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Prospects and Challenges of Islamic Banking and Finance in United States:
Lessons to be learnt from the Global Financial Crisis

By

BASAINEY EBRAHIMA JAMMEH

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DECLARATION STATEMENT

I, **BASAINEY EBRAHIMA JAMMEH**, declare that this thesis is my own work and has not been submitted in any form for another degree or diploma at any University or other institute of tertiary education.

Information derived from the published and unpublished work of others has been acknowledged in this text and a list of references is given in the bibliography.

Berlin, 05th August 2010

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Student's Signature **Place, Date**

525528

Student Matriculation Number

Supervised By HTW-Berlin Faculty Staff

Treskowallee 8, 10318 Berlin

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First Supervisor: Second Supervisor:

Prof. Dr. Claus Thomasberger **Prof. Dr. Dayanand Arora**

ABSTRACT

This study examines the prospects and challenges facing Islamic banking and finance in U.S. and identifies lessons that IFIs can learn from recent global financial crisis. The paper employs a combination of qualitative and quantitative data analysis methods. A table comprising key retail Islamic banking and home finance providers and products was developed and analysed. In addition, comparison between Islamic and conventional housing mortgage transactions was conducted to determine if differences in transaction approaches allowed the reduction of impact of recent financial crisis on IFIs.

Initial findings of the study indicates that, in general, Islamic banking accounts do not differ so much with conventional types except the way they are allowed to run in IFIs. However, their main difference lies in mudaraba account which promotes the concept of profit-and-loss sharing between bank and account holders. On the other hand, Islamic housing mortgage transactions in U.S. were found to differ with conventional types because IFIs in the first instance are required by Shariah law to purchase and own real estate properties before selling or leasing to interested home buyers.

Other findings of the study shows that in U.S., IFIs were less affected by recent financial crisis due to adoption of Islamic transaction guidelines which prohibits excessive risk-taking, requires checking of credit history and income prospects to ensure cautious lending. Risks at the level of institutions, organisations and products were identified as important lessons for IFIs from recent financial crisis. The future of Islamic finance in U.S. appears to be promising due to strong performance manifested by Islamic housing mortgages during the recent financial crisis. Major challenges facing Islamic finance industry includes fragmented regulatory/supervisory framework, possible legal and regulatory changes in mortgage market during the post crisis period and restricted funding sources for Islamic home finance companies.

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This piece of academic work is dedicated to the loving memory of my beloved father, *Ebrahima Janko Hadama Jammeh* who for natural reasons could not witness this day. May God continue to shower his endless blessings on you, **Ameen**!

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LIST OF ABBREVIATIONS

AFH	American Finance House
CIA	Central Intelligence Agency
CSR	Corporate Social Responsibility
DIB	Dubai Islamic Bank
DIFC	Dubai International Finance Centre
FDIC	Federal Deposit Insurance Corporation
IFI(s)	Islamic Financial Institution(s)
IMFs	Islamic Mutual Funds
LIBOR	London Interbank Offered Rate
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of Currency
OIC	Organisation of Islamic Conference
PLS	Profit-and-Loss Sharing
SPV	Special Purpose Vehicle
TARP	Trouble Assets Relief Program
UBK	United Bank of Kuwait
UK	United Kingdom
US	United States

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Chapter 1: INTRODUCTION

From Judaism to Christianity, and Christianity to Islam, scriptures of the world's major religions have been and continue to preach against exploitation of the masses being in business or otherwise through usurious acts. This refers to charging of excessive interest rates by banks and other financial intermediaries on borrowed money. This paper provides evidences in the literature review chapter to substantiate the above argument. However, Islam, like all the above-mentioned religions have laid down special codes of ethics for doing business in principle and in practice. Numerous studies on the subject confirmed unanimously that the sources of Islamic financial system regulations could be traced back from four main books which form the core of the Islamic legal system, also known as "Shariah": the *Holy Quran, the Sunnah, the Ijma*, and *the Qiyas*. The Islamic banking transaction model of "Profit-and-Loss Sharing (PLS)" was first pioneered undercover in 1963 by an Egyptian Savings Bank known as Mit Ghamr. However, the first Islamic bank of the world was considered to be Dubai Islamic Bank (DIB) founded in 1975.

According to Islamic Shariah law, Muslims are strictly prohibited and condemned from receiving or paying *Riba* "Usury or Interest" in their financial dealings because it serves as bottleneck to fair distribution of wealth in society and discourages social justice. Hence, the underlying concept for practicing Islamic banking and finance advocates a "*free interest-based*" financial system where profits as well as losses are shared among parties to a contract unlike the conventional interest-based system. It is important to note that banking services are one aspect of Islamic financial system which encompasses other spheres of financial intermediation such as those dealing with financial instruments, for example, Islamic bonds called "*Sukuk*", financial markets dealing with Islamic Mutual Funds and so on.

Today, Islamic banking is constantly gaining momentum among leading financial service providers in the world. Major global conventional banking entities like HSBC, Deutsche Bank and a host of others have seen the promising trend of Islamic products and are exploiting the opportunities they offer by opening Islamic banking subsidiaries and windows. Notwithstanding, Islamic financial institutions

(IFIs) have been criticised for their lack of compliance to Shariah principles with respect to current practices. Hence, key concerns raised by two prominent scholars have been highlighted in the literature review to help balance content and give a fair representation of views expressed on the subject matter.

The purpose of this paper is to study prospects and challenges of Islamic banking and finance in U.S. and help identify lessons that IFIs can learn from recent global financial crisis. However, over the past two decades, Islamic banking has been a growing and promising industry in U.S. and focuses primarily on Shariah-compliant consumer retail banking products including home finance mortgages (Goud, 2009). The basic intention behind the setting up of IFIs in U.S. apart from the desire of Muslims to recognise and perform their financial transactions without indulging in *Riba*; was to serve the unmet needs of the increasing Muslim population. Islamic banking products in U.S. consist of current, savings and mudaraba or investment accounts. The most popular methods of Islamic home finance include mudaraba, musharaka, ijarah and marabaha. Islamic financial intermediation in U.S. is not without challenges mainly because the financial architecture is more attractive to conventional players than their Islamic counterparts. Nonetheless, this paper shares the opinion that the future growth prospects of Islamic finance in U.S. are promising.

This research paper is divided into six chapters together with bibliography and appendices sections. Contents of chapters are outlined in the thesis structure available at (pp.5-6).

1.1 **Problem Statement**

Islamic banking and finance currently enjoys high growth prospects around the world especially within the western hemisphere. This has been confirmed by well documented studies most of which estimated the industry's annual growth rate to be between 10 and 15 percent. However, one is left to wonder if such hopes have not been dashed away by the recent financial crisis which started in U.S. before engulfing both developed and developing economies. The recent financial crisis brought serious repercussions for all kinds of business establishments and originated from a country that has long been revered by many as the hub of financial success for investors the world over.

There are an estimated 1.7 to 2 million Muslims living in U.S. according to CIA estimates which are based on 0.6% share of the entire population as of July 2010. U.S. cities with largest Muslim population include Boston, New York City, Washington, DC, Atlanta, Chicago, Detroit, Minneapolis-St. Paul, Houston, Dallas, Los Angeles and San Francisco. This geographical concentration was believed to have influenced the establishment of IFIs in locations where Muslims live (Goud, 2009). It is evidently clear that the size of Muslim population when used to determine the potential market size of Islamic financial products in U.S. does not pose any significant threat to the existing market for conventional financial products. However, several evidences have shown that the increasing acceptance and adoption of Islamic financial products by western multinational banks have proven the economic viability of this emerging industry.

Many studies have indicated that retail banking and home finance are at the core of financial intermediation carried out by IFIs in U.S. Key among those IFIs providing such services before and during the financial crisis include American Finance House-LARIBA, Devon Bank, University Bank, Guidance Residential, and United Bank of Kuwait which later left for U.K. It could be recalled that housing mortgages, an important product in the portfolio of Islamic finance intermediaries, was found to be one of the causal factors of the recent financial crisis due to low quality mortgages administered by conventional banks.

Hence, the above problem background leads to the following research questions:

(a) Which types of transaction models are used by IFIs to offer consumer retail banking and home finance products in U.S.?

(b) To what extent did these transaction models reduced impact of the recent financial crisis on U.S. IFIs?

(c) What lessons can IFIs learn from the recent financial crisis?

(d) What growth prospects and challenges are there for IFIs in the wake of recent financial crisis?

1.2 **Objectives and Scope of the Study**

Since Islamic banking and finance has existed in U.S. for the past two decades, it is therefore, befitting to find out where the industry stands within the competition during the most crucial moments in the country's economic history. From the foregoing, this study aims to achieve the following objectives:

- To outline the theoretical framework of Islamic banking and finance in order to highlight concepts and principles supporting its business model.
- To examine how Islamic financial transactions are carried out in U.S. in respect of offering retail banking and finance products.
- To establish the difference between Islamic and conventional housing mortgage transactions in U.S.
- To find out the impact of the recent financial crisis on IFIs.
- To outline key lessons that the global financial crisis has offered to IFIs.
- To outline key regulatory issues that put IFIs at a disadvantage position within the U.S. financial industry.
- To outline the future growth prospects and challenges facing IFIs in U.S.

1.3 **The Thesis Structure**

The structure of this thesis comprises different sections herein referred to as "*Chapters*" each of which deliberates on a specific aspect of the topic under investigation. The structure covers the following as listed below:

Chapter 1: This chapter provides the introduction, problem statement, and concludes with objectives and scope of the study.

Chapter 2: This chapter outlines the research methodology used which includes the choice of scientific analytical method, sampling method and sample size, sources of relevant data, and limitations of the study.

Chapter 3: This chapter conducts a survey of literature with a general overview of Islamic banking and finance. It also presents the Islamic perspective of Interest "*Riba*" and *Profit* in business, Islamic principles of banking, types of Islamic banking products and modes of finance. It concludes by highlighting differences which exists between Islamic and conventional banking practices.

Chapter 4: This chapter looks into the historical origins of retail Islamic banking and finance in U.S. and identifies lessons offered by recent financial crisis to IFIs. It begins with historical developments, and provides a list of key retail Islamic banking and home finance providers and products. The demand for Islamic financial products is analysed to determine present and future market potential. Two IFIs were selected for comparative financial performance analysis based on availability of financial data. A comparison between Islamic and conventional housing mortgage transactions in U.S. is performed. Based on the above, impact of the recent financial crisis on IFIs is determined and lessons identified. Key regulatory issues facing Islamic finance industry in U.S. were also outlined. The chapter concludes with the future growth prospects and challenges confronting Islamic banking and finance in U.S.

Chapter 5: The purpose of this chapter is to determine the extent to which the findings of this paper have succeeded in answering questions raised in the problem statement. Consequently, all four questions raised were individually discussed based on empirical results gathered during the various stages of the writing process.

Chapter 6: This chapter provides conclusions drawn from analysis and offers suggestions for further research.

Bibliography: This section provides a list of all sources consulted as reference materials during the writing process.

Appendices: This section provides glossary of Islamic banking terms and table(s) containing useful information.

Chapter 2: RESEARCH METHODOLOGY

Two main research approaches have been identified by scholars commonly referred to as: *quantitative and qualitative.* The quantitative approach also known as "*positivistic/objectivist*" has its roots from the natural sciences, while, the qualitative approach known as "*phenomenological/subjectivist*" originates from the social sciences.

2.1 **Choice of Analytical Method**

For the purpose of interpreting data in this thesis, this paper chose to apply a combination of qualitative and quantitative approaches. This is necessary because not all the data required for analysis were found in the form of either judgmental or figurative. While qualitative analysis is effective in describing relationships; quantitative analysis is also effective in determining percentages changes in financial performance over a given period of time.

In examining the transaction models currently employed by IFIs in US, this paper developed a table comprising key retail Islamic banking and home finance providers and products. In determining impact of recent financial crisis on U.S. IFIs, a comparison between Islamic and conventional housing mortgage transactions is conducted to determine if differences in transaction approaches allowed the reduction of impact of recent financial crisis on IFIs. Reference is also made on views expressed by scholars and official comments from Freddie Mac with regards to performance of Islamic housing mortgages during recent financial crisis. In addition, two IFIs were selected for comparative financial analysis with a view to measuring their strengths and weaknesses by studying changes in financial position and performance during two periods before and after introducing Islamic products. While *financial position* is commonly measured by balance sheet items constituting assets, liabilities and owners equity; *financial performance,* on the other hand, is measured by income statement items such as revenue, expenses and net income. However, revenues from Islamic banking activities are considered as non-interest income in most banks. Therefore, rather than examining changes in expenses and net income, this paper chose to highlight changes that took place in interest and non-interest income streams especially after the introduction of Islamic products in both banks. Such changes in income are expected to provide useful insights as to whether the introduction of Islamic products enhanced the banks' income generating capacities.

2.2 **Sampling Method and Sample Size**

A simple random sampling method is used in this thesis. Base on this method, four retail Islamic banking and home finance providers out of a sample population of seven were selected randomly based on their successful experiments in U.S. It is assumed that their business models can provide useful insights for an intellectual enquiry of this type. These institutions include LARIBA, Devon Bank, Guidance Residential, and University Bank. However, for the purpose of comparative financial analysis, Devon Bank and University Bank were chosen. This selection is motivated by the following reasons: *First*, the availability of relevant financial data necessary to substantiate any conclusions about to be made. *Second*, both financial institutions are engaged in the provision of retail Islamic banking alongside home finance products in U.S. which makes them identical and easy to compare. *Third* and finally, these institutions belong to states ranked as third and fourth with largest Muslim population within U.S. (i.e. Illinois & Michigan). Therefore, transaction levels in such states are assumed to be high. In addition, they comprised an appropriate sample that can help us determine the benefits associated to introduction of Shariah-compliant products in financial institutions.

2.3 **Sources of Relevant Data**

It should be noted that this paper does not intend to build a new theory, but rather, to investigate the research questions based on available secondary data with a view to contribute to available literature. This is mainly due to difficulty in obtaining primary data for the project. The researcher would have loved to gather primary data, but due to cost and time implications, is forced to abandon such attempts. Therefore, the secondary sources of data consulted include textbooks, academic and scholarly journals, academic thesis, newspaper, magazine, internet articles, and

U.S. government congressional report.

The following sources were widely consulted during the writing process. They include Handbook of Islamic Banking by Hassan, M. K. & Lewis, M. K., Edited version (2007), Published in U.K; a recent study of Islamic Finance in North America by Blake Goud (2009), Published by Yasaar Media Publications, DIFC; a Master thesis submitted to Georgetown University in U.S. by Victoria Lynn Zyp, B.A. (2009) on Islamic Finance in the United States with reference to Product Development and Regulatory Adoption; and Handbook on Introduction to Islamic Finance by Muhammed Taqi Usmani (1998), Published in Pakistan. The paper also made significant use of Web pages of LARIBA, Devon Bank, University Bank, and Guidance Residential.

2.4 **Limitations of the Study**

Due to the secondary data approach adopted in this study, several constraints have been identified that serves as limitations. However, the major limitation stemmed from the researcher's inability to gather primary data due to cost and time implications. The collection of primary data would have enabled access to first hand financial information necessary for analysis some of which were not readily available especially from selected banks in the sample. For example, it would be rather interesting if comparison of financial performance was conducted on providers whose core business is Islamic banking with those that specialise to a greater degree in Islamic home financing. From this perspective, performance analysis using profitability, liquidity, risk and solvency, with efficiency ratios can reveal the true impact of recent financial crisis especially on those providing real estate property financing. In addition, lack of classified statistics specifically on Islamic banking and finance in U.S. from federal and state agencies has been another key limitation of the study.

Chapter 3: LITERATURE REVIEW AND THEORETICAL FRAMEWORK

3.1 **Overview of Islamic Banking and Finance**

Extensive research continues to be undertaken into the philosophy and objectives of Islamic banking and finance in an effort to help promote awareness and understanding about its underlying principles and values. However, in order to understand these principles and values, one has to first of all, understand the Islamic legal system through its sources of regulations. Numerous studies unanimously confirmed that the sources of Islamic financial regulations could be traced back from four main books which form the core of its legal system, also known as “Shariah”: *the Holy Quran, the Sunnah, the Ijma, and the Qiyas*. To so many western commentators, Islamic banking and finance is a new phenomenon, a term introduced in the world of finance in mid 1980s as observed by Zaher and Hassan (2001). However, several scholars agreed that the origins of modern Islamic banking and finance can be traced back to the inception of Islam when Prophet Muhammad (*peace be upon him*) served as an agent to his wife’s business undertakings.

A closer look at the term “Islamic bank” and its operations as defined by the General Secretariat of OIC shows: “An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of receipt and payment of interest on any of its operations” (Ali & Sarkar, 1995, pp.20-25). In other words, Islamic banking is an ethical way of financial intermediation that is performed in line with principles of Islamic law. Islamic banks serve as trustees of depositor funds. According to Islamic law, Muslims are strictly prohibited and condemned from receiving or paying Riba “usury or interest” in their financial dealings because it serves as a bottleneck to fair distribution of wealth in society and discourages social justice. Islam also forbids Muslims from engaging in gambling, speculation, alcohol and any related activities contrary to its principles because they spread evil in society.

The Islamic banking business model of "**Profit-and-Loss Sharing** (PLS)" was first pioneered undercover in 1963 by an Egyptian Savings Bank in the local religious area of Mit Ghamr under the leadership of Ahmad Elnaggar. Since then, after three decades of existence, Islamic banking has witnessed remarkable growth to include such areas like finance, insurance, mortgage, and asset management with an estimated annual growth rate of between 10 and 15 percent according to some research findings. Research has also revealed that the first ever successfully operated Islamic bank in the world was established in 1975 with the founding of Dubai Islamic Bank (DIB). Analysing DIB's operation and performance, Platt (2008) concluded that the bank was successful mainly because it offered clients with higher returns than conventional banks do and in addition, provided other products like auto, home and personal financing at competitive rates.

The Islamic philosophy and objective of business rests on the premise that IFIs must engage themselves in actual trading of goods and services with a view to paying reasonable returns on depositor funds while also contributing to social advancement. This is contrary to the conventional approach which has as its primary objective, profit maximisation to enhance shareholder value. In analysing Islamic banking motives, two views have been expressed and shared by scholars. The first view is referred to as *Chapra´s model* which according to Hassan & Lewis, (2007, p.26) advocates that "each of the institutions in an Islamic economic system must explicitly take responsibility for the fulfilment of the general economic and social objectives, sometimes at the cost of individual profitability." In the words of Dusuki (2008, p.7) "This model places greater social welfare responsibility and religious commitments upon Islamic banks in order to achieve the economic objectives, including social justice, equitable distribution of income and wealth as well as promoting economic development." The authenticity of the views expressed by these scholars is a reality in today's business world. That is to say, when one looks carefully at conventional corporate social responsibility slogans being championed by nations all over the world, one can safely conclude that societies expects more from business concerns than just paying tax on annual returns.

In fact, CSR was designed to encourage business establishments to give back part of their profits to society which serves as a convincing evidence to support the above model put forward by Chapra. In summary, an IFI is obliged to achieve a double bottom line by making profit to reward its depositors as well as contribute to the overall socio-economic development of society.

The second view known as *Ismail's model* advocates that "Islamic banks would act as commercial institutions, with responsibilities essentially to shareholders and depositors" (Hassan & Lewis, 2007, p. 26). However, slightly different from Chapra`s model, this model places greater emphasis on making profit for investors as the bank's primary objective, while leaving social welfare issues to be taken care of by the state. The model considers the payment of Zakat to be the bank's social contribution which facilitates such social cause like helping the needy. It is clear that this view puts much emphasis on the profit maximisation objective of banks with the condition that they do so within the framework of Islamic Shariah principles.

Today, Islamic banking is constantly gaining momentum among leading financial institutions in the world. Major conventional banking institutions like HSBC, Deutsche Bank, Citibank and others have seen the promising trend of Islamic financial products and are exploiting the opportunities they offer by opening Islamic banking subsidiaries and windows. Zaher and Hassan (2001) found out that Islamic system of banking exists in more than 60 countries throughout the world with over 250 IFIs in operation. Some countries like Pakistan, Iran and Sudan have their entire financial systems based on Shariah. Other Muslim countries include Egypt, Indonesia, Jordan, Malaysia, Bahrain, and Bangladesh, just to name few. Non-Muslim countries and the western world have not been left behind in the likes of UK, Germany, Australia, Japan and North America according to Goud (2009, Yasaar Media Publication).

Having discussed much of the literature in favour of Islamic finance, this paper would like to turn attention to other key concerns expressed by two notable scholars with reference to current practices of IFIs. This is necessary because Islamic finance recently attracted lot of criticisms from both Shariah scholars and academics.

Mahmoud El-Gamal, Professor of Economics and Statistics at Rice University wrote extensively on Islamic finance over the years and criticised IFIs for failing to comply with principles of Shariah both in Muslim majority and minority countries. He lamented that “the bulk of IFIs based their rates of return or cost of capital on a benchmark interest rate such as LIBOR which could easily be classified as interest-based debt finance” (El-Gamal, year unknown, p.1). He therefore, criticised Islamic nations for their “lack of coherent demarcation between what is “interest-based” and “interest-free” (El-Gamal, year unknown, p.4). He argued that these banks are engaged in what he referred to as “mere window-dressing for conventional bank interest-based financing” (El-Gamal, year unknown, p.19). From my own experience, these allegations contain an element of truth because when one takes a critical look at the way things are done, definitely some banks are not practicing as expected of them. However, this may be due partly to lack of professional knowledge or negligence on the part of staff, management failure to enforce guidelines given by Shariah boards or regulatory constraints especially in non-Islamic states.

Furthermore, another scholar who contributed positively to Islamic finance literature has also made some remarkable observations in the way Islamic banks conduct their operations in this day and age. Justice Muhammad Taqi Usmani, an influential jurist of Islamic finance in Pakistan, was privileged to have served in several Shariah boards in Islamic banks. He has also written extensively on the subject. He criticised Islamic banks for relying too much on cost-plus mark-up and lease financing. He argued that murabaha and ijara products were modified by Islamic bankers to serve the purpose of financing at initial stage due to difficulty in implementing mudaraba and musharaka methods in some areas. However, he stated emphatically clear that murabaha and ijara were not meant to be used as Islamic modes of financing in their origin and asserted that their implementation requires compliance to strict conditions in order for them to be permissible. Therefore, he concludes that they cannot be used as substitutes for conventional interest-based transactions.

Justice Usmani stated that due to these lapses on the part of some Islamic banks, “it is difficult to argue for the case of Islamic banking before the masses, especially those who feel that it is nothing but a matter of twisting of documents only” (Usmani, 1998, p.166). Usmani therefore, cited that “it is high time now to find out ways and means to move from debt-based to equity-based instruments in their true spirit, so that they may demonstrate the beauty of Islamic finance based on its economic ethos” (Shirkah Finance Magazine 2009, p.44). To conclude, it is imperative to note that the invaluable critique made by both scholars on the current modus operandi of some Islamic banks deserves commendation. These criticisms have revealed important weaknesses of some players in this emerging industry and create room for further dialogue among stakeholders. Above all, in my opinion, these critiques were meant to improve the business image of the industry and to ensure that underlying principles and values are strictly adhered to as cherished by the Muslim Ummah.

3.1.1 **Islamic Perspective of Riba “**Interest**” and Profit in Business**

Many research undertakings into the concept of *Riba* “Interest” have revealed that almost all contemporary scholars of Islamic Fiqh (*Jurisprudence*) agreed unanimously on its prohibition in the Holy Quran and Hadeeth. However, there are various interpretations offered by different scholars on the subject matter. According to Chapra (2008), at the time of issuing a report in 1980 on the elimination of interest from the economy, the Pakistan Council of Islamic Ideology concluded that: “The term *riba* encompasses interest in all its manifestations irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are of a personal nature or of a commercial type, whether the borrower is a government, a private individual or a concern, whether the rate of interest is low or high” (Chapra, 2008, p.109). These interpretation and many others given by scholars have clarified the Islamic perspective of *riba* as corroborated by a consensus among scholars of Islamic jurisprudence.

On the other hand, profit by common definition, is the reward for entrepreneurship which entails providing productive resources, business expertise and risk-bearing in a given undertaking. To support this point, Fahim Kahn (1995, p.54) believes that "*Profit* by definition is the reward for risk-bearing only and stated that there is no profit for guaranteed principal and any profit for such principal means predetermined positive return or time-value of resources which is not permitted in Islam."

From the foregoing perspectives, it is evident that Islam has provided Muslims a clear and convincing explanation of both Riba and profit in order to help identify their differences. A summary of the most salient differences between *Riba* and *Profit* as tabulated by Musa & Musova, (2009) is shown on Table 1 below:

Table 1: Comparison between Riba and Profit

Riba	**Profit**
1. When money is "charged", its imposed positive and definite result is Riba.	1. When money is used in productive activity (e.g., in trading), its uncertain result is profit.
2. By definition, Riba is the premium paid by borrower to the lender along with principal amount as the condition for the loan.	2. By definition, profit is the difference between the revenue from production and the cost of production.
3. Riba is prefixed, and hence there is no uncertainty on the part of either the givers or the takers of loans.	3. Even if a sharing ratio is agreed in advance, profit is still uncertain, as its amount is not known until the activity is completed.
4. Riba cannot be negative, it can at best be very low or zero.	4. Profit can be positive, zero or even negative.
5. From Islamic Shariah point of view, it is haram (prohibited).	5. From the Islamic Shariah point of view, it is halal (allowed).

Source :< http://www.ekf.vsb.cz/shared/uploadedfiles/cul33/Musa_Hussam-Musova.pdf>

3.1.2 **Islamic Banking Principles**

The principles of Islamic banking practice are derived from Islamic Shariah law which accords it a unique religious identity. They include five elements as discussed below:

(i) **Prohibition of Riba** (Interest or Usury**)**

The prohibition of receipt or payment of interest in business dealings is an important principle that IFIs must observe in order to be in line with the teachings of Islamic law. However, before highlighting its important characteristics, first and foremost, this paper would like to provide some convincing evidences that were found in the world's major religious scriptures. This is to reinforce the belief that prohibition of interest in Islam was preceded by similar warnings in two other major religious scriptures. For consistency purposes, this paper presents their excerpts in the sequence that they were claimed to be revealed starting with Torah, New Testament and concluding with Quran.

In Torah, the Hebrew Bible, (1917) Jewish Publication Society English Translation, the Lord of Moses Commands in Exodus, chapter 22, verse 24:

"If thou lend money to any of My people, even to the poor with thee, thou shalt not be to him a creditor; neither shall ye lay upon him interest."

In New Testament, Luke, chapter 6, verse 35, the Lord commands Jesus:

"But love ye your enemies, and do good, and lend, hoping for nothing again; and your reward shall be great."

Finally, in Quran, scholars agreed that the prohibition of interest or usury came in four separate chapters, one of which is translated by Yusuf Ali (2009-10).

"**O ye who believe, fear God, and give up what remains of your demand for usury, if ye are indeed believers. If ye did it not, take notice of war from God and His Apostle: But if ye turn back, ye shall have your capital sums: Deal not unjustly, and ye shall not be dealt with unjustly**." (*Al-Baqarah, Chapter 2, verses 278 to 279)*

Other sections found in Quran include chapter 30, verse 39 (*Ar-Rum or the Roman Empire*); chapter 4, verse 161 (*Al-Nisaa or the Women)*; and chapter 3, verse 130 (*Al-Imran*) respectively. All the above mentioned verses of divine admonition shows the evil associated to consuming interest and its repercussion in the hereafter. Thus, this paper is able to conclude that Islam, like other divine religions which preceded it, have prohibited interest or usury and warned believers to stay away from anything that encourages such practices.

(ii) **The Prohibition of Gharar** (Uncertainty) **and Maysir** (Speculation)

The Islamic law has equally treated uncertainty and speculation to be forbidden acts in the sight of God and therefore, warned believers to stay away from them. Islam requires full disclosure of details pertaining contractual relationships between parties in order to protect the weak from exploitation. On the issue of speculation, Algaoud & Lewis (2007) cited its condemnation in both the Quran and Hadeeth which shows the severity of engaging in it. It was concluded that this condemnation applies to foreign exchange transactions involving options and futures on the stock market.

(iii) **Business Transactions must be Ethical** (Halal)

It is forbidden in Islamic law for any IFI to engage in investments such as construction of a gambling palace or support the acquisition of products like alcohol and illicit drugs. These are perceived as fuel for social evil from Islamic point of view. Therefore, investments are encouraged in productive sectors that help humans to satisfy their daily basic needs for food, shelter, clothing, healthcare and education.

(iv) **Payment of Zakat is Obligatory**

Since Zakat or Islamic tax is an important source of revenue for Islamic economies and Muslim societies, its payment is therefore mandatory on owners of wealth based on Islamic principles of social justice and equitable distribution. Scholars shared the opinion that it helps the state to support the needy to fulfil their basic human needs. The primary objective of levying Zakat on individual and corporate wealth is to “moderate social variances and enable the poor to lead a normal, spiritual and material life in dignity and contentment" (Algaoud & Lewis, 2007, p.40). It is paid on annual basis and amount is determined by applying 2.5% on total wealth at the end of the Islamic calendar year.

(v) **Conformity with Islamic Law**

At the centre of Islamic financial system is the Shariah law which provides guidance to Muslims requiring them to conduct their business or non-business affairs strictly in accordance with laid down principles. For this reason, all Islamic banks are required to have a Shariah Supervisory Board tasked with the responsibility of overseeing compliance issues on all transactions and to offer advice on a timely manner where deviations occurred from the norm.

3.1.3 **Types of Islamic Banking Accounts**

Virtually, Islamic banks do not differ so much with conventional banks regarding names and purposes of various deposit accounts. According to Abdul Gafoor (1995), the minor difference is in the way these accounts are allowed to operate in an Islamic bank. All Islamic banks operate three types of accounts at retail level, namely: *current, savings and investments***.**

However, there is a major difference in the case of *investment accounts*. While conventional banks accept deposits from investors for either a fixed or unlimited period of time and pay predetermined rates of interest at the end of the period; Islamic banks on the contrary, are engaged in a profit-and-loss sharing relationship with account holders. So that in the event of either a profit or loss at the end of investment period, the parties agree to share proportionately and capital is not guaranteed. This kind of arrangement is also known as *Mudarab*a "Partnership" agreement.

Furthermore, Tamer (2005) also made similar observations regarding the type of accounts operated by Islamic banks at retail level and their various uses as shown on Table 2 below:

Table 2: Islamic Banking Accounts at a Retail Level

Account Type	**Purpose of Deposit**	**Use of Funds**
Current Account	Safety and Trust	Qard al-Hassan
Saving Account	Readily available, small investment return	Finance small or medium size investments
Investment Account	Large investment return or partial (up to total) loss	Finance large-scale or long-term investments

Source: Tamer, S. (2005), p.76

3.1.4 **Modes of Islamic Financing Contracts**

Mirakhor & Iqbal (2007) observed that the most significant principle in Islamic finance is the prohibition of riba “interest”. This view is further supported in Quran when God says to the believing folk that he “has permitted trade but forbidden interest” (Quran: chapter 2, verse 275). Islam therefore, encourages investment of money into economic activities that promotes socio-economic well-being of society.

However, it is out of the scope of this paper to give an exhaustive list of all Islamic financing models. Rather, attention is given to those that have been adopted by various Shariah boards as compliant and are being offered in several parts of the world. They comprise the following as discussed below:

(i) **Musharaka** (*Financing by way of Equity*)

This type of contract is the most preferred model of finance partly because most scholars agreed that its implementation is quite “closer to the principle of profit-and-loss sharing concept” (Mirakhor & Iqbal, 2007, p.51). Under this model, the parties to an independent project, contribute capital and agree to share all risks proportionate to individual capital contribution and returns on an agreed formula based on actual profit accrued to the business. To clarify this statement, Usmani (1998) pointed out that it a “consensus among Islamic jurists that each partner shall suffer the loss exactly according to the ratio of his investment” (p.24).

One popular form of musharaka is known as "*Diminishing Musharaka*" which according to Usmani (1998) is "used mostly in home financing where a client wants to purchase a house for which he does not have adequate funds" (p.57). It is also commonly used in the purchase of other fixed assets based on joint ownership.

(ii) **Mudaraba** (*Financing by way of Trust*)

This type of contract involves the provider of funds known as "*Rabb al-mal*" and manager as "*Mudarib*". In this model, the rabb al-mal may either be a bank or its customer or vice versa. According to Mirakhor & Iqbal (2007), this finance mode though looks "similar to musharaka, does not require the setting up of a separate new business concern" (p.51). Profits are shared based on a predetermined ratio, while losses are borne by the financier. However, it must be noted that "… the mudarib has the option to buy out the rabb al-mal´s investment" (Mirakhor & Iqbal, 2007, p.52), if he so wish.

(iii) **Murabaha**

This is a type of contract where the bank carries out purchase of an asset or good from a third party seller on behalf of its client and then resell to him either immediately or on deferred basis for a price which includes its profit margin. To an ordinary man, this seems much like charging interest. However, under this model, there are strict conditions laid down before banks can enter into such contracts. One of these conditions is that the bank must establish its ownership of asset or good with all associated rights and risks before it can sell it. This ownership, according to scholars can either be physical or constructive. In other words, the bank may be in physical possession of the item on sale or have it somewhere in its name, for example, in a store. Additionally, the bank must fully disclose the acquired price of item as well as the margin it intends to add on cost price in order to satisfy the popular slogan in consumer rights "*let the buyer beware*" and give chance for negotiations to take place. This type of contract is mainly classified into two transaction forms also known as "*cost-plus mark-up and deferred payment*".

(iv) **Ijarah** (*Leasing*)

In this type of contract, the bank acquires capital assets and leases it to interested users for an agreed rental fee payable either on a monthly, quarterly or yearly basis. The bank serves as "*lessor*" and client as "*lessee*". Most at times, the lessor assumes responsibility of all costs associated to maintenance and insurance of assets. Two types of lease financing have been identified by Mirakhor & Iqbal (2007,) and these consist of operating and financing lease contracts. While under the operating lease contract, user pays a fixed rental fee either in advance or by monthly instalments as it may be agreed with the bank; he "does not have the option to buy the asset during or at the end of the lease term" (Mirakhor & Iqbal, 2007, p.52). Under the financing lease contract, lessee agrees to pay regular instalments to lessor with the objective of buying the lease at the end of its rental period. From the point of view of Mirakhor & Iqbal, rent is therefore, pre-arranged in this type of contract to avoid speculation.

(v) **Qard al-Hassan** (*Benevolent Loans*)

Islamic, unlike conventional banks, are required to set aside part of their funds to provide financial support of short-term nature to the needy in society at zero cost. These types of loans are known as "*benevolent loans*" because they are provided on goodwill basis and borrowers are expected to pay back only amounts borrowed. However, the bank is entitled to levy a one-off service fee to cover its administrative and materials expenses according to some Shariah scholars. Such loans are provided, inter alia, to finance pilgrimage, medical treatment, and educational purposes.

3.2 **Differences between Islamic and Conventional Banks**

Islamic and conventional forms of banking can be differentiated in several ways. According to Zaharuddin (2007), a key difference between the two financial institutions is that, whereas Islamic financial intermediation is dictated by rules contained in Shariah law; conventional banks operate according to man-made laws. Table 3 in the appendices provides a summary of key differences between Islamic and conventional banks.

In conclusion, this theoretical framework is intended to provide us with definitions of Islamic banking and finance products in order to prepare the foundation upon which analysis is based in subsequent chapters. However, it is hope that this comprehensive review will help us better understand that overall, Islamic banks do not differ with conventional counterparts so much in the area of banking accounts. Their main difference lies in mudaraba account which promotes the concept of profit-and-loss sharing between bank and account holders. On the other hand, there is visible difference in the area of retail financing mainly due to the fact that Islamic banks are required by Shariah to engage in trading of real assets or goods through the use of popular financing models like musharaka, mudaraba, murabaha and ijara as opposed to their conventional counterparts. It is envisaged that these theories when applied in subsequent chapters, can provide useful findings capable of answering key research questions raised earlier in the problem statement.

Chapter 4: ISLAMIC BANKING AND FINANCE IN UNITED STATES: *Lessons to be learnt from the Global Financial Crisis*

4.1 **History and Development of Retail Islamic Banking and Finance**

History shows that the arrival of Islamic banking and finance in U.S. took place in the 1980s after twelve years of its existence in other parts of the world. It all began with the establishment of two IFIs in 1986 and 1987 namely: Amana Funds, a mutual fund company located in Washington and American Finance House-LARIBA based in California. In a recent study, Goud (2009) cited that Shariah-compliant retail home finance and small business investment are the core business products provided by IFIs which were designed primarily to target the underserved segment of U.S. population. According to Goud, LARIBA became the first Islamic home financier to strike a $1 million deal with Freddie Mac in 2001 to facilitate home purchases.

However, it is a consensus among analysts that the first favourable pace for development of this infant industry in U.S. was set in motion during the mid 1990s. This period witnessed the issuance of two interpretive letters in a decade by Office of the Comptroller of Currency (OCC) at the request of United Bank of Kuwait (UBK) in respect of two popular products used for its home purchase program. These products consist of Ijara wa iqtina (*lease-to-own*) in 1997 and Murabaha (*cost-plus mark-up)* in 1999. The OCC approved the offering of these products by IFIs "because their structures" according to Goud, "were economically identical to conventional financial products" (Goud, 2009, pp.14-15). Victoria Lynn Zyp (2009) observed that UBK's Al-Manzil program first operated in California before expanding to other states where it specialised in small commercial properties and single-family home financing. Due to the small market size of Islamic financial products in U.S., UBK after merging with Ahli United Bank in 1999, decided to quit in 2000 (Victoria Lynn Zyp, 2009). On the other hand, from the view point of Goud (2009), "This was mainly due to the fact that the OCC interpretive letters did not translate immediately into significant growth in Islamic finance, but enabled significant growth in the later half of this decade" (p.15).

Another leading financial institution that followed suit was HSBC Amanah, a subsidiary of HSBC multinational bank. In the early part of 2000, HSBC entered the U.S. Islamic finance market and began offering Islamic home finance products using its "*Murabaha model*" in the state of New York by 2002 (Goud, 2009, p.21). In his analysis of HSBC's Islamic finance business, Goud argued that success was due to its ability to purchase homes worth $20 million during the first year of operation. Notwithstanding this performance, the bank finally left U.S. market in 2006 due to what was considered as "insufficient demand for Islamic products" (Goud, 2009, p.21).

Furthermore, one would have thought that the tragic events of 9/11 terrorist attach on World Trade Center in New York could have retarded the growth of an industry that was perceived as infant but growing in U.S. That is to say, the strict financial regulations that came in the wake of 9/11 resulted to mass movement of funds from U.S. to European and Middle Eastern countries because most investors feared losing their investments. But to the chagrin of most critics, what happened in the years that followed became contrary to what many anticipated. Despite the sheered uneasiness amongst critics and observers, the Islamic finance industry in U.S. grew remarkably both in the early and mid 2000s due to entry of new financial players. One of these new players is Guidance Residential (formally called Guidance Financial) that joined the industry in 2002 to complement efforts made by its predecessors. Its initial target markets were Washington DC, Maryland and Virginia suburbs where it made use of its "*diminishing Musharaka model* to provide retail home finance to target customers. Following an agreement with Freddie Mac to finance $200 million in home finance purchases, its financing eventually rose to more than $1 billion by the middle of 2007" (Goud, 2009, p.21). In addition, while Devon Bank launched its Islamic Finance Division in 2003 to service the surrounding neighbourhoods of Chicago; University Bank in 2005 also inaugurated its subsidiary of University Islamic Financial Corporation based in Ann Arbor, Michigan. Today, both institutions continue to provide retail banking as well as Islamic home finance products to their target clients and are part of the success stories of Islamic banking in U.S.

Other small players mainly constitute Islamic community credit and housing co-operatives that can be found in many parts of the country today.

In recognition of the capital constraints faced by IFIs in U.S., the federal government authorised Freddie Mac and Fannie Mae to invest in Islamic mortgages. Since 2003, Islamic home mortgages in U.S. have been regularly purchased publicly by these two agencies (Victoria Lynn Zyp, 2009). Their involvement in the Islamic home finance market has in no small measure reduced liquidity constraints faced by IFIs. Goud (2009) argued that their involvement is beneficial for IFIs but raised pertinent questions relating to Shariah compliance. His argument is based on the fact that the two "government-backed agencies are financed by using interest-bearing debts and mortgages" (Goud, 2009, p.20). However, it was concluded by Shariah scholars that "In so far as the contract governing the home purchase meets both Shariah compliance standards and Freddie Mac's underwriting standards, the source of the funds is not crucial to determining whether the transaction is Shariah-compliant" (Goud, 2009, p.20). Reports received from Freddie Mac revealed that the institution had "purchased more than $250 million in Islamic home loans by 2007, which is a small but notable fraction of the enterprise's $1.7 trillion in business activities" (Shayerah Ilias (2008, p.4: U.S. Congressional Report).

Finally, launching of the first *"Dow Jones Islamic Market Indexes"* on the NYSE in February 1999 became another milestone development. The existence of this Islamic investment platform provided Muslims and non-Muslim investors in U.S. and abroad a unique opportunity to engage in ethical investments. "The new Islamic Indices provided a benchmark for Shariah-complaint equity managers" (Goud, 2009, p.16). Initially, it consists of eight sub-indices but the present size of the investment pool is estimated to be more than 70 indices as at July 2009 says Goud (2009).

Table 4 below shows performance of key Islamic Mutual Funds (IMFs) in U.S. with annualised rates of return for ten years. This analysis is based on changes in rates earned on total assets between 1999 and 2009. This paper conducts a comparative analysis of performance between Amana Funds and Dow Jones Islamic Market (DJIM) U.S. Index. It is clear from the table that Amana Funds and DJIM U.S. Index both under-performed during the first year. However, while Amana Funds registered positive returns from year three through to tenth year; DJIM U.S. Index only managed to register moderate return in the fifth year. This may be attributed to the fact that Amana Funds came into existence in 1986 and 1994 earlier than the DJIM U.S. Index of 1999. Hence, it can be concluded that due to high customer loyalty and confidence, Amana Funds succeeded in out-performing DJIM U.S. Index during a ten year period.

Table 4: Islamic Mutual Fund Performance between 1999 and 2009

Fund Name	**Ticker**	**Dividend Yield**	**1-year**	**3-year**	**5-year (Annualised)**	**10-year**
Amana Income Fund	AMANX	1.14%	-13.1%	2.1%	8.4%	4.2%
Amana Growth Fund	AMAGX	0.00%	-15.3%	1.5%	8.3%	5.3%
Azzad Ethical Income Fund	AEIFX	0.71%	-32.0%	-9.9%	-4.4%	n/a
Azzad Ethical Mid Cap Fund	ADJEX	0.00%	-22.2%	-4.7%	0.9%	n/a
Iman Fund	IMANX	0.00%	-28.9%	-3.8%	-0.3%	n/a
DJIM US Index	JMUS	n/a	-21.5%	-2.4%	0.7%	-3.5%
Dow Jones Industrial Index	DJI	n/a	-23.6%	-6.6%	-2.9%	-2.5%

Source: Goud, B. (2009), p.18

It is also evident from the table that both IMFs registered a decline in return during the recent financial crisis. This shows investor dissatisfaction and waning confidence in Wall Street institutions and indicates negative impact of recent financial crisis on IMFs.

4.2 **List of Key Retail Islamic Banking and Home finance Providers and Products**

Numerous studies have confirmed that under listed IFIs constitute the most successful experiments of Islamic banking and finance in U.S. from 1986 to date. A careful scrutiny of the distribution of Shariah-compliant retail Islamic banking deposit products on the table below reveals that there are two main Islamic banking providers in U.S. They consist of Devon bank in Chicago and University bank based in Ann Arbor, Michigan. These are the Islamic banking providers who are engaged to a greater degree in the provision of riba-free banking in different parts of U.S. Both of them operate current and savings accounts. However, the distribution has also revealed that University bank's subsidiary of University Islamic Financial Corporation is the only full-fledged riba-free banking provider offering a deposit product on profit sharing "*Mudaraba*" basis. This was equally confirmed by both Goud (2009) and Victoria Lynn Zyp (2009). Hence, it is safe to conclude that there are three types of deposit accounts provided by IFIs in U.S.

Table 5: Key Retail Islamic Banking & Home finance Providers and Products

Institution Name *Product Type*	**LARIBA (AFH)**	**Devon Bank**	**Guidance Residential**	**University Bank**
▪ Banking				
Current A/c	No	Yes	No	Yes
Savings A/c	No	Yes	No	Yes
Mudaraba A/c (Profit-Sharing)	No	No	No	Yes
▪ Financing				
Ijarah	Yes	Yes	No	Yes
Murabaha	Yes	Yes	No	Yes
Musharaka	Yes	Available But Not Yet Offered	Yes	No

Source: Compiled from individual IFIs website as of May 2009

Furthermore, a similar distribution of retail Islamic financing products among key players in U.S. is also clearly evident from the table above. One is able to see that there exist two main Islamic finance companies namely: American Finance House-LARIBA and Guidance Residential as also confirmed by Victoria Lynn Zyp (2009) and Goud (2009). Both of these companies have strong presence in U.S. market of Shariah-compliant products. LARIBA provides such financing facilities like Ijara, Murabaha and Musharaka designed to facilitate equipment, trade and home finance respectively; while Guidance Residential is highly specialised in home mortgage finance through its "Declining Balance Co-ownership" also known as musharaka model. However, it is important to note that apart from banking products, Devon bank provides Islamic home finance through its Islamic Finance Division, whereas University bank does it through its subsidiary of University Islamic Financial Corporation. Both institutions provide home finance to their clients on the basis of Ijara and Murabaha models alongside their banking products. Based on this analysis, one can safely conclude that there are three main Islamic finance models commonly used by IFIs in U.S. This finding is supported by a similar view expressed by Thomas (2007) when he examined the "Methods of Home Finance in United States".

4.3 **Demand for Retail Islamic Banking and Home finance Products**

During their study of Islamic home finance in U.S., the pioneer of LARIBA, Abdul-Rahman and its president, Abdelaaty (year unknown) discovered that the state of California has the largest Muslim population estimated around 1 million. Other states with large Muslim population based on percentage share of total population includes New York 4.7%, Illinois 3.6%, Michigan 3.2%, New Jersey 2.5%, and Texas 2%. It was also discovered that "Islamic home finance companies in U.S. target a small segment of American Muslims who refused to participate in *Riba* or interest under any circumstance, many of which comprised households who mostly have reasonable cash savings but not enough to buy a home" (Abdul-Rahman & Abdelaaty, unknown year, p.6).

A conservative figure of 10,000 households and a median house price of $150,000 were used by Abdul-Rahman & Abdelaaty to estimate the market size for Islamic home finance product alone in U.S. despite price differences among states. From these estimates, it was assumed that the Islamic home finance market has the potential to generate income worth $1,050 million excluding other Islamic financing needs such as auto, small business and construction financing as well as banking services (Abdul-Rahman & Abdelaaty, year unknown). Regarding the growth prospects of U.S. Muslim population, the authors predicted that by 2025, population is expected to double "as a result of growth in number of children born to the first generation Muslims." Hence, it would be safe to conclude that there is a steady but growing demand for Islamic banking and finance products in U.S. which is expected to increase in future.

4.4 **Comparative Financial Analysis of Selected Islamic Banking and Home Finance Providers in U.S.**

Devon and University banks were selected for this purpose based on availability of financial data. The purpose of this analysis is to measure their strengths and weaknesses by studying changes in financial position and performance during two periods before and after introducing Islamic products. While financial position is commonly measured by balance sheet items constituting assets, liabilities and owners equity; financial performance, on the other hand, is measured by income statement items such as revenue, expenses and net income. However, revenues from Islamic banking activities are considered as non-interest income in most banks. Therefore, rather than examining changes in expenses and net income, this paper chose to highlight changes that took place in interest and non-interest income streams especially after the introduction of Islamic products in both banks. Such changes in income are expected to provide useful insights as to whether the introduction of Islamic products enhanced the banks' income generating capacities. It could be recalled that introduction of Islamic products by these banks took place in two separate periods. While the Islamic Finance Division of Devon bank was set up in 2003; the Shariah-compliant subsidiary of University Islamic Financial Corporation of University bank was launched in 2005.

A comparative analysis conducted on Table 6 below shows 2001 and 2002 as the last two periods before introduction of Islamic products by Devon bank; while those of University bank were 2003 and 2004. Analysis shows that between 2001 and 2002, asset portfolio for Devon bank declined by 0.78% as oppose to that of University bank which grew by 13.73% between 2003 and 2004. On the other hand, University bank's liabilities grew by 16.67% as oppose to that of Devon bank which declined by 1.31%. This clearly reflects the former's high level of indebtedness. In addition, while University bank's capital portfolio declined significantly by 25%; that of Devon bank grew modestly by 3.7%. This can be explained by the fact that during the period preceding introduction of Islamic products, University bank has been found relying more on debt to finance its operations than Devon bank. Therefore, it is safe to conclude that Devon bank enjoys better financial position than University bank during the period preceding introduction of Islamic products.

Table 6: **Historical Total Assets, Liabilities and Capital ($ mil)**

Institution	*Details*	*Year*								
		2000	2001	2002	2003	2004	2005	2006	2007	2008
Devon Bank	Assets	241	255	253	256	267	296	291	274	294
	Liabilities	217	229	226	228	239	268	262	244	264
	Capital	24	26	27	28	28	29	29	30	30
University Bank	Assets	47	46	46	44	51	63	87	88	129
	Liabilities	45	43	43	40	48	59	82	82	123
	Capital	2	3	3	4	3	4	5	6	6

Source: Compiled from Summary Financial Historical Charts on FAQS.org
<http://www.faqs.org/banks/>

Both banks were found to have classified their incomes into "*interest and non-interest income*". Interest income according to Gaurav Sharma, (year unknown), "…is generated from what is known as 'the spread'. The spread is the difference between the interests earned by bank on loans extended to customers, corporate etc.

and interests paid to depositors for the use of their money. It also includes interest earned on securities such as treasury bills" (Sharma, year unknown, p.1).

On the other hand, Sharma observed that Non-interest income "is earned by providing a variety of services, such as trading of securities, assisting companies to issue new equity financing, commission on securities, wealth management, sale of landed properties and so on," just to name few (Sharma, year unknown, p.1).

Table 7: **Historical Income Statement ($ mil)**

Institution	*Details*	*Year*								
		2000	2001	2002	2003	2004	2005	2006	2007	2008
Devon Bank	Interest Income	17,1	16,4	14,4	12,8	13,3	15,1	18,1	17,9	16,1
	Non-Interest Income	2,1	2,4	2,5	2,6	3	3,3	2,9	3,1	3,4
University Bank	Interest Income	3,3	3,5	3,2	2,7	2,7	3,3	4,1	5,1	6
	Non-Interest Income	2,6	3,7	3,8	5,1	3,2	5,1	5,2	4,5	7

Source: Compiled from Summary Financial Historical Charts on FAQS.org <http://www.faqs.org/banks/>

In order to compare their respective incomes, this paper assumes that operations in both banks were based on conventional banking practices prior to introduction of Islamic products. During the periods before introducing Islamic products, evidences from Table 7 above shows that while University bank's interest income remained stagnant; that of Devon bank declined significantly by 12.20%. At the same time, non-interest income for Devon bank grew favourably by 4% as oppose to the 37.26% decline manifested by University bank. This may be partly explained by the fact that University bank lacks the capacity to convert its assets into net earnings because the increase in its assets could not compensate the increase in liabilities during the same period. It is therefore, safe to conclude that Devon bank enjoys better financial performance than University bank during the period preceding introduction of Islamic products.

Furthermore, analysis of the banks' financial position between 2007 and 2008, the period after introducing Islamic products and during which financial crisis took place, has revealed mixed findings. It is interesting to note that the banks' asset portfolios during the period under review had grown favourably. Evidence shows that asset portfolios for University and Devon banks grew by 31.78% and 6.8% respectively at the end of 2008. In addition, while University bank's liabilities grew by 33.33%, those of Devon bank increased slightly by 7.58%. However, the increase in assets and liabilities for both banks may be partly attributed to increase in deposit funds received from customers patronising Islamic products. Their respective capital portfolios neither increased nor decreased during the period under review. Therefore, it would be safe to conclude that Devon bank enjoys better financial position than University bank after introducing Islamic products. This can partly be explained by the fact that the latter's liability exposure is higher than the former because it relies more on debt than equity to finance its operations even during the financial crisis.

Moreover, income from real estate property finance and other Islamic banking services provided by the banks were considered under their non-interest income streams. To have this at the back of our minds is to help us determine what impact, if any, was made by the introduction of Islamic products to their non-interest revenues. The interest income for University bank shows an increase of 15% as oppose to a decline of 10.06% registered by Devon bank at the end of 2008. During the same period, University bank's non-interest income favourably increased by 35.71% when compared to the 8.82% similar increase by Devon bank. This substantial increase in non-interest income on the part of University bank can be explained by the fact that its University Islamic Financial Corporation remains the only wholly operated Shariah-compliant subsidiary in U.S. (Goud, 2009). Therefore, it is safe to conclude that University bank enjoys better financial performance than Devon bank after the introduction of Islamic products based on its ability to boost non-interest income by a considerable margin.

The findings with respect to financial position and performance of these two IFIs in U.S. can be summarised as follows:

- Devon bank enjoys better financial position and performance than University bank during the period preceding introduction of Islamic products.
- Devon bank enjoys better financial position than University bank after introducing Islamic products because the latter is found to have relied more on debt than equity to finance its operations.
- University bank enjoys better financial performance than Devon Bank after the introduction of Islamic products based on its ability to boost non-interest income by a considerable margin.

4.5 **Comparison between Islamic and Conventional Housing Mortgage Transactions**

It may be difficult to carry out any interesting comparison between Islamic and conventional housing mortgage transactions in U.S. without touching on the subject of securitisation. In the ordinary sense of the word, Securitisation refers to "the process of pooling assets, packaging them into securities, and distributing to investors" according to Abdi Dualeh (1998, p.2) through a Special Purpose Vehicle (SPV). However, under Shariah law, Islamic Securitisation strictly concerns asset-backed transactions. Jobst (2007) described Islamic Securitisation as "…the process and the result of issuing certificates of ownership as pledge against existing or future cash flows from a diversified pool or portfolio of assets to investors through an SPV" (Jobst, 2007, p.14).

In an attempt to highlight the differences between Islamic and conventional mortgages, this paper used as a basis for analysis, their transactional relationship with Freddie Mac or Fannie Mae in light of home mortgage loans. It is hope that by identifying the transaction processes inherent in each financing approach, tangible differences will emerge.

In a succinct explanation of the conventional housing mortgage transactions in U.S., Goud (2009) gave a simple description and said it involves three parties --- *a home buyer, mortgage broker* or *bank* and *Freddie Mac* or *Fannie Mae*. The broker or bank "originates the mortgage with a home buyer and then sell to Freddie Mac or Fannie Mae which in turn repackage them into marketable interest-bearing securities and sell to investors, a process which facilitates their removal from the originator's balance sheet, freeing up additional liquidity to finance more home purchases" (Goud, 2009, p.19). This view was supported by Jobst (2008) who also confirmed that the conventional mortgage securitisation at "its basic form, involves two steps" (Jobst, 2008, p.48). It is therefore, safe to conclude that conventional housing mortgage transaction qualifies the notion of "originate and distribute" as used by conventional banks and brokers. Consequently, title to properties and associated credit default risks are transferred from banks to investors at the conclusion of sale. This clearly provides room for excessive risk-taking through trading of debts which is contrary to Islamic principles.

Conversely, the Islamic housing mortgage provider, unlike its conventional counterpart, owns significant stake in real estate properties during the processes of origination and distribution. The transaction stages found in IFIs involve three steps. To illustrate how these processes are carried out in U.S., the "*Declining Musharaka*" co-ownership model of LARIBA is used. The initial stage of origination shows that LARIBA and customer agree to a maximum monthly payment based on the value of property and monthly rent, and signed conventional mortgage documents (Goud, 2009, p.19). In the second step, LARIBA sells to Freddie Mac or Fannie Mae by assigning these documents. LARIBA stated under its Frequently Asked Questions that the purchase is funded "within a week or less by Freddie Mac or Fannie Mae."

Finally, in an effort to satisfy conventional as well as Shariah mortgage requirements, LARIBA goes further to perform a third step to ensure compliance on both fronts. This step which begins with setting aside the transaction already completed with one of the government-backed agencies was perfectly described by (Goud, 2009, p.19) as follows:

> "*American Finance House –LARIBA signs a separate agreement with the home buyer recasting the transaction in terms of the maximum monthly rent agreed on between the two parties as a Musharaka agreement. Monthly payments pay the 'rent' as well as purchase a portion of the house 'conceptually' owned by LARIBA.*"

From the foregoing, it is safe to conclude that Islamic home mortgage providers unlike their conventional counterparts must first of all, assume ownership of property with associated rights and risks before they can sell to home buyers. Additionally, this financing model is asset-based and requires home buyer's equity contribution in the form of a minimum down payment of 20%. It encourages a unit by unit acquisition of LARIBA's share through payment of rent by client to financier over an agreed period of time. It suffices to say that Islamic transaction guidelines do not have any room for excessive risk-taking through trading of debts as prohibited by Shariah law. Therefore, home mortgage providers cannot transfer credit default risks to investors as in the case of conventional players.

4.6 **The Impact of Recent Financial Crisis on IFIs**

Up till now, U.S. IFIs have not been found seriously affected by the recent global financial crisis. However, Wilson (2009) and Al Maraj (2008) agreed that Islamic banks are not immune to such global recession especially when one looks at the case of Amlak and Tamweel, two Islamic housing finance institutions that were forced to merge after facing problems of high exposure to the Dubai property market. Robin Wigglesworth (2010) agreed and stated that "…many have been hurt by the global downturn in real estate – the most popular class of Islamic finance" (Financial Times, 20.04.2010, p.15). Factors which allowed the reduction of impact of recent financial crisis on U.S. IFIs includes Islamic transaction guidelines which prohibit excessive risk-taking and requires checking of credit history to identify customers with good income prospects in order to ensure cautious lending. Victoria Lynn Zyp (2009) quoted Brad German at Freddie Mac as saying that the strong performance manifested by IFIs in U.S. during recent financial crisis was as a result of pre-mortgage counselling and nature of Islamic home mortgage products.

The above findings are consistent with the fact that none of the IFIs benefited from U.S. federal bailout fund launched in October 2008 called "Trouble Assets Relief Program (**TARP**)" in order to recapitalise and avoid bankruptcy.

4.7 **Lessons offered by the Global Financial Crisis to IFIs**

Most analysts of the recent global financial crisis blamed issuers of subprime mortgages for issuing low quality mortgages to buyers with low or no credit history and poor income earning prospects. In addition, due to low interest rates, high liquidity and financial innovation, conventional institutions ventured into excessive risk-taking in their search for higher returns, while regulatory and supervisory agencies remained ineffective. Hence, Mirakhor & Krichene (2009) and Ahmed (2009) agreed that the recent financial crisis was caused by excessive risk-taking in U.S. financial institutions.

Evidences from impact of the recent financial crisis shows that conventional financial institutions shouldered most of its negative implications. On the other hand, IFIs for their part, so far escaped relatively unaffected. However, according to Al Maraj, Governor of Bahrain's Central Bank, "there is no room for complacency" (Al Maraj, 2008, p.1). He posited that in the long run, some IFIs will be affected to a certain degree especially those dealing in real estate properties as home prices continued to be low during this post crisis period. Perhaps, one cannot continue without mentioning that so far, the Dubai real estate crisis which took place in the later part of 2009 serves as one important lesson that IFIs needs to learn from because it proves that the Islamic industry is not immune to such economic downturns.

The lessons offered by recent financial crisis to IFIs were summarised by Ahmed (2009) to constitute "risks that should be approached at the level of institutions, organisations and products" (Ahmed, 2009, p.21). In a nutshell, all these concerns buttressed one central theme and that is -- the urgent need on the part of IFIs to put in place effective and efficient risk management apparatus that are capable of reducing impact of such crisis in future.

At the *institutional level*, Ahmed (2009) argued that legal and regulatory risks emanating from the conventional framework must be minimised by IFIs to support their operations. He cited that non-compliance to Shariah principles is a source of reputational risk that can lead to bank failure.

At the *organisational level*, Ahmed (2009) emphasized that effective and efficient management of risk must be "an integral part of corporate strategy involving everyone in the organisation because it is the key to good governance" (Ahmed, 2009, p.26). He advised for increase transparency, information disclosure, and observance of appropriate credit standards as well as maintaining adequate capital to cover liquidity risks.

At the *product level*, Ahmed (2009) challenged that there is need to better understanding the various risk characteristics of Islamic products in order to come up with effective and efficient controlling mechanisms different from conventional regulations. However, this paper argues that in order to minimise product risks, IFIs must strictly follow Islamic transaction guidelines that encourages cautious lending by prohibiting excessive risk-taking.

Other lessons from the financial crisis includes avoiding trading in debts and minimising currency risks through hedging which are all prohibited by Shariah law.

4.8 **Key Regulatory Issues facing IFIs**

This paper assumes that since the U.S. financial system is based on conventional framework, IFIs are placed at a disadvantage position when compared to their conventional counterparts. From the words of the Vice President of Banking Supervision, William L. Rutledge, (2005), "…while the U.S. is committed to accommodating Islamic finance, these institutions will be treated with the same high licensing and supervision standards like the conventional ones" (Rutledge, 2005, p.2).

The writings of Rutledge (2005), Salah (2009) and Goud (2009) have indicated that key regulatory issues facing IFIs in U.S. may include the following:

- Both Salah and Goud agreed that the indiscriminate treatment of Islamic products like conventional types by regulators is a matter of concern.
- Goud cited that the absence of a single government regulatory/supervisory agency makes it difficult for IFIs to increase their presence.
- Salah observed that IFIs are required to pay tax upon purchase of home from seller as well as when transferring title to consumer which does not occur in conventional financing.
- On the issue of ownership of real estate property, Salah cited that IFIs must obtain indemnification undertakings from customers or insurance companies for risk associated to injuries sustained by third parties on property.
- Rutledge and Salah expressed similar opinion that U.S. regulatory framework requires the principal amount to be guaranteed by FDIC insurance scheme something that is not Shariah-compliant.

From the above, it is therefore, safe to conclude that the current interest-based regulatory framework in U.S. offers an advantage position to conventional banks than their Islamic counterparts. And until this situation is improved, a genuine growth in the Islamic finance industry may be restricted.

4.9 **The Future of Islamic Banking and Finance in United States**:
Prospects and Challenges

Although there is potential market for Islamic finance in U.S., the industry with all sincerity, has been growing at a moderate rate during the past two decades. While the recent financial crisis brought about reformation of U.S. financial architecture, it also provides an opportunity to identify strengths and weaknesses of the Islamic finance business models.

Several studies highlighted the numerous growth prospects and challenges facing this infant industry in the world and U.S. in particular. Among them are Abdul Rahman & Abdelaaty (year unknown), Victoria Lynn Zyp (2009) and DeLorenzo & McMillen (2009). In summary, some of these prospects include:

- The U.S. Muslim population, especially youths, are increasingly interested in Shariah-compliant products as alternatives to interest-based products.
- New bank regulations in U.S. enabled IFIs to provide non-traditional banking products to their customers in order to increase availability.
- The Shariah-compliant profit-and-loss sharing deposit account is expected to be approved by U.S. regulators in order to alleviate liquidity constraints faced by IFIs.
- A consistent positive rating for Dow Jones Islamic Indexes on the NYSE will motivate investors from the Gulf region to invest in U.S.
- The favourable growth registered in Islamic mortgages during recent financial crisis is expected to be consolidated in years to come.
- As the industry matures, more and more Islamic banking subsidiaries might be opened which will enhance competition and bring about service excellence.

On the other hand, since the industry is not without challenges, studies equally revealed that to sustain growth and ensure future progress, a significant number of the under listed challenges must be overcome:

- IFIs must put in place efficient and effective risk management mechanisms capable of mitigating risk at all levels in preparation for any eventual downturn in future.
- IFIs must engage in aggressive marketing now because possible regulatory changes in the mortgage market can affect future business performance.
- IFIs must use traditional terminologies that can be easily understood and accepted by regulators in order to communicate the nature and benefits of Islamic products.
- Alternative sources of funding for Islamic home mortgages needed to be identified to avoid too much reliance on Freddie Mac and Fannie Mae.
- U.S. regulators are still reluctant to approve Shariah-compliant deposit accounts that do not require FDIC insurance protection.
- Lack of highly qualified human resources with the requisite education and professional skills to deliver services to consumer expectation.
- Other challenges include lack of innovative product development, price competitiveness and consumer awareness.

Chapter 5: DISCUSSION OF EMPIRICAL RESULTS

The purpose of this chapter is to determine the extent to which findings of this paper have succeeded in answering questions raised in the problem statement.

5.1 **Which types of transaction models are used by IFIs to offer consumer retail banking and home finance products in U.S.?**

Findings have shown that transaction models used by IFIs in U.S. with respect to consumer retail banking products consists of current, savings and investment or mudaraba accounts. These accounts do not differ much with conventional types except the way they are allowed to run in IFIs. However, their main difference lies in mudaraba account which promotes the concept of profit-and-loss sharing between bank and account holders as opposed to conventional investment account. On the other hand, Islamic transaction models used in retail home finance were found to include murabaha, ijara and musharaka. The values underlying these models are based on trading of real assets or goods. The Islamic housing mortgage transactions in U.S. differs with conventional types because IFIs in the first instance are required by Shariah law to purchase and own real estate properties before selling or leasing to interested home buyers.

5.2 **To what extent did these transaction models reduced the impact of the recent financial crisis on U.S. IFIs?**

This paper is of the opinion that sharing of risk between IFIs and home buyers did not play any significant role in reducing impact of the recent financial crisis. This is because house prices fell for all home owners as a result of the financial crisis. However, factors which allowed the reduction of impact of recent financial crisis on U.S. IFIs are believed to include Islamic transaction guidelines which prohibit excessive risk-taking and require checking of credit history to eliminate customers with poor credit history and/or without good income prospects to ensure cautious lending. The success of Islamic finance transactions in U.S. can be illustrated by Devon bank's Islamic finance portfolio which was found to be successful since introduction partly because "it has not taken a penny of loss to date" (Victoria Lynn Zyp, 2009, p.37).

5.3 **What lessons can IFIs learn from the recent financial crisis?**

Three risk areas have been broadly categorised to constitute important lessons that IFIs are required to learn from recent financial crisis. They include lessons at institutional, organisational, and product levels. The U.S. financial landscape is based on conventional framework which is more attractive to conventional players than their Islamic counterparts. However, all institutional risks facing IFIs especially those relating to legal and regulatory issues can be termed as systemic risks because they affect the entire financial market and cannot be diversified by IFIs' management. For example, under deposit schemes, U.S. regulatory framework requires the principal amount to be guaranteed by FDIC insurance and account holders can only share in profits, not in losses which contravene Shariah law. Therefore, this paper is of the opinion that since U.S. regulatory system appears not yet ready to accord Islamic finance that special treatment, such risk areas will continue to affect the operational efficiency of IFIs.

The risks at organisational and product levels relates more to good governance structures and portfolio diversification in IFIs. These risks are manageable and are termed as unsystematic risks. They can be mitigated by encouraging transparency, information disclosure and adherence to standard credit guidelines. They can also be mitigated through increased in product knowledge among staff, price differentiation and portfolio diversification. This paper is of the opinion that IFIs in U.S. can manage these risks by strengthening the oversight role of their Shariah Supervisory Boards. In other words, monitoring and evaluation of activities must be ongoing to correct deviations wherever they occurred. The findings also highlighted that in order to learn from recent financial crisis, IFIs must not engaged in trading of debts and currency hedging which are all prohibited by Shariah law. This can be explained by the fact that Islam encourages risk-sharing and risk-taking in financial transactions and not a shifting of risk.

5.4 **What growth prospects and challenges are there for U.S. IFIs in the wake of recent financial crisis?**

The findings have revealed good prospects of growth for IFIs in the wake of recent financial crisis. The today's Muslim population of U.S. than ever before is increasingly interested in using Islamic financial instruments as alternatives to conventional types for investment purposes. The launching of Shariah-compliant banking products by both Devon and University banks have improved the availability of Islamic financial services and serves as successful experiments for others to emulate. The pioneering role undertaken by University bank in the introduction of a mudaraba profit-and-loss sharing deposit scheme which if approved by U.S. regulators for country-wide marketing in coming years, can boost the deposit mobilisation capacities of IFIs.

Furthermore, as the ratings for Dow Jones Islamic Indexes continue to improve, more and more investors interested in ethical investments from abroad are likely to invest in them thereby providing a new source of raising capital for IFIs. The favourable growth registered by Islamic housing mortgages during recent financial crisis has every potential to encourage many customers who are searching for alternative products to patronise IFIs in years to come. And as industry matures, the chances of having Islamic banking subsidiaries set up by major players in the Gulf region are high which will induce competition and bring about service excellence.

On the other hand, Islamic finance industry is not without challenges. These challenges could be categorised into institutional, organisational and product levels. At institutional level, the fragmented regulatory/supervisory framework and impact of possible legal and regulatory changes in the mortgage market remains major challenges facing IFIs. At organisational and product levels, risk management remains a key challenge which calls for good governance and portfolio diversification. This includes IFIs' lack of better understanding of the various risk characteristics associated to Islamic products and their inability to effectively communicate the nature and benefits of these products to regulators. Another challenge at the organisational level is that funding for Islamic home mortgages is currently restricted to Freddie Mac and Fannie Mae which limits the activities of IFIs. Other challenges include lack of highly qualified human resources capable of delivering services beyond customer expectation, lack of product innovation and consumer awareness campaigns. From the foregoing, this paper shares the views expressed by other authors that in order to sustain growth and ensure future progress, IFIs must overcome a significant number of these challenges.

Chapter 6: CONCLUSION

In a broader perspective, this study examines the prospects and challenges facing Islamic banking and finance in U.S. and identifies lessons that IFIs can learn from recent global financial crisis. As highlighted in the problem statement, the study attempts to examine various transaction models used by IFIs in providing retail banking and home finance products to customers in U.S., and how their application reduced impact of recent financial crisis. Initial findings of the study shows that transaction models used by IFIs in U.S. with respect to consumer retail banking products consists of current, savings and mudaraba accounts. These accounts do not differ so much with conventional types except the way they are allowed to run in IFIs. However, the main difference lies in mudaraba account which promotes profit-and-loss sharing between bank and account holders, unlike conventional investment account. On the other hand, transaction models used in retail home finance were found to include murabaha, ijara and musharaka. The finding shows that Islamic housing mortgage transactions in U.S. differs with conventional types because IFIs in the first instance are required by Shariah law to purchase and own real estate properties before selling or leasing to interested home buyers.

Furthermore, other results of this study shows that U.S. IFIs were less affected by recent financial crisis due to adoption of Islamic transaction guidelines which prohibits excessive risk-taking and strictly requires checking of credit history to eliminate customers with poor credit history and/or without good income prospects to ensure cautious lending. This paper is of the opinion that sharing of risk between IFIs and home buyers did not play any significant role in reducing impact of recent financial crisis. This is because house prices fell for all home owners as a result of the financial crisis. However, official confirmation from primary investor in Islamic mortgages supported this finding when Freddie Mac was quoted as saying that strong performance manifested by Islamic housing mortgages in U.S. during recent financial crisis was as a result of pre-mortgage counselling and nature of Islamic products. The above findings are consistent with the fact that up till now, none of the IFIs has benefited from U.S. Trouble Assets Relief Program (TARP)" in order to recapitalise and avoid bankruptcy.

Three risk areas were identified as important lessons that IFIs can learn from recent global financial crisis. This is because the U.S. conventional financial architecture is more attractive to conventional banks than their Islamic counterparts. Therefore, at institutions level, IFIs are expected to carefully manage risks emanating from possible legal and regulatory reforms taking place in U.S. because such risk areas can affect their operational efficiency in future. At organisations level, IFIs must institute proper governance structures and strengthen the oversight roles of Shariah Supervisory Boards to ensure compliance to Islamic credit transaction guidelines. At products level, IFIs must diversify product portfolios and coordinate financing activities without indulging in excessive risk-taking. They must not venture into trading of debts and currency hedging to minimise exchange rate risks as prohibited by Shariah.

Moreover, despite the continuing decline in consumer confidence within U.S. financial institutions during the post crisis period, the future of Islamic financial intermediation in U.S. appears to be promising due to strong performance manifested by Islamic housing mortgages during the recent financial crisis. The successful experiments of LARIBA, Guidance Residential, Devon and University banks with other community credit and housing cooperatives highlights these future expansion prospects. In addition, the emergence of Islamic mutual funds on NYSE provides a new investment platform of raising capital for IFIs apart from those provided by Freddie Mac and Fannie Mae.

Finally, results also shows that major challenges facing IFIs in U.S. includes fragmented regulatory/supervisory framework, possible legal and regulatory changes in the mortgage market especially during the post crisis period, and restricted funding sources for Islamic home finance companies. Other challenges include lack of qualified human resources, little product innovation due to absence of keen competition among players, and lack of proper understanding of the various risk characteristics of Islamic products in order to effectively communicate the nature and benefits of these products to regulators using traditional terminologies that are can be easily understood and accepted.

6.1 **Suggestion for Further Research**

This paper would like to suggest the following areas for further research.

- A comparative performance ratio analysis on key Islamic and conventional institutions with real estate property financing as core business. It is envisaged that such findings will reveal the real impact of financial crisis on IFIs.
- What is the state of preparedness in U.S. tertiary institutions towards reducing human resource constraints faced by IFIs?
- Does the U.S. have any future plan to integrate its fragmented federal and state regulatory/supervisory agencies into a single umbrella organisation just like the Financial Services Authority in UK?
- Are there any differences in marketing approaches between Islamic and conventional financial service providers in U.S.?

Word Count

From Declaration Statement to Conclusion: **15,820**

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APPENDICES

Appendix 1: **Glossary of Islamic Banking Terms**

Gharar**:** refers to uncertainty or speculation.

Hadeeth (Hadith): the technical term for the sources related to the *Sunnah*, the sayings and doings of Prophet Muhammad (peace be upon him), his traditions.

Halal: refers to anything permitted according to Shariah.

Haram: refers to anything forbidden according to Shariah.

Ijarah: refers to a leasing contract whereby the bank purchases a fixed asset and in turn leases it to customer over a specific period of time.

Ijma: refers to the consensus among jurists based on Holy Quran and Sunnah on a certain Shariah matter in a certain age.

Maysir: refers to gambling, from a pre-Islamic game of hazard.

Mudaraba: refers to a trustee financing contract, where one party, the financier, entrusts funds to the other party, the entrepreneur, for undertaking an activity. The profit is shared in pre-arranged ratios, and loss, if any, is borne by the Bank.

Mudarib: refers to an entrepreneur or manager of mudaraba project.

Murabaha: refers to a form of sale whereby the Islamic bank buys an item on behalf of a customer and either resells immediately or on deferred basis to him with a cost-plus mark-up.

Musharaka: refers to an equity participation contract whereby two or more parties contribute funds to carry out an investment. The profits are shared according to an agreed ratio, while losses are shared according to amount invested by each party.

Nisab**:** refers to the minimum amount of property or wealth capable of providing the individual with an acceptable standard of living.

Qard al-Hassan: refers to a benevolent interest-free loan usually advanced by Islamic banks to customers facing financial distress.

Qiyas: refers to the use of comparison or analogy by Islamic jurists in which a given law is derived from an existing law that has the same basis.

Quran: refers to the divine revelations that were sent through Prophet Muhammad (*peace and blessings be upon him*) for the guidance of humankind.

Rabb al-mal: refers to the own of capital or financier in a mudaraba contract.

Riba: literally refers to “excess” or “increase” over principal in a loan transaction or in exchange for a commodity and covers both interest and usury.

Shariah: refers to Islamic religious law derived from the Holy Quran and the Sunnah of Prophet Muhammad (*peace and blessings be upon him.*

Sukuk**:** refers to a freely tradable Islamic participation certificate based on ownership and exchange of an approved asset.

Sunnah: refers to a source of information concerning the practices of the Prophet Muhammad and his Companions (*May peace and blessings be upon them all),* and is the second most authoritative source of Islamic law.

Ummah: refers to the community of believers; the world-wide body of Muslims.

Wadiah**:** refers to an Islamic type of deposit account in which the bank is deemed as a safe-keeper and trustee of customer funds.

Zakat: refers to a religious levy on wealth greater than the amount of Nisab with a view to helping the needy and poor in society.

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Appendix 2: Table 3: Differences between Islamic and Conventional banks

Conventional Banks	***Islamic Banks***
1. The functions and operating modes of conventional banks are based on man-made principles.	1. The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah.
2. The investor is assured of a predetermined rate of interest.	2. In contrast, it promotes risk-sharing between provider of capital (investor) and user of funds (entrepreneur).
3. It aims at maximising profit without any restriction.	3. It also aims at maximising profit but subject to Shariah restrictions.
4. It does not deal with Zakat or Islamic tax.	4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be Zakat Collection Centre and they also pay out their corporate Zakat.
5. Lending money and getting it back with compound interest is the fundamental function of conventional banks.	Participation in partnership business is the fundamental function of the Islamic banks. So they have to understand their customers' lines of business well.
6. It can charge additional money (penalty and compound interest) in case of default.	6. The Islamic banks have no provision to charge any extra money in case of default. On a small amount of compensation and these proceeds are given to charity. Rebates are given for early settlements, though at the discretion of the Bank.
7. For interest-based commercial banks, borrowing from the money market is relatively easier.	7. For the Islamic banks, it must be based on a Shariah approved underlying transaction.
8. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluation.	8. Since it shares profit and loss with providers of funds, Islamic banks pay attention to developing project appraisal and evaluation.
9. The conventional banks place greater emphasis on credit-worthiness of clients.	9. The Islamic banks, on the other hand, place greater emphasis on the viability of projects.
10. The status of a conventional bank in relation to its clients is that of a creditor and debtors.	10. The status of an Islamic bank in relation to its clients is that of a partners, investors and traders, buyer and seller.
11. A conventional bank has to guarantee all its deposits.	11. Islamic bank can only provide guarantee for deposit accounts, which are based on the principle of al-wadiah, thus, the depositors are guaranteed repayment of their funds. However, if the account is based on the mudaraba concept, clients have to share in a loss position.

Source: <http://www.zaharuddin.net/content/view/297/72/>