Regulation of Islamic Financial Services in the United States

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Good morning, ladies and gentlemen. As you already know, my name is Thomas Baxter, and I serve as General Counsel and Executive Vice President of the Federal Reserve Bank of New York. My remarks this morning will focus on the regulation of Islamic financial services in the United States, and I ought to preface them by noting that they are my own and do not necessarily reflect the views of the Federal Reserve.

As foreshadowed yesterday in my opening remarks, one of the most fundamental principles in American law is enshrined in the First Amendment to the U.S. Constitution. The First Amendment provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof…." In the two centuries since its ratification, our courts have expounded on the meaning of this amendment, which Thomas Jefferson once described as having erected "a wall of separation between church and state."[1] While extending its reach to cover conduct by the states as well as the federal government, the courts have recognized that this separation is not absolute. Indeed, as Chief Justice Warren Burger observed some 20 years ago, the Constitution "affirmatively mandates accommodation, not merely tolerance, of all religions, and forbids hostility toward any."[2] In other words, a corollary of the principle of religious freedom enshrined in our Constitution is that the secular law should adapt, as much as possible, to accommodate differing religious practices. Today, I am honored to be able to share my thoughts about how this has been done—or can be done—in the context of the regulation of Islamic financial services in the United States.

As Mike McMillen has already noted, in many cases existing U.S. law is broad enough to encompass *shari'a*-compliant structures. Practitioners create products that simultaneously satisfy the demands of secular and religious law, in much the same way as they must look to the law of two or more jurisdictions in structuring a cross-border transaction. This is possible because, in general, the secular law in the United States is silent with respect to matters of religion and because the common law tradition is one of flexibility and adaptation. Thus, for example, bankruptcy-remote special purpose vehicles created under U.S. law have been used in both conventional securitization transactions and in *ijara*-based commercial real estate financings. That in the latter case the structure is used to comply with a religious law is irrelevant in the eyes of the secular law.

Of course, the secular law may not always be accommodating. Indeed, as our earlier speakers have already made plain, introducing Islamic principles of finance into the field of banking in Western economies such as the United States' presents unique challenges. This results, in part, because Western law developed out of a different cultural environment, and not because of some latent bias. Regulators, including regulators in the United States, are just beginning to recognize the growing importance of Islamic finance, globally as well as domestically. We are striving for a better understanding of the principles and tenets underlying Islamic finance, so we can accommodate the free exercise of religion and still carry out our secular mandate—the fostering of safe and sound practices in the banks that we supervise. This is complicated in the United States by our very complex system of financial services regulation, which divides responsibility for supervision among a number of federal agencies as well as between the federal government and the states.

Even so, U.S. banking regulators have made a number of efforts to broaden our understanding of Islamic finance and to identify challenges market participants may face in trying to introduce new products. In 2001, for instance, the Federal Reserve Bank of Minneapolis brought together government, financial institutions, investors, and Muslim and Somali community groups to explore various issues associated with Islamic finance, including alternatives to interest-based lending. Although ultimately unsuccessful in its aim of implementing an Islamic mortgage pilot program, the Minneapolis Fed helped raise awareness among Twin Cities lenders and Muslim community representatives of the constraints each face in providing or obtaining financing. More recently, in May 2004, the U.S. Treasury named Dr. Mahmoud El-Gamal, a Rice University professor, as its first Islamic Finance Scholar-in-Residence. Last but not least, the Fed, through the cosponsorship of conferences like this one, hopes to underscore its continuing interest in this dynamic field.

To date, regulation of Islamic financial products in the United States has been somewhat haphazard for two main reasons. First, the industry is relatively new in the United States. That means there are relatively few players and relatively few products in the market. Second—and this is related to the first point—on a retail level, the industry has mostly confined itself to home financing activities (that is, the marketing of mortgage substitutes). Because of this small scale and limited product mix, U.S. regulators have generally dealt with issues raised by Islamic finance on a case-by-case basis.

As in other jurisdictions, two types of Islamic financing vehicles are commonly used in the United States: *ijara* and *murabaha*. Although federal banking regulators have provided little formal guidance with respect to Islamic financial products, the Office of the Comptroller of the Currency (the OCC) issued two key interpretive letters in 1997 and 1999 concerning products designed to be *shari'a* compliant.[3] In each case, the OCC looked beyond of the form of the transaction to its economic substance and concluded that the product was "functionally equivalent to or a logical outgrowth of" secured lending and therefore permissible under existing banking law.

The 1997 approval involved a residential net lease-to-own home finance product (*ijara wa iqtina*) proposed by the New York branch of United Bank of Kuwait. The program involved a home buyer identifying a property he or she wanted and approaching the bank for financing. The bank and the home buyer would then simultaneously enter into a purchase agreement and a net lease agreement. The bank would fund the purchase price and take legal title to the property. It would then lease the property "as is" to the home buyer. Once the home buyer has paid the final lease installment, he or she acquires title to the property. The terms of the lease require the home buyer-lessee to maintain the property and pay expenses that an owner-purchaser would ordinarily pay. In case of a material default under the lease, the bank's remedies against the home buyer for nonpayment would be similar to those available to a lender on a traditional nonrecourse mortgage. (That is, the bank could sell the property at auction to recover the money owed under the lease.)

The 1999 approval involved a proposal by United Bank of Kuwait to offer certain *murabaha*-based financing products. These products were designed to permit the bank to acquire an item of commercial inventory or equipment or a parcel of real estate and then resell that property to the bank's customer on an installment basis at cost plus a markup. In each case, the bank's customer would identify the property to be financed. Because the purchase and sale transactions occurred simultaneously, the OCC took the view that the bank would be acting as a "riskless principal" in such transactions and that they were therefore permissible activities.

Commercial banks in the United States are generally restricted from owning real property, apart from their own premises and parcels they may have acquired through foreclosure proceedings. The latter must generally be sold as soon as practicable. The prudential regulatory restriction against banks owning real estate is a perfect illustration of a secular rule that may fetter the free exercise of religion. Some in the industry had predicted that such regulatory restrictions would prevent the use of *ijara* or *murabaha* in the real estate context. The OCC's subsequent approval of these *shari'a*-compliant products proved those predictions wrong. The approvals also demonstrate the type of creative thinking necessary to accommodate a religious practice not generally considered when the banking laws were first drawn up. The restrictions on bank ownership of real estate were put in place not to penalize or prevent Islamic institutions from operating but to address risks associated with real estate speculation. By looking to the economic substance of the transaction, the OCC was able to recognize that the risks incurred by the proponents of these products were not the same risks the statutes sought to curtail. As banking supervisors, we ought to be prepared to reach similar accommodations, while continuing to insist that financial institutions operate in a safe and sound manner.

U.S. financial institutions are beginning to recognize the importance of the Islamic financial market. Major U.S. banks, such as Citigroup, now operate Islamic windows abroad. In New York, HSBC Bank USA currently offers three products principally targeted at Muslim consumers: *Murabaha* Home Finance (through HSBC Mortgage Corporation), HSBC Interest Free Checking, and HSBC MasterMoney® Debit MasterCard®.[4] SHAPE Financial Corp. has developed a number of proprietary *shari'a*-compliant products that are currently sold through University Bank in Ann Arbor, Michigan. These include an *ijara*-based mortgage substitute and a profit-sharing deposit product.

SHAPE's experience in gaining approval of its profit-sharing deposit illustrates that not all regulatory obstacles to Islamic finance have been overcome. In 2002, SHAPE approached the Federal Deposit Insurance Corporation (the FDIC), which insures deposits in commercial banks up to $100,000 per depositor, with a proposal to create a deposit product whose returns would fluctuate based on the offering bank's profits or losses. The "catch" was that the deposit could decline in value. According to SHAPE, the FDIC was not prepared to countenance a deposit that could lose value.[5] Consequently, SHAPE redesigned the product to eliminate downside risk. Instead of a true profit-and-loss–sharing deposit product, it became a profit-sharing deposit, whose capital is guaranteed by the bank but whose returns fluctuate based on the profits of the bank overall or on the profits of specific operations. If there is no gross profit, the deposit pays no yield.

SHAPE's experience demonstrates the challenges in applying rules created for a so-called "conventional," interest-based economy to Islamic financial products. In the United States, in an effort to ensure that banks and insurance companies do not assume unnecessary risk in the investments they make, laws often restrict the types of such investments. Generally, they are geared toward fixed-income, interest-bearing securities, which are *haram* (that is, prohibited by the *shari'a*). Under existing U.S. banking law, profit-and-loss–sharing (PLS) arrangements such as *musharaka* and *mudaraba* may be difficult to implement since commercial banks in the United States are generally restricted from entering partnerships or taking equity stakes. Of course, non-PLS assets continue to form the lion's share of Islamic banks' total assets, even in countries with a more developed Islamic financial services industry,[6] so it is unclear whether amending U.S. law to permit PLS arrangements by commercial banks would result in a significant increase in this type of investing.

From the perspective of Muslim consumers, obtaining insurance that satisfies the requirements of the *shari'a* remains a challenge. Both Fannie Mae and Freddie Mac, two large government-sponsored enterprises that are giants in the U.S. mortgage industry, participate in American Finance House - LARIBA's home finance model, but they each require property insurance and private mortgage insurance for the mortgages they purchase from originators. Muslim consumers and others interested in obtaining *shari'a*-compliant financing may therefore have no choice but to turn to a traditional insurance company for these policies. Yet, as already noted, traditional insurance carriers commonly invest in *riba*-based securities. This problem is further compounded by the wave of insurance companies in the United States that have "demutualized"—that is, gone from being owned by their policyholders to shareholder-owned, for-profit enterprises—thus moving the American insurance industry further away from the concept of mutual insurance that lies at the core of *takaful*, Islamic insurance.

As we have heard from our other panelists, many of these challenges are not specific to the United States. U.S. bank regulators face the same questions about application of capital adequacy standards to Islamic financial products and Islamic financial institutions as bank regulators in other parts of the world. So far, no U.S. regulator has taken a formal position on the capital treatment of Islamic mortgages. Should the risk weighting for such mortgages differ from that for traditional mortgages? Does the *shari'a*-compliant structure of a given financial product amplify or mitigate risk? These questions are difficult ones, but we are eager to work with industry to answer them in a prudent manner.

I began my remarks this morning by noting our long and cherished history of religious freedom in the United States. It must be recognized that, as financial regulators, we operate within a statutory framework created by others, namely, the United States Congress and the various state legislatures. Yet within that framework we enjoy a considerable degree of freedom to see that our enforcement of those laws (and the regulations we promulgate under them) does not interfere unduly with the religious practices of members of our body politic, including Muslims. Separation of church and state is a fundamental doctrine in American constitutional law, but that does not mean we should be willfully blind to the religious implications of regulatory rulings. In fact, such willful blindness may well be the enemy of the “affirmatively mandate[d] accommodation” referenced by Chief Justice Burger. To fulfill this mandated accommodation while meeting the needs of this growing market, we will need to continue to exhibit the creativity and flexibility that the OCC showed in approving the *ijara* and *murabaha* financing products.

I appreciate the opportunity to speak with you today, and I welcome hearing your thoughts about how we as regulators can help adapt the secular law to accommodate *shari‘a*-compliant practices.

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[1] *See Reynolds v. United States, 98 U.S. 145, 164 (1878) (quoting reply from Thomas Jefferson to an address by a committee of the Danbury Baptist Association [Jan. 1, 1802]).*

[2] *Lynch v. Donnelly, 465 U.S. 668, 673 (1984).*

[3] *See OCC Interpretive Letter No. 806 (Oct. 17, 1997), [1997-1998 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-253 (Islamic Home Finance Leases); OCC Interpretive Letter No. 867 (June 1, 1999), [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-361 (Murabaha Financing Products).*

[4] *“MasterMoney” and “MasterCard” are registered marks of MasterCard International Incorporated.*

[5] *See SHAPE Financial Corp., SHAPE Profit Sharing Deposit Products Fatwa, available at http://www.shapefinancial.com/links/Fatwa.asp.*

[6] *See V. Sundararajan & Luca Errico, Monetary & Exchange Affairs Dep’t, International Monetary Fund, WP/02/192, Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead 9 (Nov. 2002), available at http://www.imf.org/.*