



ISLAMIC FINANCE

and the U.S. BANKING SYSTEM

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What would you do if you wanted to buy a home or take out a loan for your business but your religion prohibited you from paying interest? Millions of Muslims currently living in the United States and some Jewish and Christian believers face this situation.

The Federal Reserve Bank of Minneapolis is the facilitator of an initiative established to find ways for Muslims and others to finance homes or businesses—ways that will not violate an important religious principle that prohibits the paying or receiving of interest. Partners in the initiative include local, state and federal government agencies, banks, community development corporations (CDC) and nonprofit housing organizations, a secondary market investor and Islamic and Somali community organizations. We in the initiative do not have the answers yet. We are gaining an appreciation of Islamic finance, and this article is presented to aid in an understanding of the issues.

INTEREST VERSUS PROFIT AND LOSS

So what is the Islamic view of financial transactions? Wafiq Fannoun, president of Reba-Free, LLC, an Islamic financial, investment and consulting service, and consultant to Neighborhood Development Center (NDC)¹ in St. Paul, Minnesota, wrote on this subject for NDC. According to Mr. Fannoun, “Islam’s aim from any financial transaction is to maintain economic justice between those who have and those who have not. It is essential in Islam that all parties involved in a financial transaction share the actual profit or loss of a venture, and that no one gets predetermined com-

pensation such as interest. In effect, the Islamic system functions much like western equity financing, while protecting borrowers from leveraging themselves into the poorhouse.”

Mr. Fannoun goes on to state, “In the Quran and the teachings of the Prophet Muhammad (PBUH)², it has always been understood that investors have the right to a decent rate of return as long as they share the risk and maintain the economic justice for all. Islam does provide alternative forms and techniques of financing which works within these parameters of maintaining the economic justice and sharing the risk.”

Thus, under the Islamic principles guiding our initiative, financing involving interest or *Reba*, as interest is called in Arabic, is prohibited while a profit or loss on financial participation in an activity is not. Therefore, while Muslims cannot pay (or earn) interest, they

¹ *The Neighborhood Development Center is a nonprofit community development agency offering business training, loans and technical assistance to help inner-city residents revitalize their neighborhoods. In partnership with 18 community groups, NDC has helped nearly 400 entrepreneurs open businesses since 1993. www.windndc.org/*

² *peace be upon him.*

can pay (and earn) a profit. This is an important point: Reba-free financing will likely cost the same as a standard loan. Under Islamic principles, the person providing the financing, who has an ownership interest in whatever is being financed, is entitled to a profit, just not in the form of pre-determined interest. And of course, the expected profit could turn out to be a loss. But how would this work in the traditional American system of debt financing and banking?

ISSUES IN THE TWIN CITIES

The Twin Cities of Minneapolis and St. Paul have experienced an influx of Somali refugees over the past several years. Combined with Muslims already living in the area, it is estimated that the population of Muslims in the Twin Cities metro area is around 100,000. Two acute needs are driving the initiative facilitated by the Minneapolis Reserve Bank:

- The Twin Cities has few rental properties with enough room for families. In this market, families are expected to buy houses
- Many Somali refugees have followed the path of other refugee groups and become entrepreneurs. They have started small businesses, financed through gifts and equity investments from family and community members. Now many of these businesses face a critical need for working capital in amounts larger than the community can provide

ISSUES IN BUSINESS FINANCE

Business finance, especially finance of durable goods, is perhaps the easiest type of Reba-free financing to do. Lease-to-own arrangements are common for business equipment and can work quite well for Muslim business owners. More difficult is the provision of working capital, since this likely requires the provider of the capital to take at least a limited equity position

in the business. Current United States banking laws, with limited exceptions, prohibit banking organizations from participating in such arrangements, leaving this type of financing to government agencies and nonprofit organizations. For example, NDC, a nonprofit community development agency in St. Paul, offers an Islamic financing program, and to date has closed four Reba-free business financing arrangements. Also, the City of Minneapolis Community Development Agency is investigating ways to do Reba-free financing of working capital.

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ISSUES IN HOUSING FINANCE

Housing finance may be the most difficult to arrange Reba-free. If all parties to a financial transaction must be in a position to share the actual profit or loss of a venture, then the financier must share the equity risk and rewards of purchasing a home. That means that the financier maintains an ownership interest in the home. Certainly, homes have been bought and sold on this basis. In times of high interest rates, sellers take a contract-for-deed and the homebuyer does not actually own the home until the final payment is made. This method of financing has also been used in the past in minority communities unable to get financing from local lending institutions. But when rates are low and the markets are functioning well, sellers usually prefer to get their equity at the time of sale and sever all ownership in the property.

So if the seller does not share in the

profit and loss with the buyer, who does? The bank does not want to own the house, nor generally could it maintain an equity interest in the house under current banking laws. So could the financier be a government agency, perhaps the state housing finance agency, or a community development corporation that would own the home and sell it on a lease-to-own or contract-for-deed basis? But, would a state agency be willing to devote or a CDC be able to raise enough funds to finance a large number of homes for 15 to 30 years? In the Twin Cities alone, there are an estimated 15,000 to 20,000 Muslim families.

And there are other issues. Who makes sure the home is maintained? How would tax benefits such as homestead property taxes and tax deductibility of home mortgage interest work? Finally, Islam has no formal clerical hierarchy. Local scholars often make rulings as to the acceptability of a financing arrangement. So how do national financiers make certain that products they establish will be acceptable to Muslims throughout the country?

SEARCHING FOR SOLUTIONS

We are considering all of these questions and more. We are looking at pilot Muslim financing projects. We are talking to our counterparts in other communities, such as Detroit, that have large Muslim populations. We are looking at various financing models to see if we can craft models for commercial, consumer and mortgage financing that will work on a large scale. These models include Habitat for Humanity, lease-to-purchase, cooperative ownership, financing arrangements that use an intermediary such as NDC and the taking of a mini-equity position in a business. We are also considering having various financing models submitted to the worldwide Fatwa, a group of eminent Islamic scholars who offer religious opinions that are widely accepted throughout Islam.

This project is a learning experience. Those working on this initiative who are not Muslim are increasing their knowledge of Islam and alternative financing methods. Those who are not bankers are increasing their knowledge of American lending practices. We are joined together to find a way for American followers of Islam and other interest-averse religions to participate fully in the community and economic life of this country. **CI**

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ABOUT THE AUTHOR



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Ms. Tyndall has an MBA from the University of Minnesota and a BA in sociology from the University of Illinois.