residential property by observant Muslims. Given that these transactions require banks to buy, sell, and hold title to real property, some have mused that these techniques might conflict with U.S. restrictions on bank ownership of real property.

The secular purposes behind the long-standing U.S. restrictions on bank ownership of real property are still germane today: to hinder speculative activity, to ensure that the capital of banks are not tied up in static assets, and to prevent the accumulation of large tracts of land by financial institutions.[5] It is also clear, however, that the risks meant to be addressed by these restrictions are not necessarily present in *ijara* and *murabaha* transactions, where the bank takes title to property only for a limited purpose.

The Office of the Comptroller of the Currency (OCC), as supervisor of national banks, came to this conclusion in reviewing two separate applications in the late 1990s. In 1997 the OCC reviewed and approved a residential *ijara* product and in 1999 reviewed and approved a residential *murabaha* product.[6] Each of these decisions considered the contractual features of each type of transaction in some detail. The agency concluded that the products were the functional equivalent of residential secured lending and, as such, permissible activities for a national bank.[7] While

4. 12 U.S.C. § 29 (West 2006).
5. *Nat'l Bank v. Matthews*, 98 U.S. 621, 626 (1878).
6. OCC Interpretive Letter No. 806, 12 U.S.C. 24(7), 12 U.S.C. 371 (Dec. 1997), *available at* http://www.failaka.com/Library/Articles/OCC%20and%20UBK%20Lease.pdf; OCC Interpretive Letter No. 867, 12 USC 24(7), 12 USC 29 (Nov. 1999), *available at* http://www.failaka.com/Library/Articles/OCC%20Letter%20on%20Murabaha%2011-99.pdf.
7. *Id.*

noting the general prohibition against the ownership of real property and the policy considerations behind them, the OCC determined that these policies were not implicated by the Islamic products.[8]

Moreover, the OCC took great pains to point out that this functional approach was not a novel one, and certainly not one unique to Islamic finance. It cited numerous OCC and court precedents–reviewing bank offerings of everything from net lease products to the sale of mortgage-backed securities?where the economic substance of an activity, rather than its form, was what mattered in determining permissibility for national banks.[9]

Shortly after these decisions, the New York State Banking Department followed the OCC's analysis to approve *ijara* and *murabaha* products being offered by HSBC, and again found that these transactions were the functional equivalent of otherwise permissible activity.[10]

These are good examples of supervisors working cooperatively within their statutory mandate. And it is important to note that neither of these interpretations required a stretch: regulators have considerable experience in evaluating the substance of complicated transactions, experience that can be brought to bear in this context.

Another frequently mentioned issue that I have encountered in this area, and one that has, in my opinion, already taken on out-sized significance in the U.S. perception of Islamic finance, is BSA/AML compliance.

I think that the reason for this concern is probably obvious to most of us: the horrific terror attacks that took place in Washington, Pennsylvania, and a few hundred yards from the Federal Reserve Bank of New York on September 11, 2001. These attacks focused many Americans and their elected officials on risks emanating from the Middle East. As a practical reality, whether fairly or unfairly, the Islamic financial services industry has been subject to extra scrutiny as a result of this.

In the wake of the September 11 attacks, some observers speculated that Islamic banking transactions might facilitate terrorists' access to funds. I think that much of this speculation derived from a rudimentary understanding of Islamic financing techniques–or worse, from stereotypes. For example, some have posited that Islamic deposit products, which typically involve a profit-and-loss sharing (PLS) mechanism rather than the payment of interest, might be susceptible to abuse because their commingling of funds would "creat[e] ready opportunities for anonymous money transfers and settlement."[11] While this type of statement has a surface plausibility, when you get down into the details, it is hard to see

8. *Id.*
9. *Id.*
10. Letter from Jay Kane, Assistant Counsel, N.Y. State Banking Dep't, to Patricia Grace, HSBC Bank USA (Aug. 27, 2001); Letter from Barbara Kent, Assistant Counsel, N.Y. State Banking Dep't, to John G. Holinka, HSBC Bank USA (Apr. 12, 1991).
11. WILLIAM F. WECHSLER ET AL., TERRORIST FINANCING: REPORT OF AN INDEPENDENT TASK FORCE COUNCIL ON FOREIGN RELATIONS 9-10 (N.Y. Council on For-

how a PLS account creates any more risk than any ordinary deposit account. That an account's value may fluctuate up or down depending on the success of a bank's investments–and I will discuss these accounts more fully later–does not, in my view, distinguish it in any meaningful way from an account that steadily accrues interest and moves up and down in conjunction with deposits and withdrawals. Any PLS adjustment to a deposit account can be documented and verified just as easily as any adjustment to a deposit account resulting from the payment of interest, deposits, or withdrawals can be. Perhaps it can be documented even more easily and with greater certainty because the same adjustment will have been made on a pro-rata basis to all of the deposit accounts on an Islamic bank's books.

Other observers have simply conflated Islamic finance with the informal trust-based money transfer system, commonly referred to as *hawala*, that exists in the Middle East and some other Muslim countries, and that did have some role in the financing of the September 11, 2001 attacks. Since *hawala* is often associated in people's minds with Islamic finance, I will take a moment to explain *hawalas* so that you can better appreciate the difference between *hawala* and Islamic finance.

A *hawala* arrangement, in its simplest form, is one where money is transferred via a network of *hawala* brokers, or *hawaladars.* A customer approaches a *hawala* broker in one city and gives a sum of money to be transferred to a recipient in another, usually foreign, city. The *hawala* broker contacts another *hawala* broker in the recipient's city, gives disposition instructions of the funds (usually minus a small commission), and promises to settle the debt at a later date. The unique feature of the system is that no promissory instruments are exchanged between the *hawala* brokers; the transaction takes place entirely on the honor system. Consequently, no records are produced of individual transactions; only a running tally of the amount owed by one broker to another is kept.

The possibilities for untraceable transfers of terrorist funds are obvious. But *hawala* is not related in any way to Islamic finance or *Shariah* compliance and is neither exclusive to, nor universal within, the Islamic world. It is simply a commercial practice that developed in medieval times to safely transfer value over long distances in the absence of any legal or technological infrastructure.

A more subtle concern was expressed by Professor El-Gamal of Rice University in his testimony before a congressional committee hearing earlier this year.[12] Professor El-Gamal's overall conclusion was that "there is no reason – in theory - to suspect that Islamic finance would be particularly immune or particularly vulnerable to abuse by money launderers or

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eign Relations 2002), *available at* http://www.9-11commission.gov/hearings/hearing1/witness_wolosky.htm.

12. Mahmoud El-Gamal, Chair of Islamic Econ., Fin. & Mgmt., Rice Univ., Prepared Statement for the U.S. Senate Comm. on Banking, Housing, and Urban Affairs: Money Laundering and Terror Financing in the Middle East (July 13, 2005), *available at* http://banking.senate.gov/_files/gamal.pdf.

terrorist financiers."[13] Professor El-Gamal worried, though, that Middle Eastern regulators lacked the familiarity with complicated financial techniques that had been developed in the West, and that this lack of expertise might lead to regulators not grasping the purpose of Islamic bank transactions.[14]

While I appreciate Professor El-Gamal's praise for Western supervisors, I do take his point as well. In their supervision of these institutions, U.S. supervisors will need to come up to speed on Islamic financial products in order to appropriately evaluate them for BSA/AML and other risks. That said, as Prof. El-Gamal notes, U.S. bank supervisors often grapple with complexity in our supervision of conventional large complex banking organizations.[15] Our responsibility to carefully supervise such arrangements does not differ in an Islamic context from a conventional context.

The third, and in my view the most difficult category of challenges presented by Islamic finance from a U.S. regulatory standpoint, is the provision of *Shariah*-compliant deposit products.

First, some Islamic deposit products sit comfortably within U.S. statutes and regulations. Non-interest-bearing current accounts and checking accounts fully satisfy the mandates of both secular and religious law. The challenge comes in designing a deposit account for an institution that is insurable by the Federal Deposit Insurance Corporation (FDIC) that will serve the function of an investment or other interest-bearing account, while also observing Islam's prohibition of either paying or receiving *riba*. As a practical matter, any bank seeking a new charter in the United States will probably need to become a federally insured depository institution.[16] To do so, the bank will need to satisfy the requirements of the FDIC and the relevant chartering authority on the structuring of its investment accounts.

Islamic banks abroad typically offer investment products by offering PLS accounts. These are structured so that the bank has something like a joint investment with the depositor, with returns based on a portion of the profits earned by the bank or the bundle of investments made by the bank and not on a set rate. That way, if the bank loses money, so does the account holder. The sharing of risk is a key component of *Shariah*-compliant finance. Without legislative intervention, it may be hard for the FDIC and the relevant chartering authority to approve an institution whose deposit products will allow for the possibility of loss. For example, representatives of SHAPE Financial Corporation have described modify-

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13. *Id.*
14. *Id.*
15. *Id.*
16. *See* 12 U.S.C. § 222 (West 2006); 12 U.S.C. § 1842(e) (banks that are or are part of bank holding companies); state law generally requires that banks be required to have federal deposit insurance, MILTON R. SCHROEDER, THE LAW AND REGULATION OF FINANCIAL INSTITUTIONS §2.01(5)(A) (Sheshunoff Information Services, AS Pratt & Sons Group 1995).

ing a profit-and-loss deposit product it proposed to offer through University Bank in response to the FDIC's requirement that the principal be guaranteed.[17] SHAPE's experience illustrates the challenge that Islamic institutions will face on the deposit side of their business.

An additional difficulty arises from the FDIC insurance itself. Some Muslims consider traditional insurance arrangements to violate prohibitions against both *riba* and *gharar*. This is because a traditional insurance arrangement involves one party paying a premium in exchange for a possible payment on a future date, and this it is thought to resemble gambling.[18]

This is an interesting example of where secular purposes and religious principles seem to collide. To a western bank regulator, deposit insurance is the furthest thing from gambling: it is one of our most important tools to preserve the predictability of consumer deposits and the safety and soundness of the banking system. Given the importance of these requirements under the U.S. bank regulatory system, these will probably require some flexibility from Islamic institutions, together with sincere cooperation from supervisors.

This is what occurred with the Islamic Bank of Britain. Britain has a deposit insurance scheme similar to the U.S. bank insurance scheme. After a long period of intensive consultation with the United Kingdom Financial Services Authority, the Islamic Bank of Britain (IBB) came up with a deposit product that satisfied both secular and religious imperatives. In theory, the IBB's investment accounts have the possibility of both profit and loss. But the bank undertakes to make good any losses on the account.[19] In case of a loss, the bank invites devout customers to sign a voluntary waiver of this offer, in order to comply with *Shariah* law.[20] Depositors who sign this waiver would not be eligible to receive insurance of their deposit in accordance with Britain's insurance scheme.[21]

This is a hopeful example that illustrates the value of flexibility and good will of both the regulator and the regulated. I would hope that the

17. Abdulkader Thomas, *Equity Finance Vehicles: Mudaraba and Musharaka, in* STRUCTURING ISLAMIC FINANCE TRANSACTIONS 54 (Abdulkader Thomas et al. ed., Euromoney Books 2005); *see also* SHAPE Deposit Accounts, UNIVERSITY ISLAMIC FINANCIAL CORPORATION, http://www.university-bank.com/IslamicBanking/deposit.html.

18. FRANK E. VOGEL & SAMUEL HAYES III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN (Kluwer Law International 1998).

19. The bank also undertakes that, in case of a shortfall, (i) it will forego receipt of fees, (ii) it will dip into a profit stabilization reserve to the extent of the shortfall, and (iii) its directors will not declare a distribution to shareholders until there is no shortfall. Islamic Bank of Britain, Consumer Banking Terms & Conditions Current Account & Savings Accounts, http://www.islamic-bank.com/imagesupload/PersonalApplicationForm+TCs.pdf (last visited Apr. 11, 2006).

20. Tim Plews, *Establishing Islamic Banks in the West: The Case of the Islamic Bank of Britain, in* ISLAMIC RETAIL BANKING AND FINANCE: GLOBAL CHALLENGES AND OPPORTUNITIES 37-38 (Sohail Jaffe red., Euromoney Books 2005).

21. Kate Burgess, *Bank Gains Authorization to Accept Deposits*, FIN. TIMES UK, Aug. 14, 2004.

level of cooperation that was achieved between the IBB and the British regulators can be duplicated on this side of the Atlantic. Still, it should be pointed out that innovation may have some limits. The IBB compromise required that their *Shariah* supervisory board become comfortable with this arrangement. Other *Shariah* supervisory boards may or may not take the same view. Thus, it remains a possibility that bank statutes and regulations will allow a certain shape of religious observance in the financial services arena, but will not be able to encompass others.

These are some of the highlights of the issues that might confront an American Islamic bank. But I expect a host of other challenges to present themselves to the operators of an Islamic bank. One area that I consider particularly compelling regards consumer protection. When a customer comes to an Islamic bank, he or she probably does so for reasons that go far beyond interest rates and convenience of service: that customer wants to know that their financial services comply with the dictates of conscience. How does a customer know this? Will regulators have a role in protecting that customer?

A regulator's role in protecting a consumer from suffering harm in a religious context is a delicate one, as the regulator will always need to be mindful of constitutional concerns regarding the government establishment of religion. As an example, you may recall a decision of the Second Circuit a few years back, invalidating New York State's regulatory regime for preventing kosher fraud.[22] The State of New York provided for the inspection and certification of meats that were to be sold as kosher to consumers.[23] A meat packer alleged that New York's standards for what qualified as kosher adopted a view of kosher that was particular to one group of Orthodox Jews and was not one shared by all observant Jews in New York.[24] In reviewing the complaint, the Second Circuit found that the challenged laws "excessively entangle[d] government and religion" because they took sides on a religious question and created an impermissible fusion of state and religious functions.[25]

A supervisor of an Islamic bank might also need to be cognizant of such concerns. Islamic financial institutions generally have a body referred to as a *Shariah* supervisory board that reviews and approves their practices and procedures for compliance with religious principles. Because the interaction of religion and finance can be complex, these boards can disagree with each other on what is compliant with the *Shariah* and what is not. I think that a supervisor would have a very difficult time wading into these waters.

Even absent the religious component, establishing rules regarding unfair or deceptive acts and practices can be tricky. Regulators have wrestled for many years with the question of how to deal with the green

22. *Commack Self-Serv Kosher Meats, Inc. v. Weiss*, 294 F.3d 415, 425 (2nd Cir. 2002).
23. *Id.*
24. *Id.*
25. *Id.*

marketing of products with an eye to protecting consumers who make their shopping choices based on what is good for the environment. The answer may ultimately lie with the securities regulator's best friend: sunshine. Transparency is all the more important for an Islamic bank, given the complexity of their practices, and the importance that their customers attach to how they conduct their business.

Bank supervisors will need to seriously weigh how well existing bank disclosure statutes and regulations can accomplish this goal for Islamic customers. The Truth in Savings Act and the Truth in Lending Act were each passed in order to make sure that customers received certain basic information about deposits and consumer loans, respectively, even as the forms that deposits and loans are furnished grew continually more complex.[26]

Supervisors and Islamic banks will need to think carefully about the disclosures that the current regulations require for an Islamic bank. For example, what disclosures will need to be made regarding a bank's methods for investing and then distributing pooled depositors' funds? Again, I don't pretend to know the answer to these questions at this point, but I present them as an important subject for further contemplation.

Furthermore, I hope that I have managed to convey my optimism about the possibility of chartering an Islamic bank in the United States. There are quite a number of complex questions that will need to be attended to in the chartering of an Islamic bank in the United States, in order to ensure that *Shariah*-compliant banking services are offered safely and soundly, and in compliance with the imperatives of secular law. But coping with complexity is nothing new for bank supervisors. It is very much our stock in trade. I look forward to bank supervisors using this accrued capability, flexibly, and creatively to permit the fullest extent of religious observance that is consistent with our statutes.

26. Milton R. Schroeder, The Law and Regulation of Financial Institutions § 18.05 & § 22.03 (A.S. Pratt & Sons 2005).

Comment