

*Islamic Finance in the US: What Are the Challenges to Overcome in order for  
the Industry to Subsist Viably Under Secular Regulation?*

**Fatimah S. Baeshen**

**University of Chicago, Center for Middle Eastern Studies**

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## **Islamic Finance in the US: Introduction**

Islamic Finance is making its United States' debut. Due to the current economic downturn in the US, curious minds, opportunists, and even policy makers<sup>1</sup> are looking for innovative investment strategies. Given that the global Islamic finance's industry's estimated asset worth stands at \$200 billion dollars with a 15% CAGR,<sup>2</sup> it appears to be a resourceful arena to investigate. Plus, Islamic financial markets are holding up relatively well, compared to their conventional counterparts during this global financial crisis, due to their intrinsic investment principles. But, the United States still seems hesitant to completely accommodate the industry. Although there are conventional institutions that offer Islamic financial products; there are not any Islamic financial institutions that operate as such, e.g., a fully Islamic bank. Even though the United States is home to roughly five to eight million Muslims from each corner of the Islamic globe;<sup>3</sup> it seemingly lingers behind the United Kingdom-another "western," non-Muslim country,<sup>4</sup> in comprehensively accommodating this religious financial sector. This point is further substantiated given that 'Islamic banking' licenses are not issued by

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<sup>1</sup> The US Treasury department recently held an "Islamic Finance 101" workshop in October, 2008; following a visit to Saudi Arabia, which included meetings with the Ministry of Finance, the SAMA, and prominent entrepreneurs, such as Prince Al-Waleed.

<http://www.worldnetdaily.com/index.php?fa=PAGE.view&pageId=80003>

<http://www.arabnews.com/?page=6&section=0&article=115802&d=26&m=10&y=2008>

<sup>2</sup> Compound Annual Growth Rate (CAGR): ISI Analytic Report, Islamic Financial Services Industry: 2007. Pg.34. This is a conservative estimate. Figures vary from \$200Bn - \$800Bn.

<sup>3</sup> Estimates vary from 3-10 M.

<sup>4</sup> <http://www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml> (with only a fourth of the Muslim population of the US- if we accept the 8M statistic for the US)

financial regulators in the US. The issue, then, is subtext of a larger matter-how do secular countries<sup>5</sup> accommodate observant citizens of religious communities?

The large scope of the broader question is too wide to comprehensively distill in the forthcoming pages, but it hints at the inevitability of inter-disciplinary approaches in comprehending Islamic banking. Since I cannot feasibly explore the larger question, there will naturally be gaps in addressing the US response to Islamic finance. A more thorough work would assess the sovereign-relationships among states, religions, and selves. Still, my inquiry will draw widely from related spheres of scholarship: economic, religious, historical, political, and legal, in order to address the US response to Islamic finance.

### **Islamic Finance in the US: a Brief Note on Scholarship and My Approach**

Abundant scholarship exists on Islamic finance in a global context: its relation to conventional finance, regularity challenges, growth, historical evolution, etc. This point could be substantiated further by the spectrum of academic opinions regarding the industry's authenticity; ranging from a genuine attempt at *Shariah*-compliant banking to a masked-poser of conventional finance. Later in this work, I will address some of the various positions in the academic field-mainly Ibrahim Warde's and Mahmoud El Gamal's; however, the important message to convey here is that the crucial dialectic to explore and question Islamic finance on the international finance stage is taking place; i.e., there is a defined academic space with

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<sup>5</sup> The UK is not a secular nation; however, the relationship between 'Church and State' is so minimal that one could draw a fair comparison between the US & the UK. Ibrahim Warde discusses this further in his book, which has a specific chapter on Islamic banking in the UK.

numerous participants that systematically discuss the industry in a global context. This scholarship, in turn, gleans together Islamic finance's successes and challenges, but also identifies the progressive steps the industry needs to take in order to productively evolve. However, the same cannot be said about Islamic finance-specifically- in the United States. There is a salient gap in academic discourse surrounding Islamic finance in the domestic arena. This is likely due to very recent interest in the United States to learn more about Islamic financial practices; given that the industry has fared better during this tumultuous economic climate.

In light of this, my research approach is both constructive and heuristic. That is to say, I attempt to tersely construct Islamic finance's historical, religious, evolutionary, and eventually, domestic narrative against a global socio-political, economic backdrop in order to distill its successes and challenges. Given that there are not adequate sources on the US Islamic finance environment, constructing the narrative is an integral part to this research in so much that it, hopefully, leads down a heuristic path.

First, I define the term Islamic finance and extract its religious roots from economic and historical frameworks. Then, I use secondary sources on Islamic finance's global context to distill its modern evolution,<sup>6</sup> highlight the crucial regulatory organizations stemming from its growth, and explore the industry's successes and challenges.<sup>7</sup> Employing a legal theoretical framework, I then survey Islamic finance's subsistence outside the Muslim world- first, in the

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<sup>6</sup> Warde, Ibrahim: Islamic Finance and the Global Economy

<sup>7</sup> Archer & Karim: Islamic Finance and the Regulatory Challenge

United Kingdom and then the US. Although the majority of this work refers to Islamic finance; I use 'Islamic banking' as proxy to provide a specific example for my UK-US comparative assessment, as well as distilling some of the global challenges the industry faces.

Considering the lack of scholarship on the industry in the US, I construct the US narrative by interviewing finance regulators and practitioners to distill how the industry peripherally exists in the domestic landscape.<sup>8</sup> I also offer a possible solution to alleviate its fragmented existence in the US using two theories: Ibrahim Warde's dual regulation and Jurgen Habermas' political communicative theory in post-secular societies. Finally, I close with a call for more scholarship surrounding Islamic finance in the US.

The goal of this exploratory work is to contribute to the nascent conversation taking place regarding Islamic finance in the United States and shed light on areas that need further research by constructing the industry's US narrative. 'Islamic banks' do not exist in the United States because there are no 'Islamic banking' licenses being issued. Although this may seem as though regulators are purposely blocking the industry's growth, this is not the case. After interviewing several regulators from across the financial regulatory arms; i.e., the Office of the Comptroller of Currency (OCC), the Federal Deposit Insurance Company (FDIC), the Federal Reserve Bank (FRB), I am convinced that regulators are open to accommodating the industry overall; as long as the proper channels are in place that will allow them to adequately oversee financial transactions. Given that there are some Islamic practices that are incongruent with

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<sup>8</sup> I also use news and journal articles, but again- there is nothing in the form of a book that comprehensively addresses Islamic finance in the US.

current conventional financial standards; e.g., profit-loss sharing (PLS) deposit structures, there are certainly obstacles to overcome. However, systematic dialogue among the participating parties; practitioners, financial regulators, and *Shariah* scholars, can attenuate such issues. Thus, my research objective is a heuristic one; driven by the anticipation that this attempt will spark the US Islamic finance dialectic.

### **Islamic Finance in the US: a Contemporary Definition**

Before constructing a narrative surrounding Islamic finance in the domestic arena, I will relay a definition of the term 'Islamic finance' posited by Ibrahim Warde; then, distill the religious foundations intended to drive the industry. The latter part is crucial for a terse understanding of the broader question stated earlier regarding how do secular functioning states accommodate religious communities. Then, I will shift my focus to the historical evolution of modern Islamic banking, which will clarify the root of the challenges the industry faces today. The global obstacles- due to lack of regulatory consistency- advertently stump the industry's domestic growth. But, first, let us begin with a working knowledge of the term 'Islamic finance.'

Warde opens his work with the following caveat; "Islamic finance is a complex and paradoxical phenomenon," to possibly warn his reader that the task of drawing concrete parameters around this field is not an easy one, i.e., there is no clear cut definition.

Nonetheless, he goes on to posit the following:

*“Islamic financial institutions are those that are based, in their objectives and operations, on Koranic principles. They are thus set apart from ‘conventional’ institutions, which have no such preoccupations...Two aspects of Islamic finance must be singled out. First, the risk-sharing philosophy...Second is the promotion of economic and social development through specific business practices and zakat (almsgiving). ...In sum, the defining difference is that while ‘conventional’ finance usually seeks profit-maximization within a given regulatory framework, Islamic finance is also guided by other, religiously inspired goals.”<sup>9</sup>*

Unlike some definitions that reduce the field to nothing more than ‘interest-free financing’ or ‘profit-loss sharing techniques,’ Warde’s description is mindful of the various elements that encompass this industry, such as, religion, social conscientiousness, and fair practice. He even hints at capitalistic elements prevalent in the industry. Warde’s definition is sufficient and comprehensive because he draws from an Islamic economic base; although he does not venture deep into an economical sphere.

Zamir Iqbal and Abbas Mirakhor focus on the Islamic economic elements in their work, **An Introduction to Islamic Finance: Theory and Practice**, which are crucial to understanding not only Islamic finance- but Islam, in general. Their approach in defining Islamic finance forces the non-Muslim inquisitor to shed the self-imposed teleological view and understand the industry autonomously; as more than a strictly transactional facet of Muslim life. Iqbal and Mirakhor provide a robust background to the term ‘Islamic finance’ by painting the larger Islamic picture- economically and, more importantly, socially- thorough an Islamic economic paradigm which includes five components.

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<sup>9</sup> Warde, Pg. 5

First, they discuss the concept of “Justice and Equity:” “The notion of justice and equity from production to distribution is embedded deep into the system...social justice in Islam consists of the creation and provision of equal opportunities and the removal of obstacles equally for every member of society.”<sup>10</sup> Then, they shift their attention to man’s relationship to material goods: “The Islamic paradigm incorporates a spiritual and moral framework that values human relations above material possessions.” Next, Iqbal and Mirakhor, with in the same Islamic economic framework, directly address the notion that Islam is socialist, communist, or capitalist by saying:” The Islamic system creates a balanced relationship between the individual and the society. Self-interest and private gains...are not denied, but they are regulated for the larger betterment of the collectivity.”<sup>11</sup>

They go on to discuss the concept of Time Value of Money (TVM) in Islam, which intrinsically denotes a high-level of acceptance for profit.<sup>12</sup> In other words, Islam encompasses, within it economic framework, elements of socialism, communism, and even capitalism, but does not advocate for any one economic system over the other. As a comprehensive doctrine, Islam supersedes the temporal concept of ‘an economic system;’ however, it simultaneously recognizes individual gains whilst necessitating efforts towards a collective good. Thus, ultimately, Islam is neutral with respects to its economic advocacies.

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<sup>10</sup> Iqbal, Zamir & Mirakhor, Abbas. An Introduction to Islamic Finance: Theory and Practice. John & Wiley Sons, Singapore: 2007. Pg. 17.

<sup>11</sup> Ibid

<sup>12</sup> Iqbal & Mirakhor: Pg. 61.



The fourth component of their Islamic economic system reinforces the above comment regarding individual wealth: “The individual’s pursuit of maximum profit in enterprise and maximum satisfaction in consumption are not the sole objectives of society and any wasteful consumption is discouraged.”<sup>13</sup> This also speaks to the concept that wealth is ordained by God, which will be discussed further later. Finally, the fifth facet relates to property rights: “Recognition and the protection of property rights of all members of the society is the foundation of a stakeholder-oriented society...”

Defining Islamic finance, couching it in a social responsibility framework, and understanding its economic intentions allows for an inclusive purview into the ethos intended to drive the industry. Between Warde and Iqbal & Mirakhor’s explanations, we begin to understand Islamic finance within its own right and as part of a larger comprehensive doctrine. Their explanations are crucial to our contemplating the broader question regarding how secular states accommodate plural religious constituents; and ultimately, how the industry can viably subsist in the US.

### **Islamic Finance in the US: Islamic Law 101\***

Having established an in-depth definition of Islamic finance, we must turn to the derivation of its principles. The term “*Shariah*” in Arabic can translate to ‘path to the water source.’ Muslim tradition equates it to the ‘Divine Way.’ *Shariah*, then, is a pure morality that learned Muslim scholars attain through Islamic sources and promulgate to the rest of Islamic

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<sup>13</sup> Iqbal & Mirakhor: Pg. 17.

society. *Shariah* is not a static system of laws, but rather-theoretically- a series of interpretive accretions obtained by religious scholars who study sources of Islamic jurisprudence. *Usul al fiqh* (roots of the jurisprudence/law) is the Sunni framework through which Islamic law is derived. It constitutes the following sources: the *Quran* (Muslims' holy book), the *sunna* (the ways of the Prophet Muhammad\*\* captured in the *Hadith*), *ijma* (consensus), and *qiyas* (reasoning).<sup>14</sup> Subsequently, scholarly interpretations of the sources sometimes vary due to different regional cultures across the global Muslim community. This is imperative to note; as we shall later see that various interpretations of the *Shariah* affect Islamic finance globally. Thus, understanding the cause of these variances will ultimately provide insight into some of the industry's biggest challenges.

Islamic law, during its early period in the eighth and ninth century, witnessed a phase of rapid growth when early jurists attended different religious scholars' circles and shared their interpretations of the sources mentioned above. According to Sunni tradition, four jurists' methodologies' stood the test of time and crystallized into Islamic schools of jurisprudential thought, i.e., *madhahib*, which display their respective jurists' eponym. The Hanafite, Malikite, Shafi'ite and Hanbalite Schools thrived and exist still today. Although most juristic circles originated in Iraq and the Arabian Peninsula, school identification shifted over time to different geographical regions within the global Muslim community. The Hanafite School sustains a

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\* This paper's focus will be on the developmental history of Islamic law based on Sunni traditions.

\*\*Peace be upon him

<sup>14</sup> Schacht, Joseph. An Introduction to Islamic Law. Oxford: Clarendon Press, 1982. Pg. 60.

general following in Central Asia and parts of the Levant. The Malikite School predominately exists in North and West Africa. The Shafi'ite School maintains robust adherences in Southeast Asia/Asia Pacific. And, the Hanbalite School governs societal norms in the Arabian Peninsula.<sup>15</sup> Of course, there is some regional over-lap in practices and judgments; however, the above break-down portrays the common geographical locations of the *madhahib* today.

The *madhahib* historical narrative briefly constructed above lends insight into the fragmentation concerns in Islamic finance today, which in effect, make implementing standard regulation practices difficult in both Muslim and non-Muslim countries. *Shariah* scholars issue religious decrees, *fatwas*, based on their respective *madhib* loyalty. Since not all religious scholars follow the same Islamic school of thought, varying allegiances directly affect fatwa issuances and ultimately Islamic financial products structures. We will discuss the affects of *Shariah* scholars on the Islamic finance industry in the “Global Challenge’s” section of this work.

### **Islamic Finance in the US: Islamic Ethos**

We already established that Islam intends to not only serve as a moral compass to guide individuals but also build thriving and cohesive Muslim societies.<sup>16</sup> Having gone through; the definition of the industry, solid background on the religious principles, and parts of its historical narrative, we are equipped to delve into the core rules of Islamic finance. There are four essential principles that Islamic product structures and investments practices attempt to

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<sup>15</sup> Warde, Pg 33.

<sup>16</sup> Fazlur Rahman talks about this further in his book **Major Themes of the Quran**. Man has a duty to God- and ultimately- his community to act righteously, as one man is the building block of a larger society. If one tiny facet of society is rotten, then the whole crumbles.

capture: profit-loss sharing, avoidance of *riba* (excessive mark-up; i.e., often simplified to mean interest) and *gharar* (uncertainty, risk, speculation, deception), and participating in *halal* (religiously permissible) activities.<sup>17</sup>

The profit-loss sharing (PLS) principle is a vital concept in Islamic finance. Although there is no conclusive evidence to verify that the PLS system in Islamic banking is directly tied to the wealth distribution ethic prevalent in Islamic mores, it is not a far reach to associate the two. According to Muslim tradition, wealth is pre-destined for an individual, and he/she is not the owner of that wealth but rather, a trustee.<sup>18</sup> As everything on earth belongs to God, it is incumbent upon Muslims to distribute bounty, and in turn, off set each other's burdens.<sup>19</sup> Therefore, a PLS structure could possibly be the means to insert this Islamic theme into financial operations. The profits are shared; as are the risks. Two investors can partake in a joint-venture that ultimately benefits them both or hinders them less; as the hit from the losses are also shared.

Islamic finance is often times erroneously referred to as interest-free finance. *Riba* is a complex Arabic term that cannot adequately be encapsulated in a single English term, i.e., interest. Iqbal and Mirakhor offer a thorough assessment: "...*Riba* refers to excess, addition and surplus, while the associated verb implies "to increase, to multiply, to exceed, to exact

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<sup>17</sup> Warde, Pg. 5.

<sup>18</sup> Quran 4:32

<sup>19</sup> Quran 57:5

more than what is due, or to practice usury.”<sup>20</sup> Avoiding *riba* is a concept that appears in several Quranic verses and one in particular states, “Devour not usury (riba), doubled and redoubled...,”<sup>21</sup> because money is considered a medium of exchange; as opposed to a means of storing value. However, an important point to bring up here is that avoiding usury in financial transactions is not endemic to Islam; in fact, it preceded Islam. This same principle was prevalent in the Judeo-Christian narrative. Thus, it can be found in the Torah and the Old Testament: “Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury.”<sup>22</sup> According to Muslim tradition, Islam is a continuum of the Judeo-Christian monotheistic story-line, and many an ethos was inculcated into Islamic mores. Thus, the avoidance of usury did not originate during the advent of Islam; although it is seemingly an integral part of Islamic finance.

Two Islamic finance scholars, Vogel and Hayes, offer a possible explanation as to how this financial code became intrinsically tied to the Islamic commercial environment. In an abbreviated format, they put forth the following logic for its existence the : “Mathematical equivalency, avoiding commercial exploitation, minimizing commerce in currency and foodstuffs, linking lawfulness of gain to risk-taking, and using money and markets to allocate and moderate risks.”<sup>23</sup> As mentioned earlier, Islamic ethics are meant to build sustainable

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<sup>20</sup> Iqbal & Mirakhor: Pgs. 54-55

<sup>21</sup> Quran 3:130

<sup>22</sup> Deuteronomy 23:19

<sup>23</sup> Vogel, Fank & Hayes, Samuel. Islamic Law and Finance: Religion, Risk, and Return. Kluwer Law International, The Hague: 1998, Pg. 78.

societies. Thus, another thought to consider: would charging excessive mark-ups to brethren establish stronger communal ties? This is not to say that ‘profit’ is forbidden in Islam. Making a profit is permissible- for example, through trade- but the idea is not to gain exponential wealth off loans or the backs of fellow Muslims who may not be in an equally solid financial position. “...However, God permits commerce, and prohibits usury...”<sup>24</sup> The intentions of one’s actions, even in financial transactions, should exemplify the moral precedent set forth in the *Quran* and *sunna* that call a Muslim to act towards a collective good; as opposed to self-gain.

Sources and uses of funds are other key components in Islamic finance, i.e., transacting business in a *halal* manner (permissible activities) and avoiding *gharar* (excessive speculative risk). A note worth mentioning here is that it is this very principle which attenuated some of the Islamic financial industry’s losses during the global economic crisis because Islamic finance requires a visible degree of economic substance in each transaction. With respects to *halal* industries, Islamic law forbids Muslims to drink alcohol, eat pork, commit adultery, or gamble.<sup>25</sup> Thus, Muslim investors are prohibited from investing in alcohol, pork, pornography, or casino industries. [In a contemporary context, this causes major issues for conventional banks with Islamic windows, such as HSBC Amanah, with regards to their treasury functions. How does a bank, then sift its *halal* (permissible) funds from its conventional pot to meet Muslim clientele

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\*Peace Be Upon Him

<sup>24</sup> Quran 2: 275

<sup>25</sup> These are only to name a few forbidden acts. There are several others, such as robbery or false testimony, but I only mentioned some which are relevant to the Islamic financial field.

needs?]<sup>26</sup> Seemingly, Islamic financial practices are rooted in inherent Islamic principles that guide other aspects of a Muslim's life, which advertently link to his/her monetary practices.

Avoiding *gharar* is also a crucial element. As Warde indicates, this word does not explicitly manifest in the Quran; although other concepts directly related to it, such as deception and delusion, do.<sup>27</sup> Within a contemporary financial context, Warde references Maxime Rodinson's explanation, "Any gain that may result from chance, from undetermined causes, is here prohibited..."<sup>28</sup> Although *gharar* is clearly outlawed, there are disagreements among scholars as to what constitutes *gharar*. With respects to financial product structures, this explains why Malaysians, under Shafi'i law, deem it permissible to structure derivatives, for example. While Arabians, under Hanbali law, claim such financial products are not *Shariah* compliant.<sup>29</sup> Regardless of the inconsistency between the Shafi'i and Hanbali *madhahib*-overall- the global Islamic financial industry has fared better during this economic crisis because

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<sup>26</sup> During my Barclays' Bank internship in Dubai with the Chicago Booth School in spring 2008, this was a crucial issue that repeatedly came up. Our final presentation offered a costly strategy (mostly due to IT implementation) that essentially separated out *halal* funds by earmarking Islamic monies as they came in. Islamic product needs were only sourced from the *halal* pot and conventional products/deposits were serviced from all other funding. The crux of our strategy was that no Islamic funding can be sourced from conventional monies and vice versa. The same applied to nightly inter-bank transactions. *Halal* funds had to be closely watched to ensure they did not end up financing a forbidden industry. For more information on Islamic banks & Conventional banks' treasury functions, consider: Juan Soles, "Introducing Islamic Banks into Conventional Banking Systems," IMF Working Paper, July 2007.

<sup>27</sup> Warde, Pg 59.

<sup>28</sup> Ibid

<sup>29</sup> Derivatives are only one product in dispute under *gharar*; other products include insurance, hedge funds, fx swaps, etc.

there were not substantial amounts of Islamic investments tied into excessively speculative instruments. “While not immune from the financial crisis, [Islamic financial institutions] are being less impacted than conventional institutions. This is because Islamic financial institutions, by their nature, have not invested in toxic assets or derivatives structured instruments that many conventional institutions invested in.”<sup>30</sup>

A historical framework may lend insight to the example regarding the differing religious perspectives on derivatives mentioned above. Southeast Asians converted to Islam under a different pretense than those in the Arabian Peninsula.<sup>31</sup> Malaysians and Indonesians came to Islam by way of trade merchants and Sufis- who did not have as literal interpretation of the primary sources of law; as Arab Muslim followers subjugating peoples and territories through the Arab conquests. Thus, the Southeast Asian interpretations lean towards more permissive outcomes which tend to promote mercantilism.

Despite the global Muslim umma (community), Islamic mores are defined at the local level. Unlike Catholicism, Islam does not have a central authority promulgating the law, e.g., the Pope from the Vatican.<sup>32</sup> So, how does an industry with various interpretations and no

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<sup>30</sup> “Islamic banks in the United States: breaking through the barriers,” Shayestah, Abdi. New Horizon Magazine, April 2009. Available at: [www.newhorizon-islamicbanking.com](http://www.newhorizon-islamicbanking.com)

\*Questioning the islamicity of derivative investments is a debate among Shariah scholars, and thus there are Islamic financial institutions that structure “Shariah-compliant” derivatives. This point was explored further previously in the section on the core Islamic ethos of Islamic banking.

<sup>31</sup> Warde. Pg 15

<sup>32</sup> Warde. Pg. 15



central authoritative entity best regulate itself in a manner to build convergence in order to build trust in its practices?

### **Islamic Finance in the US: the Modern Evolution**

Now that we have explored the definition of Islamic finance and understand its theological roots, let us turn to its modern evolution in the Muslim world to further our effort in constructing the US narrative. In its modern debut, Islamic finance grew with such convexity in the last thirty years, which lends insight into some of challenges the industry faces today. “Modern Islamic finance took the form of Islamic banks and investments houses in the 1970s and 1980s, and a growing body of scholarship was generated by the practical needs of those institutions as they began to proliferate...”<sup>33</sup> This growth was not realized in one central place; rather in different parts of the Muslim globe. The regional remnants are salient and manifest in divergent product structures and investment practices mainly due to adherences to different schools of Islamic thought. Plus, over the years, customer needs evolved from simple commercial banking products to more complicated structures, such as project financing and syndicated loans structures, which forced Shariah scholars and bankers into more accommodating positions to appease their respective clientele. Thus, the reconciliation between local Islamic traditions and keeping up with contemporary financial markets has been a difficult syncretism for this industry.

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<sup>33</sup>DeLorenzo, Yusuf & McMillien, Michael, “Law and Islamic Finance: An Interactive Analysis,” Islamic Finance: the Regulatory Challenge. Ed: Archer & Karim. John Wiley & Sons: Singapore, 2007. Pg. 132.

Despite its seventh century origins, Islamic finance did not emerge onto the contemporary financial landscape until the early 1960s; beginning in Egypt.<sup>34</sup> The 1970s also witnessed a surge in Islamic financial institutions in Southeast Asia, specifically Malaysia. Since then, Malaysia dominated the Islamic finance arena leading the way with product innovation. However; with the influx of cash in the oil rich Arabian Gulf countries through the 1980s, Islamic finance became prevalent in Bahrain, Qatar, and the United Arab Emirates. Interestingly, with the surge of wealth in this area; Arab Muslims began to question the ethical means by which they invested their new-found monies; hence, the shift to Islamic finance. This is when the Islamic finance industry made its mark on the global financial scene.<sup>35</sup>

### **Islamic Finance in the US: Islamic Regulatory Organizations**

Understanding Islamic finance's modern evolution, one rooted in its 'own (Islamic) turf,' is imperative to assessing how the industry can function outside of its breeding ground because the industry's successes and challenges can be highlighted. One challenge mentioned earlier is that of regulation. There have been several systematic and institutional attempts across the Muslim globe; e.g., in Bahrain and Malaysia, at building a strong regulatory arm- many of which have been successful for specific regions. However, the crux of the issue lies mostly in divergent adherences due to the different *madhahib* followings mentioned earlier. Warde provides an in-depth socio-political, economic background onto which these various regulatory bodies emerged. He compartmentalizes their emergence into two segments: the first and

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<sup>34</sup> Vogel, Frank and Hayes, Samuel. Islamic Law and Finance. Cambridge Press, 1998. Pg 4

<sup>35</sup> Vogel, Frank and Hayes, Samuel. Islamic Law and Finance. Cambridge Press, 1998. Pg 5

second “aggiornamento”, i.e., coming up to speed with modern capital markets, because pioneering Islamic regulatory agencies were- in effect- a means by which to attempt integration into the modern financial scene. There are too many organizations to review each one’s socio-political, economic background. Thus, I will review only those that are crucial for this research: the Islamic Development Bank (IDB), the Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI), and the Islamic Financial Services Board (IFSB).

Part of the first aggiornamento, the Islamic Development Bank developed out of a pan-Islamist movement by the hand of Saudi Arabia, and it was established on a banking reform platform during the Organization of the Islamic Conference’s summit in Lahore, 1974. Although not strictly a regulatory organization, the IDB “was to become of the cornerstone of the Islamic banking system.”<sup>36</sup> IDB was an effort by Muslim countries- namely Saudi Arabia and Pakistan’s governments- to set up a banking framework, independent of the conventional markets, to monetarily feed Islamic banks. “In addition to injecting funds into the regions where they were most needed and providing fee-based financial services and profit-sharing financial assistance to member countries...the new institution was to promote, through direct participation, training, and advice, the creation of additional Islamic institutions.”<sup>37</sup> IDB developed at a crucial time in the industry’s modern evolution. Warde goes on to say: “The paradigm of modern Islamic banking was established in those years [70s & 80s].” IDB still exists today and is headquartered in Jeddah, Saudi Arabia; serving mostly as an Islamic financier.

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<sup>36</sup> Warde: Pg. 75.

<sup>37</sup> Ibid

Two other more recent attempts to build robust regulatory standards came by way of Bahrain and the IMF. Bahrain led the way in attempting to institute regulatory standardizations with the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 1991. Despite its issuance of fifty-seven standards, not all Islamic banks adhere to their guidelines. “A financial practice that one Islamic bank’s Shariah board finds acceptable may be unacceptable to the board of another bank.”<sup>38</sup> However, many Islamic financial institutions residing in the Gulf follow AAOIFI standards.

In an effort to establish cross-regional uniform governance, the IMF sponsored the Islamic Financial Services Board (IFSB) in 2002, which is headquartered in Malaysia. Although its “Islamic” identity is questioned by some Muslim clerics,<sup>39</sup> the organization boasts nearly 200 bank member/observers from Morocco, Sudan, Lebanon, and Turkey- to name few. Plus, the supervisory council has a prominent participant list-ranging from the governor of the Saudi Arabian Monetary Agency to the MD of the Singapore’s Monetary Agency. The IFSB’s standards are heavily rooted in Basel II principles, i.e., corporate governance, capital adequacy standards, etc.<sup>40</sup> But, even if an Islamic regulatory agency roots its regulation in both conventional practice and Shariah standards, the difficulty lies in gaining blanket adherence across the global Muslim umma.

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<sup>38</sup> Henry, Clement. Essays in Islamic Finance. “Introducing the Challenges of Regulation,” Presented at the Sixth Harvard University Forum on Islamic Finance, May 2004. Pg 4

<sup>39</sup> Ibid

<sup>40</sup> IFSB Standards: [http://www.ifsb.org/standard/eng\\_IFSB\\_Guidance\\_Note\\_CAS.pdf](http://www.ifsb.org/standard/eng_IFSB_Guidance_Note_CAS.pdf)

An important point to keep in mind is that during Islamic finance's modern debut; a few Islamic financial institutions were avaricious breeding grounds; particularly 'Islamic' banks. So much so that Muslim societies that were victims of these scandals, such as in Egypt,<sup>41</sup> doubt the authenticity of Islamic claims a financial institution makes. Nonetheless, the regulatory issue does not stem from the lack of organic attempts in the Muslim world to build safe-guarding measures and convergence. As noted above, there have been several organized attempts across several Muslim countries to build standardization; whilst maintaining the industry's inherent ethos. The socio-political element that Warde injects to the historical development of these various organizations is crucial to comprehending why 'fair practice standards' has not yet been comprehensively established in the Islamic finance industry. This, too, can shed light on where the potential lies in trying to establish standardization.

### **Islamic Finance in the US: the Global Challenges**

The Islamic finance industry faces several challenges globally which affect its perception among consumers, practitioners, and regulators. The ability to consistently regulate banking operations and systematically handling various *Shariah* board interpretations are two major points that often come under scrutiny. Globally, lack of consistency in product structures and investment practices affect the industry's credibility, reputation, consumer faith, and subsequently- the ability to regulate it properly. **Islamic Finance: the Regulatory Challenge** highlights the global risk concerns that are scrutinized most: inadequate liquidity in capital

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<sup>41</sup> In 1963, there were seedy examples of banks operating under Islamic pretenses that abruptly closed with nearly two million Egyptian pounds lost. Warde: pg73.

markets, the inability to thoroughly manage and assess *Shariah* risk, and the lack of a cohesive secondary market to unload Islamic bank assets.<sup>42</sup>

The famous saying ‘geography is destiny’ becomes a topos for understanding financial regulation in Muslim societies. Islamic financial institutions are essentially governed by their *Shariah* boards; the religious scholars that deem a product *Shariah*-compliant. The entire Islamic financial industry is driven by *Shariah* boards’ *fatwa* issuances, which sometimes yield inconsistent decrees globally.

With respects to commercial/retail banking, *Shariah* board members tend to be recruited locally in relation to the bank’s region, which they serve-especially for regional banks; e.g., Emirates Islamic Bank- a local bank in Dubai vs. HSBC Amanah- a bank with international presence. This is important to stress; especially with respects to consumer confidence. Muslims who choose to bank Islamically do so for various reasons.<sup>43</sup> Some banking consumers may use Islamic banks exclusively-on either the commercial or retail side; while others use both conventional and Islamic institutions simultaneously but reserve *Shariah*-compliant accounts for special occasions, i.e., clients’ requests, wedding or funeral savings, home purchase, etc. On average-particularly on the retail side, consumers are not banking operations’ savvy. Thus, trust is placed in the Islamic bank, and ultimately, the *Shariah* board, to deal with an individuals’

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<sup>42</sup> Archer & Karim, Islamic Finance: the Regulatory Challenge. John Wiley & Sons, Singapore. 2007

<sup>43</sup> Synovate Marketing Report: Dubai. “*Exploring Attitudes Towards Islamic Banking*” May, 2008.

money in a *halal* manner.<sup>44</sup> So, the *Shariah* board members' name recognition is crucial to an Islamic banks' vitality. (This, in turn, manifests a tangential issue with respects to overlapping board memberships in different banks. This point will be discussed further momentarily.) However, consumer confidence and its link to *Shariah* board affiliation directly affect Islamic finance's growth potential in the United States possibly due to the intrinsic domestic ideology of 'separation of Church and State.'

Understanding the *Shariah* boards' function within an Islamic bank is vital to comprehending their wide-ranging impact on the global Islamic finance industry. Several Islamic finance scholars posit varying opinions on *Shariah* boards, and I will explore some of their views in this section. In order for an Islamic bank to be a part of the International Association of Islamic Banks (IAIB), they must be governed by a *Shariah* board.<sup>45</sup> However, the characteristics and duties of boards may vary from one bank to the next. Theoretically, *Shariah* board members function autonomously, but conflict of interests may arise because they are on Islamic banks' pay rolls.

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<sup>44</sup> This is how many consumers view it. "I put my money in an Islamic bank, and I wash my hands of it. The rest (of the process) is between [the *Shariah* board] and God." Synovate Marketing Report: Dubai. "*Exploring Attitudes Towards Islamic Banking*," May, 2008.

<sup>45</sup> Warde, Ibrahim. Islamic Finance in the Global Economy. Edinburgh: Edinburgh University Press, 2001. Pg 226

“From the stand point of Islamic banks as a collective group, the major criticism is that the practice of banks having their own *shariah* boards adds to the fragmentation of Islamic finance, making it difficult to arrive at a consensus on products and procedures, which in turn complicates the task of developing a secondary market for Islamic products. Different boards have different interpretations of the *Shariah*, and no uniform rules apply to the industry as a whole.”<sup>46</sup>

Other issues that arise pertain to external ‘conflict of interest’ factors and financial qualifications. Since consumer confidence is directly tied to the name recognition of the *Shariah* scholar, Islamic banks often end up having over-lapping *Shariah* scholars on their boards. Additionally, the talent pool for scholars who are well versed in both Islamic and financial practices is limited. Mahmoud El Gamal, Chair of Islamic Economics, Finance and Management and Professor of Economics and Statistics at Rice University, criticizes *Shariah* board members for their lack of financial/economic training; as most tend to be unilateral experts in Islamic jurisprudence; as opposed to aspects of banking transactions. He claims that *Shariah* scholars engineer Islamic products to directly mimic conventional banking counterparts.<sup>47</sup> Warde also makes mention of this issue and refers to it as “rubber stamping” financial products with Islamicity, after a banker financially engineers what he/she needs.

To some degree, I concur with both Warde and El Gamal; particularly on their opinions regarding the adequate talent pool of *Shariah* scholars. However, a point worth repeating here is the one brought up earlier regarding the increased demand and complexity of Islamic banking product structures over the last thirty years. El Gamal’s contribution to the Islamic financial academic field is substantial; however, his assessments are sometimes too narrow in that he

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<sup>46</sup> Warde, Ibrahim. Islamic Finance in the Global Economy. Edinburgh: Edinburgh University Press, 2001. Pg 228

<sup>47</sup> El Gamal, Mahmoud. Islamic Finance: Law, Economics, and Practice. Cambridge: Cambridge University Press, 2006.



tends to portray the entire industry as a facade. Undoubtedly, there are industry challenges to overcome and resolutions can only begin to unfold by reforming *Shariah* board practices; specifically with respects to divergent interpretations. However, he seems to overlook the salient attempt that *Shariah* scholars make to maintain the Islamic ethos in today's financial market setting. The syncretism in extracting the Islamic principles and applying them to contemporary capital markets is not easy, and *Shariah* scholars are facing new precedents. Overall, Warde and El-Gamal bring up valid concerns; as the scarcity of qualified *Shariah* scholars with financial training and divergent product structures raise a bigger issue in the Islamic financial arena- *Shariah* risk. And, this issue is a critical piece in the regulatory challenge dilemma.

*Shariah* risk essentially means that an Islamic products' authenticity has come into question by a *Shariah* scholar. In an industry where consumer confidence is intrinsically tied to the *Shariah* cleric, an imminent financial disaster could be on the horizon if a widely used product were doubted. The increased use of the *Murabaha* product to structure trade-financing, home purchasing, or even bank deposits exemplifies an element of *Shariah* risk. The *Murabaha* is essentially a cost-plus structure that has a fee increase that may, at times, even be directly linked to the London InterBank Offering Rate (LIBOR). This product has come under scrutiny by prominent *Shariah* clerics for emulating interest and reducing the use of the PLS structure.<sup>48</sup> Another example of increased *Shariah* risk is the recent questioning of *ijara sukuk* (bond) structures by the respected *Shariah* scholar *Shaikh* Taqi Usmani in November 2007. As

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<sup>48</sup> Henry, Clement. Essays in Islamic Finance. "Introducing the Challenges of Regulation," Presented at the Sixth Harvard University Forum on Islamic Finance, May 2004. Pg 3

mentioned earlier, Islamic financial transactions have to encapsulate a certain level economic substance. In the case of *sukuks*, the transaction must be asset-backed and distinct ownership/transfer of the underlying good should also clearly occur. His dissent stemmed from the lack of transfer in ownership of the underlying asset within the bond's structure; as the structuring of the *sukuk* was so elaborate that it made ownership of the asset immaterial.<sup>49</sup> Since, then, there has been a shift in focus with respects to bond structures in an attempt to rectify the matter; specifically with regards to the Special Purpose Vehicles' (SPVs) functions.

Although the above mentioned challenges are valid concerns, they are occurrences and not general industry practice. Plus, *Shariah* scholars often call each other out, as in the immediate case mentioned above; thus the industry, to some extent, inherently contains an amorphous self-regulating system.

Industry players recognize that divergence hinders Islamic finance from realizing its maximum potential. In the last thirty years, there have been systematic attempts at building convergence. Warde elaborates on one such example; "To avoid fragmentation and the reliance on the opinions of lone scholars, since the first "aggiornamento " 'group *ijtihad*' has been encouraged, through international conferences, symposia and convocations as well as through permanent new bodies such as *fiqh* academies."<sup>50</sup> These academies have multi-national memberships, and *fatwas* across the international Muslim society are published in the

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<sup>49</sup> Malek, Hoossam S. "Islamic Finance Today; Is it the End of Yesterday's Risk Sharing?" MA Thesis, June 2008. Pg. 40.

<sup>50</sup> Warde, Ibrahim. Islamic Finance in the Global Economy. Edinburgh: Edinburgh University Press, 2001. Pg 229

*Fiqh Academy Journal*. However, the academy has historically been directly associated with Saudi Arabia.<sup>51</sup> Having discussed the historical development of the *madhahib* earlier; we know that Saudi Arabia adheres to the Hanbali doctrine, which deters other religious scholars who are loyal to other *madhahib* from buying into doctrines promulgated from these *fiqh* academies. One way of attenuating this issue would be to establish an international supervisory *Shariah* board with diverse juristic representation on neutral ground that already has robust financial regulatory systems in place. This has been attempted before in the Muslim world, but again, dominant associations often lead *Shariah* scholars to link organizations to specific *madhahib*.

### **Islamic Finance in the US: Exploring Plural Legal Frameworks in the UK**

A significant amount of time has been spent in this work on constructing the overall picture of Islamic finance within a global context. This is necessary to understand the industry's potential capabilities outside its original setting, i.e., Muslim countries. As noted earlier, I cannot adequately delve into legal frameworks or political theories, which are required to fully grasp the question posed in this work's title: "*What are the challenges to overcome in order for the Islamic financial industry to subsist viably under secular regulation in the US?*" In the forthcoming sections, a brief comparative assessment on the UK and US's Islamic finance experience will unfold. The Islamic banking sector is the proxy for this comparison; as this specific segment of the Islamic financial industry succinctly captures the question at hand.

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<sup>51</sup> Ibid

Thus, in the spirit of my heuristic objective, I am tersely presenting legal, and later political, ideologies that may lend themselves to more thorough analyses that other qualified parties can research regarding states accommodating plural religious constituencies in secular societies.

As noted in the introduction, the United Kingdom has been successful in integrating their Muslim community into the regulatory folds of their financial system. This fact is substantiated by the UK having the only fully functioning Islamic bank outside of the Muslim world. I will discuss the tangible steps taken by UK authorities further momentarily; however, understanding their successes requires a broader perspective that directly relates to legal pluralism. We established earlier that Islamic banking is essentially *Shariah*-compliant banking, and thus, rooted in Islamic law. Islamic law, for Muslims, is supra to any temporal legal systems. So, then, how do civil legal systems accommodate religious law? One response could be to employ a legal pluralism approach; as the UK has done.

**Ethnic Minorities in English Law** covers this exact matter in great detail.<sup>52</sup> Chapter four, “*Legal Pluralism in the British Context*” discusses the political theory further: “Legal pluralism refers to the situation where two or more laws interact.” Richard Jones and Welhengama Gnanapala go on to elucidate that this definition requires the recognition of more than one set of codes. In the case of Islamic banking, English law has come to recognize the *Shariah* as a valid source for rules- at least, among Muslims. Thus, this theory sheds the centralist approach and instead uses a symbiotic one. “Legal pluralism opposes claims of the superiority or

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<sup>52</sup> Jones, Richard & Gnanapala, Welhengama. Ethnic Minorities in English Law. Gems No. 5. Trentham Books: London, 2000. Pg. 91.

dominance of one legal system at the expense of other normative orderings or personal laws of sub-groups...’the state has no more empirical claim to being the centre of the universe of the legal phenomenon than any other element of the system does.’”<sup>53</sup> Jones and Gnanapala use many examples to illustrate how this pluralist legal system works in the UK, and it is far from easy. They comprehensively lay out the successes and the many challenges the English courts have faced in developing an inclusive legal framework.<sup>54</sup>

### **Islamic Finance in US: Assessing the UK Precedent**

The United Kingdom has been successful in integrating Islamic banking into their financial regulatory schema, mostly due to their adopted attitude of “no obstacles, no special favours.”<sup>55</sup> UK financial regulators took the following steps in order to engage Islamic bankers: establishing a central financial regulatory unit, adjusting financial regulatory policies to accommodate *Shariah* standards, and communicating with a central Islamic banking

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<sup>53</sup> Jones & Welhengama: Pg. 97.

<sup>54</sup>Jones & Welhengama: Pgs. 179-189. One specific example of legal systems coming head-to-head pertains to the Salman Rushdie affair with the publishing of his book, Satanic Verses. I venture to say that this specific incident, which took place in the 1980s, may have paved the path for the Muslim community’s robust voice in the UK. Essentially, the English courts were forced to deal with fatwa issuances against Salman Rushdie for his Satanic Verses; given that there is an English law that forbids blasphemy against Christianity. UK Muslim citizens deemed this unfair that the blasphemy law only pertained to Christianity...the critical point is that the English legal system had the opportunity to see the force of their Muslim constituency and recognize – eventually, accommodate them; as well as their dual legal adherences to both English and Shariah laws. More recently, the archbishop of Canterbury admitted the need to recognize Shariah laws and its implementation for Muslim constituents; as “[it] seems unavoidable.”

[http://news.bbc.co.uk/2/hi/uk\\_news/7232661.stm](http://news.bbc.co.uk/2/hi/uk_news/7232661.stm)

<sup>55</sup> “*Introducing Islamic Banks into Conventional Banking Systems*,” Sole, Juan. IMF Working Paper: Monetary and Capital Markets’ Dept. July 2007; Pg. 17.

supervisory committee comprised of experts, practitioners, and *Shariah* scholars.<sup>56</sup> Although challenging, UK regulators found legitimate reasons- beyond legal inclusiveness- to accommodate Islamic banking. Why? According to Her Majesty's Treasury report, accommodating their nearly two million Muslims was financially worth while. And, third, Islamic banking provides a tangible inclusive vehicle to integrate the Muslim minority ethnic communities into mainstream societies. Thus, the UK gained both financial and political advantages in providing a strong platform for Islamic banking to subsist.

An integral piece to this puzzle is the founding of the Financial Services Authority in 1997. Although not directly related to the Islamic banking position, this central unit made maneuvering through the UK's dispersed regulatory system much easier on international investors.<sup>57</sup> This, in turn, cultivated a more conducive environment for the industry's growth.

Another critical piece: in 2000, the Bank of England identified the Islamic banking market potential in the UK. This was the initial stepping stone crucial for progress towards structuring policies to accommodate the industry; as the bankable market potential justified regulators' position.<sup>58</sup> In early 2007, a sub-group consisting of regulators and practitioners was formed

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<sup>56</sup> *"The Development of Islamic Finance in the UK: the Government's Perspective,"* December 2008, Her Majesty's Treasury (HMT). Available at [http://www.hm-treasury.gov.uk/fin\\_islamic\\_finance.htm](http://www.hm-treasury.gov.uk/fin_islamic_finance.htm), Pg 3.

<sup>57</sup>(3/23/2009) phone interview. Usman Ahmed who is currently head of commercial banking for Barclays Bank, Emerging Markets, based in Dubai, UAE. He came from the UK's banking system, having served on Islamic banking advisory boards to communicate to financial regulators practitioners' needs, industry nuances, etc. He also headed up CitiBank's Islamic banking division there. During our conversation, I asked why Islamic Finance investors have been hesitant to come to the US, he stressed the decentralized financial regulatory framework was too cumbersome for many to maneuver.

<sup>58</sup> HMT Report: Pg. 3.

within the UK Trade & Investment regulatory arm strictly to communicate, oversee, and gauge Islamic banking market matters both within the UK and abroad.<sup>59</sup> These are some of the steps taken by the financial authorities in the UK, which have successfully led to the establishment of the only fully functioning Islamic bank outside of predominantly Muslim countries, the Islamic Bank of Britain (2004). As of 2008, the UK boasts 23 Islamic banks, and alongside the Islamic finance houses, the country has \$18 BN worth of *Shariah*-compliant AUM (Assets Under Management)<sup>60</sup> - remarkably, placing the country in the top-ten list of countries holding the most *Shariah*-compliant assets. The other nine are all predominantly Muslim countries, e.g., Iran, Saudi Arabia, Malaysia, Turkey, etc.

The road towards compromise has not been easy for the numerous parties involved, and there has been much communication, education, and accommodation in order to integrate Islamic banking into the UK's financial system- an effort of fairness, collaboration, and commitment, and centralization.<sup>61</sup> One of the biggest challenges faced was that of structuring deposits. Coincidentally, this is one of the main obstacles in the United States, as well. A sign of the FSA's legislative commitment manifests in the 2005 & 2006 Finance Acts, which attenuates the deposit issue:

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<sup>59</sup> HMT Report: Pg. 10

<sup>60</sup> HMT Report: Pg. 9

<sup>61</sup> HMT Report: Pg. 13

*“The Finance Act 2005 introduced the deposit arrangement that is recognized for regulatory purposes, which is based on a Mudaraba. This is referred to as a profit share return. For the investor the return is taxed as if it were interest and the legislation switches off the tax rules that might otherwise treat it as a distribution, so the deposit-taker receives a deduction for the payment. In Finance Act 2006, wakala, or profit share agency, was introduced where the investor appoints an agent to manage a sum of money being invested, receiving a return out of the investment proceeds that equates in substance to an interest-like return.”<sup>62</sup>*

Seemingly, the UK has set a feasible precedent from which other non-Muslim societies can learn, and it has done so by implementing a dynamic framework involving legal pluralism, collaboration, commitment, and regulatory centralization.

### **Islamic Finance in the US: a Pertinent Glance at Political Theory**

Grappling with the complexity of accommodating observant religious constituencies under secular authority requires the use of political theory. In an effort to promote religious freedom, the United States was founded on Jeffersonian principles that advocated the ‘separation of church and state;’ a secular ideology mirroring a sphered-sovereignty structure reflecting the rightful domains of state, religion (church), and self. Each functioned separately yet symbiotically towards a collective good. With respects to a Muslim US citizen, he/she adheres to a personal system of comprehensive doctrine (*Shariah* through Islam), which governs his/her life irrespective of the political. Thus, Muslims are bound by an internal spiritual law and also external non-Islamic civil government rules.

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<sup>62</sup> HMT Report: Pg. 16



Jurgen Habermas is a twentieth-century German sociologist whose scholarship on post-secular societies ventures deep into the political arena. Habermas employs an ideal discourse theory through communicative action where by constituents of varying comprehensive doctrines construct a neutral sphere in which to promote the necessary dialectic. For Habermas, communication is critical in order for each individual to reach his/her moral objective through the political. His theory does not call for conversion, per say- only a translation of, in this case, comprehensive religious ideals.

“The liberal state makes believers suspect that occidental secularization might be a one way street bypassing religion as marginal. The other side of religious freedom is in fact a pacification of the pluralism of world views that distribute burdens unequally...Only citizens committed to religious beliefs are required to split up their identities...into their public and private elements. They are the ones who have to translate their religious beliefs into a secular language before their arguments have any chance of gaining support.”<sup>63</sup> Habermas highlights a valid point. Interestingly, he was seemingly more secular, i.e., there was no reason to engage religious discourse in the political arena, until September 11<sup>th</sup>. At which point, his scholarship began to acknowledge and even call for the engagement of religion in the politic.<sup>64</sup> The 9/11 example is a dramatic one; as there are other non-catastrophic reasons to dialogue with religious groups- Muslim, Christian, Jewish, etc. (For example, does the FDA monitor *halal*/kosher meat slaughtering?)

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<sup>63</sup> Habermas, Jurgen. The Future of Human Nature. Polity Press; UK, 2003. Pg. 109.

<sup>64</sup> Habermas, Jurgen & Ratzinger, Joseph. The Dialectics of the Secularization. Libreria Editrice Vaticana; USA, 2005.

Nonetheless, I concur with Habermas in that a neutral sphere which cultivates discourse among various parties could further promote the greater political good. “Only if the secular side too, remains sensitive to the force of articulation inherent in religious languages will the search for reasons that aim at universal acceptability not lead to an unfair exclusion of religions from the public sphere, nor sever secular society from important resources of meaning.”<sup>65</sup> Warde discusses this very point within the UK context. Gordon Brown, the UK PM, actively pushed the Islamic finance initiative “by supporting market innovation”<sup>66</sup> in order to pull the minority Muslim communities hanging on the fringes of society into the folds of the mainstream; giving them a tangible means to collectively engage within their civic home-whilest actively participating in their religious beliefs. Thus, the UK’s narrative can serve as an interesting, comparative backdrop by which to gauge the US’s Islamic finance experience.

### **Islamic Finance in the US: Constructing the US Narrative**

As of today, Islamic banks do not operate in the United States strictly as such; there are only conventional financial institutions that offer a narrow range of Islamic products. According to a recent article published in New Horizon Magazine by Abdi Shayesteh, roughly twenty financial institutions sprinkled throughout the US offer Islamic products. Products vary from certain types of retail deposits to commercial real estate financing.<sup>67</sup> Thus, Islamic financial

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<sup>65</sup> Ibid

<sup>66</sup> Warde: 2<sup>nd</sup> edition, Pg. 53 (Rough draft)

<sup>67</sup> “*Islamic banks in the United States: breaking through the barriers,*” New Horizon Magazine, April 2009. Mr. Shayestah is also a practitioner in the field, serving as a senior associate with King & Spalding in NY. He is also a

products<sup>68</sup> do exist but somewhat peripherally; as they are regulated<sup>69</sup> by default vis-à-vis their conventional financial origins. This default regulatory structure inadvertently imposes restrictions that make the industry economically inefficient, which, in turn, hinders its growth potential because Islamic banking cannot fully achieve its optimal levels of performance.

In the late 1990s, the Office of the Comptroller of the Currency (OCC) issued two interpretive letters in response to proposals submitted by the United Bank of Kuwait.<sup>70</sup> In the context of Islamic alternatives to conventional residential mortgage financing, the first letter (1997) approved a residential net lease-to-own structure, the Islamic equivalent to an *ijara*. The second letter (1999) approved the cost-plus structure, the *murabaha*. The crucial issue in both cases was the bank's ownership of the respective property for a period of time- which is forbidden in conventional banking practices- until the ownership fully transferred to the purchaser. "The OCC demonstrated its flexibility... by looking beyond the restrictions on bank ownership of real estate to conclude that... the risks that drove the general restrictions were

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member of the Middle East and Islamic finance practice group. A copy of the list is attached in the appendix of this work.

<sup>68</sup> My focus in this section is on Islamic banking products. There are investment institutions that offer Islamic instruments. For a full listing, see Shayesetah's article.

<sup>69</sup> In the US, banking/finance regulation responsibilities is split among several agencies: Federal Reserve Bank (FRB) regulates state chartered banks; the Office of the Comptroller (OCC) regulates nationally chartered banks; the Federal Deposit Insurance Company (FDIC) insures deposits, and the US Treasury Dept. also oversees a larger regulatory scope.

<sup>70</sup> Jonathan H. Rushdoony, District Counsel for Office of the Comptroller of Currency for the National Banks, Interpretive Letters #806 & #867 December 1997, November 1999. Available at:

<http://www.occ.treas.gov/interp/dec97/int806.pdf>  
<http://www.occ.treas.gov/interp/nov99/int867.pdf>

not present...”<sup>71</sup> William Rutledge, Executive Vice President of the Federal Reserve Bank of New York, goes on to say that the dealings were equivalent to secured loans or riskless principal transactions.

Mahmoud El Gamal vehemently opposes the above structural approvals because it perpetuates the Islamic finance’s industry to subsist like a mirror to conventional finance; as opposed to a financial system in and of itself, governed by its intrinsic principles. “In the context of *murabaha* and *ijara* financing [lawyers’] arguments have successfully convinced the Office Of the Comptroller of the Currency (OCC, which regulates nationally licensed banks) that both modes as practiced constitute examples of the normal business of secured lending as a conducted by commercial banks.”<sup>72</sup> El Gamal has highlighted a valid concern. Simultaneously, however, I recognize that regulators are making an attempt and the industry’s domestic subsistence has to start somewhere. According to Juan Sole’ IMF working paper, “*Introducing Islamic Banks into Conventional Banking Systems*,” the above step of introducing certain Islamic banking products’ into the market first seems to be a natural progression in the industry’s evolution outside an exclusively Islamic financial system.

In one part of his work, Sole’ outlines the phases of the introduction of Islamic banks into a conventional system; one of which constitutes the opening of Islamic windows as a market test pilot. His research is useful to note here; as the conventional institutions in the US

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<sup>71</sup> Rutledge, William, EVP New York Federal Reserve Bank, “*Regulation and Supervision of Islamic banking in the United States*,” April 19, 2005. ABANA Conference. NY, NY.

<sup>72</sup> El Gamal, Mahmoud. Islamic Finance: Law, Economics, and Practice. Cambridge University Press; NY, NY. 2006. Pg. 14-15.

offering Islamic banking products are essentially operating as “Islamic windows.” “It must be pointed out that reliance on Islamic windows, as a take-off platform for moving into the Islamic financial industry, has been a more common practice in ...Western countries...”<sup>73</sup>

Thus, ultimately, current Islamic product offerings are those that have conventional counterparts, so to speak. These circumstances allow the OCC (and indirectly- the Federal Reserve Bank) to regulate the above mentioned Islamic products. These regulatory institutions only deal with the financial essence of the products under conventional standards- *not* the Islamicity. This is crucial to note because every regulator I interviewed stressed that he/she realized he/she does not have the knowledge, jurisdiction, or desire to contemplate a product’s Islamicity. This is worth referencing because it reiterates the need for a dialogue among various parties, i.e., regulators, practitioners, *Shariah* scholars. Thus, regulators seem to understand the limits of their domain. This sort of sphered-sovereign structure is the sort of framework it will take to cultivate the Islamic finance industry in the US.

To date, not a single Islamic banking application has been filed with the Federal Reserve Bank by practitioners.<sup>74</sup> As already established, the Federal Reserve Bank recognizes the potential for Islamic banking in the United States and is open to accommodating this sector, but

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<sup>73</sup> “Introducing Islamic Banks into Conventional Banking Systems,” Sole’,Juan. IMF Working Paper, Monetary and Capital Markets Department, July 2007. Pg. 8.

<sup>74</sup> David Loundy, Corporate Counsel, Devon Bank. Interview on 2/05/2009. Devon Bank, located here in Chicago, is a major advocate for Islamic banking in the US. They constructed the first Murabaha mortgage product in the US with the help of Fannie Mae and have been offering Islamic products to the national Muslim community for nearly ten years. He was heavily involved in the US Treasury’s ‘Islamic Finance 101’ workshop by facilitating presentations; alongside Mahmoud El Gamal. He is considered an expert practitioner in the domestic Islamic banking arena.

it has not witnessed a tangible interest-in the form of license applications.<sup>75</sup> This is one main reason why there is no Islamic banking license currently issued in the US. However, a fair rebuttal by industry practitioners to the regulators' position is that nobody wants to get rejected, and there is a strong sentiment among potential Islamic banking participants that a current license submission application would be shot-down.<sup>76</sup> During my interview with David Loundy, Devon Bank's corporate counsel, he distilled this point further by explaining that each bank has window of time to gain approval; once a license is submitted to regulators. Given that Islamic banking in the United States is still an innovative concept; undoubtedly, regulators will have several questions to ask. And, it is unlikely that these inquiries can be put forth and answered in the time allotted for an application submitted because the current banking crisis in the US has regulators distracted with more pressing issues, i.e., major conventional banks' potential insolvencies. Loundy expressed that the practitioners' strategy is to proactively conduct a pre-application consortium of regulators and bankers to sort out these issues prior to a submission in order to ensure a successful outcome.

Shayesteh argues in his article that US regulators can no longer be accused of a parochial approach with respects to Islamic banking, given the previously stated fact that there are 19 institutions domestically offering Islamic products. "The question of whether US regulators will be accommodating towards the growth of Islamic banking is now a moot

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<sup>75</sup> Sarah Bell, New York Federal Reserve Bank: Interview 2/4/09

<sup>76</sup> Loundy, David, Chicago, IL -Devon Bank: Interview 2/5/09

point.”<sup>77</sup> I agree with him; however, allowing the industry to exist and fully accommodating it are separate points that should be distilled further in the future scholarly dialectic surrounding Islamic finance in the US. As mentioned earlier, however, I concur with Shayesteh that regulators are seemingly open to the industry’s growth in the US.<sup>78</sup> This point can be further substantiated by a speech given in 2005 by Rutledge, the EVP of the FRBNY, at an Arab Bankers’ Association of North America conference (ABANA) in New York City. “At the outset, I would like to emphasize that we- and here I am referring broadly to US regulators- are open to Islamic financial products. Our mindset is to try to accommodate a variety of approaches to finance...”<sup>79</sup>

Regulators are certainly on the right track, and clearly they see that cultivating the Islamic finance industry in the US would be an advantageous endeavor both financially and politically. Financially, expanding the industry’s potential and making it easily maneuverable; i.e., by establishing a central financial regulatory unit, will undoubtedly attract Gulf investors.

*“The United States...has every interest in attracting Gulf-based capital that has built up over the last five years due to the bullish oil market...One significant misunderstanding deterring some Gulf-based Islamic institutions from entering the US market relates to the complexity of the US regulatory regime...investors launching Islamic finance in the UK predominantly had to deal with one regulator, the Financial Services Authority (FSA)...Unfortunately, many*

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<sup>77</sup> Shayestah, Abdi. New Horizen Article: Pg. 1

<sup>78</sup> John Rushdoony; Office of the Comptroller of Currency, John Stevens; Federal Deposit Insurance Company, Sarah Bell; the Federal Reserve Bank of NY

<sup>79</sup> Rutledge, William, EVP New York Federal Reserve Bank, “Regulation and Supervision of Islamic banking in the United States,” April 19, 2005. ABANA Conference. NY, NY. Available at: [http://www.newyorkfed.org/newsevents/speeches\\_archive/2005/rut050422.html](http://www.newyorkfed.org/newsevents/speeches_archive/2005/rut050422.html)

*Gulf bankers mistakenly think that they only need to deal with one regulator...in the US, as well. But this is not the case.”<sup>80</sup>*

In fact, the concept of forming a central authority within the US’s dispersed financial regulatory system recently manifested as a solution to attenuate the domestic economic crisis at the end of March 2008. Part of the US Treasury Secretary’s plan to “Reign in Wall Street,” Timothy Geithner outlined one (out of five) relevant components pertaining to a new regulatory framework: “Establishing a single entity responsible for stability among major institutions.”<sup>81</sup>

Geithner’s plan explicitly acknowledges the need for a more centralized schema within the regulatory system, which in turn could remove a major obstacle to the growth of Islamic finance in the US.

Politically, as in the UK, a concrete US Islamic banking sphere can be used to reach out to the minority Muslim constituency residing here. Shayesteh elaborates: “The reality is that US regulators have significant constitutional, policy and economic reasons to accommodate the growth of Islamic banking in the country. From a constitutional perspective, US regulators are ...involved, in part, because it is their duty as public servants under the US Constitution to make sure they accommodate the free exercise of religion, even as it relates to banking practices.”<sup>82</sup> He brings up a valid point, which we reviewed earlier under the political theory section; essentially, the concept of unified plurality and freedom of religion. However, the opposite

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<sup>80</sup> Shayesteh, Abdi. New Horizen Article: Pg. 1

<sup>81</sup> <http://www.ustreas.gov/press/releases/tg72.htm>

<sup>82</sup> Ibid



argument- that accommodating Islamic banking is a violation of the first amendment- has already been made.

A law suit was brought against the Federal Reserve Bank in the winter of 2008 for using tax payer money to bail out AIG because the company offers takaful products, i.e., Shariah-compliant insurance.<sup>83</sup>

"This lawsuit not only raises significant constitutional issues, it also shines a light on serious national security issues that our own government has created by direct financial support and ownership of a business that supports anti-American, radical Islamic activities," said Richard Thompson, president and chief counsel for the Thomas More Law Center, which is handling the case.

Of course, this is an isolated incident, and certainly not the regulator's position. However, this note is worth making in considering the future potential for this industry in the US. How will the mainstream public react to a substantial Islamic finance presence in the US? Will there be larger-scale movements to thwart the industry's development? Transversely, how will radical Islamists abroad react? Will the US's efforts to further develop the Islamic finance- particularly with respects to industry standardization- be seen as 'tainting' the industry's essence? The truth of the matter is that if US regulators were to further accommodate Islamic finance- in particular, by issuing Islamic banking licenses- the government would be seen as appealing to the middle of the Muslim constituency spectrum. That is to say, all fundamentalists, whether staunch secularists/constitutionalists or Islamic radicals, would inevitably voice concerns, but their opinion would certainly not represent any majority opinion on either the regulator or

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<sup>83</sup> <http://www.wnd.com/index.php?fa=PAGE.view&pageId=83704> World Net Daily

Muslims' side. Thus, public response and fractional reactions are areas that require further academic research and discourse; as they are integral elements to consider.

The American landscape offers fertile grounds for Islamic finance's growth, but there are certain concerns that need to be reconciled. First, the global challenges referenced much earlier in the work: inadequate liquidity in capital markets, the inability to thoroughly manage and assess *Shariah* risk, and the lack of a cohesive secondary market to unload Islamic bank assets. These issues would inevitably spill into the American financial system, which is already struggling. Second, the US financial regulation is decentralized and spread out among various agencies, and so are the *Shariah* boards of the various financial institutions that offer Islamic products. Thus, both parties- those regulating the financial aspect and those regulating the *Shariah* aspect- are dispersed, and this makes (much needed) systematic communication difficult. And, third, there are substantial issues with structuring profit-loss sharing (PLS) products and dealing with deposit insurance, which we will now address.

Under federal law, deposits are currently insured, up to \$250,000, by the Federal Deposit Insurance Company (FDIC).<sup>84</sup> This is an obstacle that needs to be resolved within a *Shariah*-compliant framework; while still satisfying banking regulations. Essentially, the deposit insurance diminishes the profit-loss sharing (PLS) element, which is an Islamic ethos. Warde explains, "Insofar as Islamic banking is supposed to be primarily based on profit-loss sharing, deposit insurance should not normally apply." But, in the American banking system, a deposit

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<sup>84</sup> Stevens, John. Counsel, Federal Deposit Insurance Company (FDIC), Chicago office. Interview 2/10/2009

cannot be subject to principal risk. If it is; it is not a deposit.<sup>85</sup> There is a financial institution in the United States currently offering Islamic bank deposits under the PLS structure; however, the products Islamicity is doubted by its competitors because it diminishes the risk element intended to be shared by both the bank and the depositor.<sup>86</sup> The deposit issue is a crucial hurdle to overcome, but it is not an impossible one. There appears to be a desire to learn more about the industry through domestic and global conferences, programs, etc.; possibly to derive feasible solutions to the challenges mentioned.<sup>87</sup>

With respects to the deposit issue, there are several examples to consider. Again, this is another point that needs to be hashed out in systematic discourse, but I use this research to introduce potential options that regulators, *Shariah* scholars, practitioners, and academic experts can either refute or expand upon. Sole' discusses one possible solution to the deposit issue in his work- Deposit Takaful (DT-Insurance). In his section on "Building a Supporting (Islamic) Financial Infrastructure," he discusses the need for a protection schema in countries where Islamic banking is emerging as a means to build consumer confidence. He also fairly addresses the point that insurance, in a conventional sense, is not permissible in Islam: "Therefore, the DT will have to be designed in a way that complies with the *Shariah*."<sup>88</sup> He goes

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<sup>85</sup> Ibid

<sup>86</sup> University Islamic Fianancial, Ann Arbor, MI; this is significant because no other institution in the US is offering this product within a Shariah compliant framework.

<sup>87</sup> John Stevens is currently enrolled in a post graduate UK's Institute for Islamic Banking and Insurance. Also, the regulators at the NYFRB actively participated in conferences held through Harvard's Islamic Finance Project, along with others in Kuwait and Bahrain.

<sup>88</sup> Sole': Pg. 18-19

on to distill that several other matters need to be addressed- if choosing this deposit option: the schema's coverage, funding and investment policies, resolution process of dealing with failed banks.<sup>89</sup> Undoubtedly, resolving the deposit issue will require the expertise of regulators, *Shariah* scholars, and practitioners. As briefly noted earlier, the UK managed to work through the deposit issue by reformatting their existing financial laws to accommodate an Islamic PLS deposit structure. A more thorough comparative analysis needs to be done on what the US can absorb from the UK's Islamic banking precedent.

Every country has its own financial regulatory schema, and thus, I cannot realistically expect the US to directly mimic the UK's deposit structure. However, if we consider the UK's approach, there could be some lessons learned. First, they adjusted their regulations by the passing of the Finance Acts of 2005 & 2006. And, second, UK regulators formulated a task force to work with practitioners and, inadvertently, *Shariah* scholars to discern the critical issues and then find solutions that appealed to all parties. This is one of many reasons why forming a central committee with members from each group to address matters such as this is vital to cultivating the industry's growth in the US.

As established earlier, the US can financially and politically benefit from a strong Islamic finance presence, but also, the industry can absorb positive lessons from the American arena, as well. The US is a leader in regulatory institutions.<sup>90</sup> Despite recent scrutiny of US regulatory

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<sup>89</sup> Ibid

<sup>90</sup> As a "modern" society, the US went through the industrial revolution at the turn of the twentieth century; therefore, it has had time to evolve and develop regulatory arms. In contrast, most Muslim societies are recently hitting their industrial strides- deeming them "emerging markets." C. Wright Mills discusses further in his, The

financial bodies, this environment is perfect for building a sustainable, bifurcated regulatory system to oversee Islamic finance in order to incite standardization. Given that the industry is a conflation of religion and finance, its organic growth in the Muslim world seemingly placed priority on ensuring a product's "Islamicity" above all other matters. Using the US's solid financial regulatory framework to support the industry's growth may shift the focus more to standardization, especially among *Shariah* scholars issuing *fatwas* for US products.

We established earlier that US financial regulation is dispersed throughout several agencies, which deflects Gulf investors from entering the US market. US regulators can use the same argument against *Shariah* scholars because each financial institution offering Islamic products is dealing with different scholars. This in turn could stump communication with regulators. One way to attenuate this issue would be if a national supervisory *Shariah* council formed in the US, representative of all the *madhahib*,<sup>91</sup> to issue standard *fatwas* on vanilla products in effort to further homogenize the industry. The US is neutral ground with no specific *madhab* association, so following a central board's rulings cannot in anyway diminish personal religious allegiances. Plus, due to the interspersedly diverse Muslim population in the United States, religious clerics may be more conducive to discuss and digest the various interpretations of Islamic law in order to produce convergent standards. Finally, the Islamic finance industry can benefit by subsisting in a dual regulatory framework that emphasizes homogeny in financial

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Sociological Imagination, (1959) the propensity for economically developed societies to build homogenous standards faster than developing ones. This is the point I am trying to distill.

<sup>91</sup> Emulating the Mamluk's legislative system (12<sup>th</sup> Century AD Egypt), Mamluks defaulted to the *Shafi'i madhab*, however, they ruled over a diverse Muslim population. Theirs was a centralized government rooted in Islam, but they had diverse juristic representation in their legislative system to accommodate their Muslim diverse public.

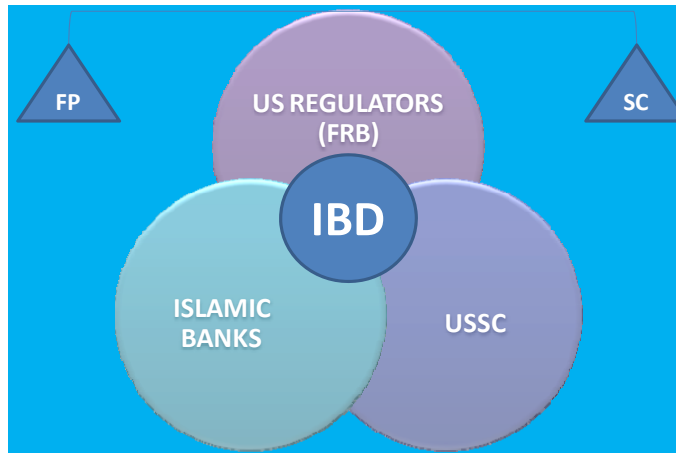
practices through uniform capital adequacy standards, corporate governance, risk management, etc., as well as, the Islamicity of financial practice. The United States offers the perfect environment to place emphasis on both Islamicity and general practice standards.

Thus, if a central financial regulatory arm were established, as well as central *Shariah* board, then the US could position itself to develop the Islamic banking industry further. This, in turn, would place the US in a more competitive standing as an innovative global financial center. The key to realizing this ambition is systematic communication among the interested parties: regulators, practitioners, *Shariah* scholars.

Essentially, Islamic finance in the US could operate most viably under a dual regulatory system. Warde distills this schema further in chapter ten of his work, “ ...The dilemma of dual regulation has generally been resolved in one of two ways: by establishing, within the central bank, a division dealing with Islamic banking, or by coordinating the supervision of the respective banks.”<sup>92</sup> Thus, if the US Federal Reserve Bank delineated a specific division to act as an intermediary among practitioners, *Shariah* scholars, and regulators; this could ensure a communicative flow, which allowed for needs to be expressed and feasible solutions to be proposed by all parties. Ideally, the employees working in this division would have a strong knowledge of Islamic finance product structures, industry trends, and US banking regulations.

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<sup>92</sup> Warde, Pg 198.



Thus, a secular regulatory framework that allows for bifurcated governance on product structures could, ultimately, support industry standardization. Ideally, banking regulators could continue to regulate financial practices that speak to corporate governance, capital adequacy standards, and risk management; while the central *Shariah* board maintained the Islamicity of products. This is a sphered framework where all parties know their jurisdiction but work symbiotically towards the collective good. This is Habermas' communicative theory in action within a post-secular society. Thus, the proposed dual schema is congruent to secular ethos; as it is not calling for favoritism, or even conversion!, but requesting a neutral sphere in which the necessary dialectic can take place in order for all constituents to have the opportunity to live by their respective comprehensive doctrines in the day-to-day political realm.

### **Islamic Finance in the US: Closing Thoughts to Consider**

My research has taken us through several academic spheres: the economic, historical, religious, legal, and political. This interdisciplinary approach to constructing the Islamic finance's narrative sheds important light on this subject- specifically as it relates the industry's

existence in the US. As I mentioned earlier, this work's title-question is simply subtext to a much broader issue pertaining to secular societies and their attempts to accommodate religious constituencies. This is a dense and complicated matter, which will require much more discourse. Unfortunately, the dialectic surrounding Islamic finance in the US is ostensibly missing from Islamic finance scholarship. Thus, this research work is constructive in so much that it leads to heuristic goals.

A more thorough work would assess the sovereign-relationships among states, religions, and selves; pulling more from the political and legal theoretical spheres. Also, a comprehensive comparative case study between the UK's Islamic finance approach and the US's would do wonders for this field; as the successes and challenges of a non-Muslim country implementing Islamic finance could then be easily picked apart, used, or dismissed for the domestic space. Another consideration to make with regards to the UK involves their *Shariah* boards. Do practitioners in the UK use the accessible *Shariah* scholars in the Middle East? Or, is there a central *Shariah* unit? If so, was the process cumbersome? That is, did scholars from different *madhahib* come together easily and is this a feasible structure for the US? If there is not a central *Shariah* unit in the UK, does this suggest the idea I proffered earlier of establishing a central *Shariah* supervisory board an unachievable ideal? Finally, a closer look at the UK's deposit structure would also be extremely beneficial.

In the US, there are salient gaps in data that, if available, could give the Islamic finance industry a stronger position. As in the UK's case, identifying a bankable Muslim market may be useful; especially with respects to justifying that legislatively accommodating this sector would



be economically worthwhile. However, market share projections would require accurate Muslim population statistics, which are lacking in this country. I ran across numbers ranging from 3 million to 8 million, and this is too wide a gap to come up with even a rough estimate to size the market. Ideally, an independent organization would conduct a feasibility study which includes the population of all Muslims in the United States, then cut the data as follows: break down by country of origin, citizen/immigrant, level of education, level of commitment to religion (i.e., nominal Muslim or practicing), profession, gender, and age. Gathering this information would not only pin down accurate population statistics, but may also reveal insight into the propensity of the domestic Muslim population to bank Islamically. Seemingly, the previous inquiries are part of a data wish list. Given that the US is a secular society, obtaining such data from a large sample would be difficult; as it goes against the secular grain.

Finally, a personal closing thought on Islamic finance subsisting in the US: given the financial crisis in this country, I dare say that the conventional system could stand to learn from the core Islamic principles that drive the Islamic finance industry- namely, the sources and uses of funds. Even with its challenges and inconsistencies, Islamic finance is seen as a 'greener,' more socially aware financial system. Its presence in the US could enlighten regulators and consumers alike on safer financial practices. And, as noted earlier, the Islamic finance industry could, in turn, learn more in the domestic arena with respects to regulatory standardization. The possibilities of methodological exchanges are seemingly endless. But, one certainty remains- there is a need for more academic discourse on Islamic finance in the United States.