

Chicago Fed Letter

Islamic finance in the United States: A small but growing industry

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This article provides an overview of the potential market for Islamic finance and some of the challenges providers face in serving this unique market.

The Federal Reserve Bank of Chicago has recently pursued a series of projects examining various aspects of immigrants' participation in the U.S. financial system. In this *Chicago Fed Letter*, we explore the demand for and the availability of financial products for Muslims who adhere

regulations. We identify three types of entities that offer Islamic financial products and services: financial entities, nonprofits, and for profit wholesalers and consultants. Drawing largely on interviews with regulators, practitioners, and experts in the field, we find that the few financial entities that offer formal Islamic finance in the United States are often motivated by strong grassroots demand in their local service areas. These entities are often charting new territory in terms of product development and conformity with government regulations. Regulatory issues have not yet been tested on a large scale, and decisions as to whether a bank may offer an Islamic financial product are typically determined on a case by case basis.

Islamic finance is the act of providing financial products or services that conform to Islamic law. It is based on a profit and loss structure rather than a lender-borrower arrangement. A profit and loss structure requires that a financial institution enter into a joint venture with a client in order to provide capital. The risk associated with the joint venture entitles the financial institution to profit from the financial transaction. Although this concept is relatively new to the U.S., various interpretations of it are widely practiced in other countries. In Egypt, Indonesia, Malaysia, Sudan, and the Gulf States, Islamic banking coexists with conventional banking. In some countries, for example Iran and Pakistan, Islamic banks are the only mainstream financial institutions. Islamic finance is also offered in Europe by a small number of conventional banks and through the recently established Islamic Bank of

1. Islamic finance providers in the U.S.

| Name of Institution | Location | Type of institution | Islamic financial products offered |
|---------------------------------|--------------------------|----------------------------------|--|
| LARIBA Finance House | Pasadena, CA | Finance house | Home, auto, and business financing |
| Guidance Financial Group | Reston, VA | Finance house | Home financing |
| Devon Bank | Chicago, IL | Bank | Home financing and business financing |
| University Bank | Ann Arbor, MI | Bank | Interest-free deposits, home financing |
| HSBC | New York, NY | Bank | Home financing, interest-free checking, credit/debit |
| Neighborhood Development Center | Minneapolis/St. Paul, MN | Nonprofit | Small business financing and training |
| World Relief | Nashville, TN | Nonprofit | Small business financing |
| SHAPE Financial Group | West Falls Church, VA | For profit wholesaler/consultant | Home financing, savings accounts, and consulting |
| Reba Free | Minneapolis/St. Paul, MN | For profit wholesaler/consultant | Small business financing models and consulting |

to religious prohibitions against receiving and paying interest. This is an evolving area and the goal of this article is to provide an overview of the potential market for Islamic finance, to describe the organizations that currently provide these products, and to highlight some of the challenges of satisfying both religious tenets and government

Britain. Over the past ten years, the global Islamic finance industry has grown significantly. Today it has between \$200 billion and \$300 billion in assets,¹ representing a very small but growing share of the global banking industry.

Potential demand

The potential size of the U.S. Islamic finance market is difficult to measure. Though Muslims represent a small minority of the U.S. population, the U.S. State Department notes that Islam is one of the fastest-growing religions in the U.S. This growth is partly due to immigration. Immigrant Muslims are mostly from Iran, Iraq, Somalia, Sudan, Afghanistan, and the former Yugoslavia. In the past few decades, the numbers of Pakistani and Indian Muslims living in the U.S. have also grown significantly.

According to the State Department, there is no official count of Muslims in the United States, so we draw from a number of sources, including the American Religious Identification Survey by the City University of New York, the Department of Homeland Security, the U.S. Census Bureau's *Current Population Survey (CPS) March Supplement*, and the Council on American-Islamic Relations' Mosque Study Project, to gauge the potential demand for Islamic finance. The CPS shows 2.1 million Muslims in the United States.² This value is close to the 2.2 million Muslims identified by the American Religious Identification Survey.³ These figures are at the lower bound of the range of published estimates; industry experts, academics, and Muslim leaders place the figure closer to 5 million–7 million.⁴ Currently, the State Department estimates that the majority of the Muslim population in the United States consists of immigrants and their descendants. According to the Department of Homeland Security, Muslims made up about 4% of new immigrants in 1990 and 7% of new immigrants in 2000, representing about 72,000 new arrivals that year. Between 1995 and 2003, the percentage of immigrants in the United States who came from a country where Islam was the majority religion increased from 10% to 14%. Non-immigrant Muslims, which account for more than one-third of the U.S. Muslim population, are mostly African American.

National datasets show that immigrants from predominantly Muslim countries and their children have relatively high

levels of education and income. An estimated 46% have at least a college degree, compared with 23% and 25% of all immigrants and natives, respectively. Similarly, Muslim immigrants and their descendants have median incomes closer to those of natives than to those of immigrants overall. Among religious groups in the U.S., the Muslim population has the highest proportion of adults under 30. Although the numbers do not necessarily imply that these Muslims would use U.S.-based Islamic finance products, they suggest an affluent population whose education and wealth make them familiar with banking institutions.

Another way to infer demand is through the degree of religious affiliation. Experts identify three distinct levels of observance in the Muslim community. The first one-third represents the most observant, who do not use conventional financing. This group represents the core market for Islamic financing arrangements. The next one-third of Muslims consists of those who currently use conventional financing, but might switch to Islamic financing if it became more widely available. The final one-third consists of those who currently use conventional financing and may continue to do so even if a religiously compliant alternative were readily available.

Several surveys⁵ collect information on membership at mosques to provide a greater understanding of the Muslim presence in the United States. Although mosque affiliation does not necessarily imply a demand for Islamic finance, financial institutions have concentrated their outreach efforts on this population. In 2001, there were about 1,400 mosques in the United States.⁶ The states with the greatest number by rank were California, New York, New Jersey, Michigan, Pennsylvania, Texas, Ohio, Illinois, and Florida. Between 1986 and 2001, California, New York, New Jersey, Michigan, and Pennsylvania experienced the most significant growth in the number of mosques. According to one religious survey of the United States, 62% of Muslims are members of a mosque.⁷ Between 1990 and 2001, the number of self-identifying Muslims increased by 50%.

Islamic finance in the United States

A very small number of entities offer formal Islamic financing products in the United States. Some banks customize

loan products for Muslim customers on an as-needed basis, but do not offer a formal Islamic financial product and book these transactions as traditional loans. Prior to 1997, no bank or bank branch in the United States offered formal Islamic financing that was both publicly approved by a U.S. regulatory agency and sanctioned by a board of Islamic scholars, known as a *Shariah* Board. We identify nine institutions that currently advertise formal Islamic asset finance products (see figure 1).⁸

Started in 1987, LARIBA Finance House is the oldest of the organizations and was originally funded primarily by U.S. Muslims. Guidance Financial Group also has origins in the Muslim community and has been offering products for the past two years. Both LARIBA and Guidance have licenses to sell their products in nearly every state. Devon Bank and University Bank are privately owned community banks with six branches between them. Their involvement in Islamic finance has developed largely as a result of their locations in multi-ethnic neighborhoods with high concentrations of Muslims. These banks are also licensed to offer their Islamic home purchase products outside of their primary states of business. HSBC, the only large bank offering Islamic financing in the United States, focuses its Islamic finance activity in the state of New York. HSBC has several other offices in its global Islamic services division overseas.

For the institutions that provide Islamic financing, home financing is the most important source of business. These organizations tend to serve socioeconomically diverse customer bases, although some recognize particularly strong growth potential among Muslims in professional occupations. In contrast, the Neighborhood Development Center and World Relief are nonprofit, small-volume lenders that offer Islamic small business financing mainly to Somali refugees in Minneapolis/St. Paul, MN, and Nashville, TN, respectively, where both communities have large concentrations of Muslim refugees. The Neighborhood Development Center has a mandate to work with the population of very small business owners, while World Relief serves refugees exclusively.

In addition to these entities, SHAPE Financial and Reba Free supply the Islamic finance market with predesigned

Shar'iah-approved products and consultation for the implementation of these products. These are for profit ventures that work with financial entities rather than Muslim customers. SHAPE Financial has successfully marketed its products and services to institutions in the United States, Canada, Singapore, and Lebanon. Reba Free offers its products and services mainly within the Minneapolis/St. Paul, MN, metropolitan area.

U.S. financial institutions that offer Islamic finance products typically offer *Murabaha*, *Ijara*, and *Musharaka* financing. These types of financing are for purchasing homes, cars, and small businesses. A *Murabaha* transaction is structured so that the financial institution purchases the desired asset for the customer and then sells the asset to the customer in monthly installments at the acquisition price plus an agreed profit rate. In an *Ijara* transaction, the financial institution purchases a desired asset and then leases it to the customer over an agreed period. The client has the option of purchasing the asset in its entirety either during or at the end of the leasing period. The *Musharaka* transaction is a declining balance or shared equity purchase, whereby the financial institution provides a percentage of the capital desired by the client. The financial institution and the customer proportionately share in profits and losses in accordance with a formula agreed upon before the transaction is completed.

In addition to the lenders, a handful of Islamic investment firms, including Saturna Capital, Azzad Asset Management, and Allied Asset Advisors, offer mutual funds, growth funds, and income funds that are *Shar'iah* approved. These are U.S.-based companies begun in the late 1990s that cater specifically to the U.S. Muslim market. Some also offer financial planning services for higher education and retirement. One basic standard to which these funds must adhere is that the money be invested in pre-approved businesses—excluding, for example, producers of alcohol and pork-related products, providers of conventional financing, and providers of entertainment services. Another standard is that money cannot be invested in financial derivatives or debt products. While some funds research their own set of *Shar'iah*-approved companies, others purchase a license to the Dow Jones Islamic Index, an Islamic equity

benchmark. Obtaining a license to the Index gives investment managers access to a list of *Shar'iah* approved companies. The assets of U.S. Islamic investment funds are estimated at \$112 million. While this number is a small fraction of the total assets of all mutual funds, these firms have recorded strong annual growth since their creation.

Challenges

Providers of Islamic finance in the United States face two principal challenges. One challenge is to offer products that conform not only to Islamic religious doctrine, but also to state and federal regulation. For example, the National Bank Act of 1864 prohibits banks from the purchase, holding of legal title, or possession of real estate to secure any debts to it for a period exceeding five years. This would seem to prohibit many Islamic home finance products. However, in two interpretive letters, 806 and 867, the Office of the Comptroller of the Currency (OCC) concluded that particular versions of *Ijara* and *Murabaha* transactions can be considered exceptions to the National Bank Act rule if they meet the standards for functional equivalence to conventional asset financing. The specific standards that must be satisfied are that: 1) the underwriting standard used in these models must incur the same risks as that of a conventional loan; 2) the risk incurred by the bank if a customer defaults on payments must be the same as that of a conventional loan; and 3) the risk from the bank's holding of legal title to the property must be the same as that of a bank providing a conventional loan.

The OCC specifies that the standards set forth in the two interpretive letters, including the structure of the *Ijara* and *Murabaha* models, must be strictly adhered to in order to receive approval. At this time, no other agency rulings have been made. This suggests that the functional equivalence standard may vary if it is applied by different regulators.

The second challenge for financial institutions involves the cost of offering new products that have little precedent in the United States. The cost includes research required to develop innovative methods of financing, the design and production of new financial documents to accompany the products, consultations with religious and regulatory experts, and the training of staff in different

home purchase procedures. Some costs are passed on to the customer but many are absorbed by the financial institution. Islamic financial products tend to generate less profit on a per transaction basis than conventional products, although, for most of the providers, the volume of these sales has compensated for the increased costs.

A further potential cost relates to the sale of Islamic financial products in the secondary market. To date, three of the institutions that offer formal Islamic finance have sold their specialized “mortgages” to Freddie Mac, and one of these has also sold to Fannie Mae. Despite the importance of securitization to the growth of this industry, other opportunities for selling assets on the secondary market may be limited. According to bankers, traditional bondholders may be unfamiliar with the underlying structure and risks of these transactions. Rather than sell to conventional investors, some of the purveyors of Islamic finance have sought to build more complex financial products that would be marketable to Islamic investors domestically and overseas. Indeed, Guidance Financial's motivation in entering the market was to be the first to build financial instruments from Islamic home financing contracts that would allow Islamic investors to invest in mortgage-backed securities. Meanwhile, *Shar'iah* boards differ in their

Michael H. Moskow, *President*; Charles L. Evans, *Senior Vice President and Director of Research*; Douglas Evanoff, *Vice President, financial studies*; David Marshall, *Vice President, macroeconomic policy research*; Richard Porter, *Senior Policy Advisor, payment studies*; Daniel Sullivan, *Vice President, microeconomic policy research*; William Testa, *Vice President, regional programs and Economics Editor*; Helen O'D. Koshy, *Editor*; Kathryn Moran, *Associate Editor*.

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opinions as to whether all models of Islamic financing can be sold on the secondary market. Some permit a bank to sell a note only if it represents an interest in the property by the bank, while others uphold a more flexible standard. The specific rules enforced by religious authorities are likely to affect the appeal of these products both to Islamic investors and to financial institutions.

In addition to specific costs related to Islamic finance, banks also face the typical expenses from offering any new product. However, financial institutions offering Islamic finance products report relatively low marketing and advertising costs due to heavy reliance on word-of-mouth communication by mosque attendees and real estate agents.

Conclusion

Islamic finance is thriving at a small, local level, where interest from Muslim communities has prompted financial

institutions to offer products that comply with state and federal regulations, as well as with *Shar'iah* law. As a result, religiously observant Muslim families who previously thought they were unable to purchase a home are now able to become homeowners. Islamic finance is sometimes better understood by the banks and finance houses that have developed and marketed the Islamic finance products than by the regulators whose approval they need. However, the regulatory agencies are interested in building their knowledge in this area. For example, the U.S. Treasury currently hosts an in-house Islamic finance scholar, so that its staff can better understand the issues as part of an international effort to design a regulatory framework for Islamic finance.

Although the Islamic finance industry has grown in the U.S., there are still some questions that remain unanswered. One question on the minds of industry policymakers is the scope of national demand

for Islamic finance. This may be a less pressing concern for individual banks that are responding to abundant demand in specific areas. Another question is how strictly Islamic finance products have to adhere to *Shar'iah* principles before a Muslim individual will become a new customer or switch from conventional to Islamic financial products. Islamic scholars would argue that even the most *Shar'iah*-compliant products in the United States have their limitations. Finally, a key issue for regulators involves understanding the risks associated with Islamic financial products. Currently, both banks and their regulators assess risk according to the "functional equivalent" standard established by the OCC. Federal and state regulatory agencies have stated their intention to hold regional discussions with financial institutions aimed at developing regulatory standards that take into account the institutional and systemic risks of Islamic financial products.

¹ Under Secretary of Treasury John B. Taylor, 2004, keynote address, delivered at the Forum on Islamic Finance at Harvard University, May 8.

² In the CPS data, we define Muslims as those who were born in a country where Islam is the majority religion or have a parent from such a country. These countries are defined as those where more than 50% of the people are Muslim, according to the *CIA World Fact Book*. It is not an exact measure, but the closest given a lack of survey questions on religion.

³ The American Religious Identification Survey asks Americans to identify their religious affiliation. It reports between 2.2 million and 2.8 million Muslims, including African Americans.

⁴ The Council on American-Islamic Relations surveyed mosques across the United States in its Mosque Study Project 2000. It found that 2 million Muslims were affiliated with mosques. However, not every Muslim is affiliated with a mosque, and typically only the household head of a family is affiliated.

⁵ CUNY American Religious Identification Survey; Hartford Seminary's Hartford Institute for Religious Research, as reported by the U.S. State Department.

⁶ Data collected from the U.S. State Department.

⁷ CUNY American Religious Identification Survey.

⁸ Information from interviews with officers of the organizations and from their financial literature.