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Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for American Financial Institutions

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Introduction

In the past few decades, the Muslim countries have witnessed considerable economic growth. The markets of these countries spanning from North Africa to South East Asia, are expanding at a fast pace, and gradually are turning into important international economic centers. The expansion and sophistication of the Islamic markets, as well as increasing demand for Islamic financial products by borrowers, have spurred a movement toward Islamization of different aspects of economic activities in these markets. This movement has resulted in the creation of an Islamic financial market alongside the conventional financial markets.[1] The data on the size of the Islamic financial market on the global level indicate that 265 Islamic financial institutions with a collective capitalization in excess of $13 billion have been formed, with assets amounting to over $262 billion, investments over $400 billion, and deposits in excess of $202 billion.[2]

[1] In three countries, i.e. Iran, Pakistan and Sudan, there is no conventional financial market and the whole banking system operates under the Islamic system.
[2] *See Anything But Conventional?* Banker Middle East, Jan. 2004, *aveilable at* www.bankerme.com/bme/2004/jan/islamic_banking.asp. Another evidence of the increasing importance of Islamic markets is the creation of the Islamic market indexes by Dow Jones. For more information, *see* the website *at* www.djindexes.com/jsp/islamicMarket.jsp?sideMenu=true.

American banks and other financial institutions have become interested in this growing non-conventional market for financial products, and are providing financial facilities to foreign business entities operating under Islamic principles.[3] Their path to this market, however, is not smooth, and they need to innovate and adjust to the requirements of Islamic finance along the way.

This paper aims at introducing the main features of the Islamic finance as applicable to an international loan agreement, and at addressing the special challenges that an American financial institution will face in doing business under Islamic principles in the Middle East, North Africa and other Muslim regions of the world. In Part I, the principles of Shari'a (Islamic Law) applicable to financing transactions will be explained. Two principles of Shari'a have important structural implications for a loan agreement. One is the prohibition of interest (*riba*), and the other is the prohibition of risk/uncertainty (*gharar*). Part II deals with the available contracts that can be used to structure an international loan agreement in accordance with Shari'a. These contracts include Islamic partnerships (*musharaka* and *mudharaba*), leases (*ijara*), cost-plus sales (*murabaha*), and commissioned manufacturings (*istisna'*). In Part III, the challenges arising from using the Islamic contractual structures for financing purposes, and the problems that an American bank encounters in this area will be analyzed. Especially, in this section, the possible legal inconsistencies between Islamic financing mechanisms and the Western approaches, and the possibility of arbitraging the two systems to one's advantage in an integrated system will be addressed. It must be noted, although the principles and some of the analyses explained below are also applicable to the growing Islamic financial markets in the U.S., this

[3] Citibank, for example, established a wholly owned Islamic financial subsidiary in 1996, in Bahrain. *See* Citi Islamic Investment Bank (CIIB), *at* ww.citibank.com/ciib/homepage/index.htm.

paper primarily focuses on the challenges that the American financial institutions face in cross-border Islamic financial transactions.

I. Basic principles of Islamic Law, Applicable to a Loan Agreement: Prohibition of Interest (*Riba*) and Risk/Uncertainty (*Gharar*)

Shari'a[4] does not directly address finance in the modern sense of the word, but it contains principles governing the economic activities of Muslims. Two principles specifically set apart the Islamic economic transactions, from their traditional Western counterparts, and consequently result in creation of a special economic system which has come to be known as Islamic finance. These two principles are the prohibition on charging or paying interest (*riba*) and the prohibition on undertaking unreasonable level of risk or uncertainty (*gharar*).[5]

A. Prohibition of Interest (*Riba*)[6]

Riba generally means an excess or increase in return, in a transaction. Qur'an strictly prohibits such excesses,[7] and a transaction involving *riba* is void under Shari'a. Qur'an refers to *riba* in different contexts,[8] among which the most relevant to the modern financial transactions is *riba* in loans. Shari'a considers any loan made in order to attract profit as involving *riba*, and

[4] Shari'a is the Islamic religious law, which includes the teachings of the Qur'an and the traditional sayings of Muhammad. It must be noted that the content of Shari'a is not common among all Muslims. Schools of Islamic jurisprudence have developed separately, and at the present time, the content of Shari'a can vary considerably from one school to another.

[5] There are other rules governing economic activities, such as ban on trading in prohibited products (haram items, such as alcohol and pork), which are not directly related to the topic of this paper.

[6] *See generally* FRANK E. VOGEL & SAMUEL L. HAYES, III**,** ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 72 (1998); Mahmoud Amin El-Gammal, A Basic Guide to Contemporary Islamic Banking and Finance 2 (June 2000), *aveilable at*
www.ruf.rice.edu/~elgamal/files/primer.pdf.

[7] Generally, the objective served by the prohibition of *riba* is the avoidance of injustice, or in other words prohibition on exploitation of the poor debtor by the rich creditor. *Riba,* as prohibited by Qur'an, however, has a broader meaning, under which "injustice" includes a decrease of the amount returned as compared to the amount originally lent. *See* El-Gamal, *supra* note 6, *at* 2.

[8] Qur'an also bans *riba* in sales, and in a certain type of refinancing which requires postponement of money due now in return for more money later ("pay or increase" or *riba al-jahiliah*).

absolutely prohibits it. As one scholar puts it, "[i]n Islam one does not lend to make money, and one does not borrow to finance business. Loan is basically a charitable transaction."[9]

In the recent years there has been a considerable debate over the scope of this prohibition.[10] A substantial minority of Muslim scholars have stated that the prohibition on *riba* does not necessarily outlaw all forms of interest on loans.[11] For example, some have stated that an interest rate below the inflation rate (which only guarantees the purchasing power of the money lent, on return), or interest on loans for production, as opposed to consumption, can be excluded from the definition of *riba*.[12] In Iran, where the financial system is fully Islamic (with no parallel conventional financial system), two important exceptions have been recognized to the prohibition of *riba*. First, banks are allowed to charge a penalty for late payment (though this not called a *riba*, but an incentive to induce compliance with repayment schedule). Second, charging interest in a transaction with foreign entities is permissible.[13] The majority view today, however, holds that any type of interest on a loan is *riba* and prohibited.[14]

B. Prohibition of Risk/Uncertainty (*Gharar*)[15]

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[9] El-Gamal, *supra* note 6, at 33. It must be noted that tax advantages may be an incentive for charitable transactions under the U.S. legal system. Under Islamic jurisprudence, however, such incentive does not exist and a loan transaction is not driven by an ulterior motive.

[10] *See* Barbara L. Seniawski, *Riba* Today: Social Equity, the Economy and Doing Business under Islamic Law, 39 Colum. J. Transnat'l L. 701, 712-719 (2001).

[11] *Id*.; Mahmoud A. El-Gamal, Interest and the Paradox of the Contemporary Islamic Law and Finance (2003), *aveilable at* www.ruf.rice.edu/~elgamal/files/interest.pdf. CHIBLI MALLAT, *The Debate on Riba and Interest in Twentieth Century Jurisprudence*, in CHIBLI MALLAT, ISLAMIC LAW and FINANCE (1988).

[12] Seniawski, *supra* note 9, at 709.

[13] S. HASSAN AMIN, ISLAMIC BANKING AND FINANCE: THE EXPERIENCE OF IRAN 11, 30 (1986). This exemption may be partly explained by the argument that if the foreign party's legal system does not prohibit transactions involving *riba*, there is no need for the Iranian legal system to protect that party from such transactions.

[14] *See* Rector of the al-Azhar University v. President of the Republic [of Egypt], (Supreme Constitutional court of Egypt), reprinted in Supreme Constitutional Court (Egypt), Shari'a and *Riba*: Decision in Case No. 20 of Judicial Year No.1, 1 Arab L.Q. 100 (1985); Ul-Rahman Faisal v. Secretary, Ministry of Law, Justice & Parliamentary Affairs, Gov't of Pakistan, 44 P.L.S. 69 (Federal Shariat Court, 1992), especially the opinion of Justice Muhammad Taqi Usmani, *aveilable at*
www.failaka.com/Library/Articles/Prohibition%20of%20Interest%20in%20Pakistan.pdf.

[15] *See generally* Vogel, *supra* note 6, at 219; E-Gamal, *supra* note 6, at 6. It must be noted that *gharar*, contrary to *riba*, is not prohibited by Qur'an. The prohibition is based on a *hadith* (quotation) from the prophet Mohammad.

Another rule in Shari'a which is indirectly related to banking and financial activities, though not directly affecting the structure of a credit facility, is the prohibition of *gharar*, which translates to an "unacceptable"[16] level of risk or uncertainty. A transaction involving a prohibited level of *gharar* is void under Islamic jurisprudence. Therefore, sale of an object which is still not in existence is unenforceable (*adam* or non-existence), e.g. an unborn calf, or an object which is not under the control of the seller, e.g. fish in the sea. Under this prohibition generally the derivatives, including forward contracts, futures and options, are invalid.[17] Moreover, when the consideration of either or both sides of a bargain is indeterminable, the contract will not be enforceable (jahala or ignorance), e.g. payment of a fixed price for a diver's catch next day. The effect of this prohibition for the modern finance is that the traditional forms of insurance are impermissible.[18] In an insurance contract, because the total amount of the premiums that the policyholder pays is not determined, there is an unacceptable level of uncertainty in the contract. It must be noticed that the insurance or the security is not considered an object of sale.[19]

The prohibitions on *riba* and *gharar* have immense repercussions for financial transactions. Under the Islamic model, banks cannot charge interest on loans or pay interest on deposits, two characteristic operations of traditional banks. In fact, under the Islamic model, there could be no banks in the traditional sense of the word. Therefore, Islamic banks have to operate under a different model, which conforms to these principles. This model is mainly based on contractual modes of financing.

Prohibition of *gharar* is in best interests of the parties and improves the stability of contractual relationships. *See* El-Gamal, *id*, at 7.

[16] Although the principle and its prime examples are well-settled in *Shari'a*, the "acceptable" level of uncertainly in each transaction is a fact-specific issue and must be determined on a case-by-case basis.

[17] El-Gamal, *supra* note 6, at 8.

[18] For information about the permissible methods of insurance under Islamic jurisprudence, *see* Norton Rose, Takaful Insurance, Islamic Insurance Briefing (Nov. 2003), *aveilable at* www.nortonrose.com/publications/1917-Takafulinsurancebriefing.pdf.

[19] *Id*, at 7.

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II. Contractual Modes of Financing under the Islamic Law

Under Shari'a, the garden variety bank loan is not permissible due to the prohibition on *riba*. Therefore, banks and their customers have to use other methods in order to finance a business operation according to Islamic principles. The main method which banks and businesses use for this purpose is to structure the credit facility through contract permissible under Shari'a.[20] The core contracts used in order to structure a financing transaction are partnerships (*musharaka*h and *mudharaba*), leases (*ijara* and *ijara va iqtina*), mark-up sale or cost-plus financing (*murabaha*), and commissioned manufacturing (*istisna'*).

A. Partnerships (*Musharaka* and *Mudharaba*)

Musharaka and *mudharaba* are partnerships, or "profit and loss" sharing ventures, and are used as a common financing methods in the Islamic financial markets.[21] *Musharaka*, an equity-based partnership, involves two parties both of whom contribute capital, and share the profits and losses of the operations. In this sense, *musharaka* is very similar to the partnership concept in the American legal system. Banks use this type of contract in long-term investment projects. Both parties have the right to participate in the management, but can also delegate that right.[22] One type of *musharaka* is *musharaka* mutinaqiza (diminishing partnership) in which the financing agency and the customer share the ownership of real estate. The periodic payments of the

[20] *See* Vogel, *supra* note 6, at 138; El-Gamal, *supra* note 6, *at* 9; V. Sundrarajan and Luca Errico, Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead [hereinafter Islamic Financial Institutions], IMF Working Paper, WP/02/192, 21 (Nov. 2002), *aveilable at* www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf.

[21] *See* generally Muhammad Taqi Usmani, *The Concept of 'Musharakah' and its Application as an Islamic Method of Financing*, 14 Arab L.Q. 203 (1999); El-Gamal, *supra* note 6, at 15; Vogel, *supra* note 6, at 195.

[22] Norton Rose, Islamic Finance Structures [hereinafter Islamic Financial Structures], Islamic Finance Briefing (Mar. 2003), *aveilable at* www.nortonrose.com/publications/1523-Islamic%20Finance.pdf.

customer contain two parts: a rental payment and a buyout part. The contract continues until the ownership of the property is completely transferred to the customer.

Another type of Islamic partnership that banks commonly use is called *mudharaba* (participation or trust financing). Under this contract one party provides the capital and the other provides the labor (management) and expertise.[23] Banks use this contract to provide venture capital for entrepreneurial projects. The losses of the project are borne by the bank, and the entrepreneur's loss is limited to his or her labor. Both parties share in the profits, which must be divided according to a percentage (as opposed to a lump sum agreement.)[24]

B. Lease (*Ijara* and "*Ijara va iqtina*")[25]

Lease (*Ijara*) financing methods are among the very popular vehicles for providing credit to businesses which operate under the Islamic principles. In a typical lease financing, the bank buys the asset that its customer needs, and leases it back to the customer.[26] These leases are different from the traditional financing transactions in that the bank must own the lease item: If the bank provides the manufacturer with a loan in the amount of the present value of lease payments, and the manufacturer leases the object to the customer, the customer will, in fact, indirectly pay an interest to the bank.[27] In addition, some Islamic supervisory boards have stated that in these transactions the lessee cannot be required to pay the cost of insurance (because the asset belongs

[23] These contracts closely resemble joint ventures under Western legal systems.

[24] Islamic banks use *mudharaba* on the deposit-taking side of their operations, too. In this case, depositor is the provider of the capital and bank provides the labor and expertise in the joint investment. This system, where banks use *mudharaba* on both sides, has been called two-tier *mudharaba*. Clearly, in these transactions, the depositor has to bear the risk of loss. Islamic Financial Institutions, *supra* note 20, *at* 23. In some banks, however, demand deposits are held as amanat, in which the bank is only a safe keeper. In these banks, the bank is responsible for the total amount of the deposit, and does not use those funds to provide credit to the borrowers.

[25] *See generally* Vogel, *supra* note 6, at 143; El-Gamal, *supra* note 6, at 13.

[26] Banks in U.S. have also occasionally used this structure to finance asset acquisition by their customers, for the accounting and tax benefits that this structure may provide.

[27] This is the common model for automobile leases in U.S.

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to the bank), and even if the bank incorporates that cost in the amount of the rent, bank is responsible for paying the premiums.[28]

Usually, lease financing transactions the customer/lessee has an option or is required to buy the asset when the lease expires. These transactions, called *ijara va iqtina*', have been used extensively in cross-border transactions for a wide range of assets including ships, aircraft, telecommunications equipment and power station turbines.[29]

C. Cost-Plus Sale (*Murabaha*)[30]

In *murabaha* the bank buys the item that its customer needs and sells it to the customer at a marked up price (hence mark-up sale, the alternative name of these transactions). The customer usually pays the price on a deferred basis or in installments. Islamic financial institutions use this transaction mostly to provide trade financing for their customers.[31] In these transactions, as in lease financing, bank takes title to the item (when it buys it from third party), and therefore assumes risk, which entitles it to profit from the transaction.[32]

D. Commissioned Manufacturing (*Istisna'*)[33]

Istisna' is a contract under which the financial institution will finance the manufacturing or construction of the item that the customer needs (building, equipment, aircraft . . .), either by pre-payment or payment in installments, and after completion, takes title to the item and then either

[28] *See* Islamic Finance Structures, *supra* note 22, at 3.
[29] *Id*.
[30] *See generally* Vogel, *supra* note 6, at 140; El-Gamal, *supra* note 6, at 10.
[31] *See* Islamic Finance Structures, *supra* note 22, at 4.
[32] *Id*. It must be noted that the bank can manage that risk independently. If the bank is an Islamic institution it must use methods of insurance permissible under Islamic jurisprudence. *See* Norton Rose, Takaful, *supra* note 18.
[33] *See generally* Vogel, *supra* note 6, at 146; El-Gamal, *supra* note 6, at 17.

sells or leases it to the customer.[34] (This part of the transaction is similar to *murabaha* (cost-plus sale) or *ijara* (lease)).

The core part of the transaction is the financing of the manufacture or construction of the item that the customer needs. Under the principle of prohibition of *gharar* (risk/uncertainty), *istisna'* is technically not permissible, because payment for something which is not still in existence carries too much risk. Islamic scholars, however, have allowed this contract by analogy (*qiyas*) to another type of Islamic contract called bai' salam, which is similar to a forward contract.[35] Under bai' salam the buyer pays for an item in full and takes delivery at a future date. Bai' salam is only applicable to products whose quality and quantity is fully specified at the time of the contract, e.g. agricultural or manufactured products. Although this contract runs the risks prohibited by the *gharar* principle, it is permitted by Islamic principles in order to facilitate commercial transactions. Islamic scholars by analogy have concluded that prepayment to finance the manufacturing or construction of an item is permissible, too.

Istisna' has been used in the present day transactions in order to provide advance funding of major industrial projects or large items of equipment such as turbines for power plants, ship and aircraft.[36]

E. Integrating Islamic and Conventional Modelsof Financing

The growing volume of assets under the management of Islamic financial institutions, and the increasing demand for their products is turning these institutions into important players in large and complex international financial transactions, such as project and asset financing, especially in the Middle East and North Africa ("MENA") region. Such transactions, however,

[34] It must be noted that in the US system banks are prohibited from the buying and selling goods. This prohibition was not affected by the Gramm-Leach-Bliley Act (1999).
[35] *See* Vogel, *supra* note 6, at 145; El-Gamal, *supra* note 6, at 17.
[36] *See* Islamic Finance Structures, *supra* note 22, at 4.

require large sums of capital to be committed over an extended period of time, which usually is beyond the capacity of a single financial institution. Therefore, normally a project or company needs to use Islamic and conventional financing alongside each other, which in turn requires isolating the Islamic financial facility from the conventional counterpart, in order to preserve the integrity of the Islamic deal. Banks and law firms are increasingly gaining expertise in structuring such transactions in manners that conform to Shari'a principles. For example, in a recent aircraft financing deal in the Middle East, the airline entered into a lease agreement with a special purpose vehicle ("SPV"), which itself financed the acquisition of the aircraft by conventional financing facilities. In fact, an Islamic lease agreement was "tacked" to the conventional financing facility (through the use of the SPV) in order to isolate the Islamic institution from the interest-based transaction.[37]

On the other hand, in integrated deals, conventional lenders may have concerns of their own. For example, because the Islamic facilities do not specify a rate of return, when they rank pari passu with the conventional facilities, it is important to devise mechanisms to ascertain which amounts payable under the Islamic facilities are analogous to principal and interest under the conventional facilities. Such mechanisms, usually provided for in the inter-creditor agreements, will address the concerns about the calculation of priority payments, both from normal income and in the event of acceleration on default.[38]

These structures provide the possibility for the American banks both to cooperate with the Islamic financial institutions, and to provide credit to an Islamic business under conventional terms.

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[37] *See* Angelo L. Rosa, *Harmonizing Risk and Religion: The Utility of Shari's-Compliant Transaction Structuring in Commercial Aircraft Finance*, 13 Minn. J. Global Trade 35 (2004); First Islamic Lease with Export Credit Support: Aircraft Deal of the Year, Asset Fin Int'l, Apr. 2002, at 16.
[38] *See* Islamic Finance Structures, *supra* note 22, at 6.

F. Assessing Compliance with Shari'a: Religious Supervisory Boards (RSBs)

An important issue for the Islamic financial industry is the method by which compliance of a certain financing structure with Shari'a is determined. Although there is broad consensus on the general principles, such as prohibition of *riba* (interest) and *gharar* (unreasonable risk), there are substantial disagreements on the details and application of the general principles. A large number of schools exist under the Islamic faith, each with their own jurisprudence, and even in each school, the scholars may not agree over all issues. There is no central mechanism to give a definitive answer to questions raised by Islamic financial transactions, even in a single political jurisdiction. In order to address the problem of compliance with Shari'a, Islamic financial institutions have established their own religious supervisory boards ("RSB"), which are constituted of prominent Islamic scholars, familiar with commerce and finance.[39] Each new type of transaction, which the institution would like to enter into, is reviewed by RSB for compliance with Shari'a. Such a procedure, obviously, carries a number of disadvantages, the most important of which is the lack of unanimity, and multiple and perhaps contradictory precedents in each area.

A recent decision of the British Court of Appeal (civil Division) highlighted some of these difficulties. In *Beximco Pharmaceuticals Ltd v. Shamil Bank of Bahrain*,[40] the court first distanced itself from getting involved in the interpretation and application of Shari'a principles to the contract. It said:

> [H]aving chosen English law as the governing law, it would be both unusual and improbable for the parties to intend that the English court should proceed to

[39] For example, Citibank has renowned Islamic scholars on its RSBs, including a former justice of the supreme courts of Pakistan. *See* the website, *at* www.citibank.com/ciib/homepage/index.htm.
[40] [2004] EWCA Civ 19 28/1/04, *aveilable at* www.courtservice.gov.uk/judgmentsfiles/j2232/beximco-v-shamil.htm.

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> determine and apply the Shari'a in relation to the legality or enforceability of the obligations clearly set out in the contract.[41]

Moreover, the court held that the insertion of the phrase "subject to the principles of the Glorious Sharia'a [sic]" in the choice of law clause of the financing agreement between the bank and the customer, alongside the English law, did not trump the application of English to the contract, because rather than "incorporating" any specific set of rules, the parties had just chosen to insert a vague and overly broad set of principles (Shari'a law), the requirements of which for a business transaction is subject to wide variation and disagreement.[42] The court said:

> The fact that there may be general consensus upon the proscription of *Riba* and the essentials of a valid Morabaha agreement does no more than indicate that, if the Sharia law proviso *were* sufficient to incorporate the principles of Sharia law into the parties' agreements, the defendants would have been likely to succeed. However, since I would hold that the proviso is plainly inadequate for that purpose, the validity of the contract and the defendants' obligations thereunder fall to be decided according to English law.[43]

The court clearly considers the application of the principles of glorious Shari'a to international financing agreements, as impractical. In order to alleviate this problem, financial institutions and Islamic governments have created international organizations and institutions with broad authority and support to establish standard guidelines to be followed in Islamic financial transactions. The most important examples of these organizations include Islamic Financial Services Board (IFSB),[44] Accounting and Auditing Organization for Islamic Financial

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[41] *Id*., at para. 54.
[42] The choice of law clause in the contract stated

> "Subject to the principles of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England."

Id., at para 1.
[43] *Id*., at para 55.
[44] For more information, *see* the website, *at* www.ifsb.org.

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Institutions (AAOIFI),[45] and Fiqh (jurisprudence) Academy of the Organization of Islamic Conference (OIC).[46]

III. Application of Islamic Financing Methods to International Transactions: Challenges for American Banks

Although growth of the Islamic financial institutions in the Middle East has been welcomed widely in the Muslim communities around the world, and Islamic banking and finance is becoming more prevalent by the day, a substantial number of issues remain for the banks, their customers and the regulators in different countries, to answer. To begin with, Islamic modes of financing are more complex than conventional financing. Banks need to carry out several activities which under the conventional model of banking they normally do not perform, such as calculation of profit-and-loss-sharing ratios as well as auditing of financed projects to ensure proper governance and valuation (considering that under the primary modes of Islamic finance, banks are partners/investors rather than the traditional lender.) [47] This feature may cause special difficulties under the American banking regulatory system, because unlike the rest of the world, the banking regulatory system in U.S. does not recognize a universal banking model, and imposes substantial limitations on the power of banks to engage in "non-banking" activities.[48]

In addition, because of the large number of the activities that Islamic banks can engage in, and lack of a central authority for determination of compliance with Shari'a, standardization of

[45] For more information, *see* the website, *at* www.aaoifi.com. AAOIFI has specifically been active in this area. It has published "Shari'a Standards" and "Accounting, Auditing & Governance Standards for Islamic Financial Institutions."
[46] For more information, *see* the website, *at* www.fiqhacademy.org.sa.
[47] *See generally* Islamic Financial Institutions, *supra* note 18, at 4.
[48] Although the Gramm-Leach-Blilely Act (1999) relaxed many of these limitations and facilitated the adoption of the universal banking model by the American banks, important limitations still remain, such as the prohibition on engaging in the management of corporations. For this reason, in U.S., a financial institution which only offers Islamic financial services to the Muslim community, would probably have to operate as a thrift. *See* J. Michael Taylor, *Islamic Banking: The Feasibility of Establishing an Islamic Bank in the U.S.*, 40 Bus. L.J. 385 (2003).

Islamic financial products can become difficult.[49] By the creation of international institutes and organizations responsible for development of guidelines for Islamic finance, this concern, however, may be alleviated in the future.

Another problem which accompanies the novel Islamic financing structures is the legal costs of preparing the contracts, as lawyers must undertake significantly more work than in an equivalent conventional financing.[50] This concern, however, will also almost certainly diminish as Islamic finance becomes more prevalent and the necessary documents become more standardized.

A crucial issue for an American bank in lending to projects and businesses operating under the Islamic modes of finance is the lack of a recognizable default.[51] Because the primary mode of finance is partnership, a "default" means that the project has failed to generate the expected profits, in which case the bank and the partner (in either *mudharaba* or *musharaka*) will share in the losses. This may cause problems, especially when a project is co-financed by Islamic and conventional financiers, where the event of default in the conventional loan does not necessarily trigger any event under the Islamic tranche. Such problems are usually coordinated among the creditors by inter-creditor agreements.[52] In addition, the bank, especially in *mudharaba* (trust financing), has no practical means to control the agent/entrepreneur, because in *mudharaba* (unlike *musharaka*) bank only provides the capital, and the agent is responsible for the management, which creates a moral hazard risk.[53] In the partnership agreements, banks also have limited power to ask for collateral, which is another drawback for the Islamic financing methods.

[49] Islamic Financial Institutions, *supra* note 18, at 4.
[50] *See* Alison Burke, *Banking on Islamic Finance: How Islamic Financing Is Being Used in Project Finance*, Infrastructure Journal, Jan.-Feb. 2004, 37, *at* 40.
[51] Islamic Financial Institutions, *supra* note 18, at 4.
[52] Burke, *supra* note 50, at 41.
[53] Islamic Financial Institutions, *supra* note 18, at 5.

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These agreements are investments, rather than traditional financing, and the bank is expected to share in the possible losses.[54] Asking for collateral against the losses would be antithetical to this requirement.[55]

In non-partnership modes of financing (lease (*ijara*) and cost-plus sale (*murabaha*)) another problem surfaces, and that is the bank's exposure to market risk in purchase and holding of the assets. Banks will inevitably take on more risks in these transactions, because they will undertake the risk of price fluctuation, which is normally borne by equity holders. American banks must also consider that in *ijara* (lease) the lessor is responsible for maintenance and insurance costs.[56] In these situations, usually bank/lessor will appoint the borrower/lessee as its agent to maintain the property or asset and pay the insurance. The insurance premiums that the lessor pays are repaid as a portion of the rent that the lessee pays.

Risk control is another issue that causes concern in Islamic financial markets, because certain traditional financial tools of risk hedging, such as options, futures and forward contracts are not available under the Islamic principles due to the inherent uncertainty in the parties' obligations (*gharar*),[57] the bank's customer may not be able to control their exposure to different types of risk like a conventional business. All the risks above may require the bank (as matter of prudence, rather than regulatory necessity) to have more rigorous capital adequacy standards to offset the risks incurred in the Islamic financial operations.[58]

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[54] *Id*., at 23.
[55] For more information on secured lending in Islamic transactions, especially project finance, *see* Michael J.T. McMillen, Islamic Shari'ah-Compliant Project Finance: Collateral Security and Project Finance Structural Case Studies, 24 Fordham Int'l L.J. 1184 (2001).
[56] Burke, *supra* note 50, at 42. It must be noted that insurance, in the form that is recognized in the West, is impermissible under Islamic law. *See supra* part I.B. (prohibition of *gharar*). Therefore, the project may need to resort to Islamic forms of insurance such as *takaful* (mutual insurance).
[57] *See supra*, part I.B.
[58] *See* Zeti Akhtar Aziz, *Ensuring Stability in the Islamic Financial System*, Speech at the 3rd Annual Islamic Finance Summit, London, Jan.13, 2004, *aveilable at* www.bis.org/review/r040121c.pdf.

Finally, if Islamic banks and financial products become popular and commonplace, secular customers who do not have any religious requirement for using Islamic financial products, will have an option between the Islamic and conventional financing. This situation creates the possibility of competition, if the Islamic mode of financing turns out to be less costly than its conventional counterpart. It seems that such a possibility has not realized at the current stage of development in the Islamic financial markets. But one could ask how banks should address this problem in the future. Considering the higher risks and less flexibility in structuring the transactions, American banks may not be willing to extend the Islamic facilities beyond the scope needed to satisfy the demand of the Islamic businesses, which would require these banks to develop a test in order to determine the eligibility of applicants for Islamic credit facilities.[59] For this purpose, the certification of the banks' Religious Supervisory Boards (RSBs) that the applicant adheres to Islamic principles in conducting its business would perhaps be sufficient. At this point, it remains to be seen whether the competition among the Islamic and traditional financial products would give rise to the necessity for such measures.

Conclusion

To Westerners, Islamic finance is an unconventional method of conducting business, especially since the conventional banking and finance models have dominated the world with no alternative model. This perception, however, is changing and with the economic growth in the Middle East and the increasing self-assertion of Muslims, it seems reasonable to expect that the use of Shari'a-compliant modes of financing by American banks will increase in the future.

[59] This issue, inside the U.S., would probably raise a discrimination problem, if the Islamic financial products turn out to be preferable, but are made available only to Islamic businesses. In cross-border transactions, however, this problem is unlikely to arise.

Many large American financial institutions, having already established Islamic financing units, are substantially involved in these markets.

Islamic finance, unlike the conventional model of finance which uses interest-based loans as its cornerstone, is based on contractual structures, where the financier participates with the borrowers in the project, or enters into trade with them, and cannot totally isolate itself from the operation's risks. Although the system is utterly unfamiliar to the American banks, these banks, alongside their law firms, are learning the details of Islamic finance, and at the same time participating in its development. In this process, however, it is important for the banks and the law firms to take notice of those implications of Islamic finance which may be problematic from the regulatory or business points of view. Islamic finance may involve the banks in operations that they traditionally do not undertake, and in which they are inexperienced, such as management of projects or certain types of trade. In addition, the standard safeguards against loss, such as default mechanism and security interest in project assets, are not applicable in the Islamic financing contracts, in the same way that they are in the conventional loans. Finally, if in the future differences develop between the Islamic and conventional modes of finance which may discourage banks from extending credit on Islamic terms to non-Muslims, banks and law firms have to devise a method for determining the eligibility of the users.