

UNITED STATES

*Mona E Dajani*¹

I OVERVIEW

Islamic finance in the United States dates from the 1980s, when two institutions opened on the West Coast. Their services were limited to investment and home finance and were available only regionally. From the late 1990s, the market size grew significantly, paralleling the growth of the Muslim population in the US: from 50 per cent in the 1990s to 66 per cent in the 2000s. In an ironic twist, while Islamic finance abides by the goals and objectives of Islam – namely the *shariah* – these same goals overlap with environmental, social and governance (ESG) considerations and the broader aim of sustainable finance. Although this may sound obvious, the ESG, especially the social aspects, have until now been less obvious. While the global covid-19 pandemic severely stressed the global Islamic finance industry, most industry participants believe there will be a mild recovery in 2021 followed by a gradual significant recovery due to the strong performance in 2019 pre-covid coupled with new ESG interests and a dynamic *sukuk* market. Trillions of dollars in play over the next decade will accelerate the economic recovery, and investors are showing interest in new performance and Islamic-based ESG and sustainability-linked debt products (SLDs), with North America following Europe's and the Middle East's lead.

At the same time, we see a tipping point pivoting to a turning point for accelerating and unlocking the long-term potential of the industry. Stakeholders are realising the importance of standardisation, as access to *sukuk* remains time-consuming and has higher transaction costs than conventional instruments. Lockdown measures have also shown the importance of leveraging AI technology. Furthermore, industry players have been discussing the potential use of Islamic SLDs to help companies and individuals economically affected by the pandemic. With the right coordination between different Islamic finance stakeholders, we believe the industry could create new avenues of sustainable growth that serve the markets. From experience in helping strategise and structure several major recent deals using these new instruments, Islamic finance-based SLDs will speed up this transition.

There are currently 25 Islamic financial institutions in operation in the US, the top three of which, according to asset size, are the American Islamic Finance House, University Bank (through its subsidiary University Islamic Financial) and the Harvard Islamic Finance Project. In 2013, JP Morgan started to offer Islamic banking services. Investment banks such as Standard Chartered Bank followed and now offer Islamic banking products in Asia, Europe, the Middle East and the US. Recently, in the US commercial real estate sector, banks such as Malaysia-based Maybank, Kuwait-based Warba Bank and National Bank of Kuwait,

¹ Mona E Dajani is a partner at Pillsbury Winthrop Shaw & Pittman LLP.

Italian bank Intesa Sanpaolo and MASIC, a Saudi private equity investment firm controlled by the Al Subeaei family together with asset manager, Boubyan Bank, have participated in commercial Islamic finance transactions in the US in connection with commercial real estate.

Retail banks operate in several states:

- a* University Islamic Financial (a subsidiary of University Bank), based in Ann Arbor, Michigan, is the first and only exclusively *shariah*-compliant bank in the US;
- b* Devon Bank in Chicago regularly offers Islamic finance services;
- c* Guidance Residential, in Reston, Virginia, is the biggest non-bank financial institution that offers Islamic finance services; and
- d* another large Islamic mortgage lender is Lariba, in California, which also provides business financing.

Shariah requirements have made further proliferation of Islamic finance difficult. Possibly because US investors are still unfamiliar with *shariah*-compliant products, the secondary market for Islamic financial products is smaller in general. The result has been that Islamic mortgage lenders have had difficulty in remaining liquid, stemming further growth of the market. Starting in 2001 and 2003 respectively, Freddie Mac and Fannie Mae, the US housing agencies, had bought Islamic mortgage products to provide extra liquidity in the US Islamic finance market. They have now grown to become the main investors in Islamic mortgages: by 2007, Guidance Residential had been relying on Freddie Mac for more than US\$1 billion in financing.

II LEGISLATIVE AND REGULATORY FRAMEWORK

i Legislative and regulatory regime

Unlike the United Kingdom, where there is a plethora of Islamic financing services, there are no US laws specifically addressing Islamic banking in the US. Moreover, the US market for Islamic financial products is much smaller than that of the United Kingdom, where there is US\$19 billion worth of assets owned by Islamic financial institutions, and more than 20 banks, six of which exclusively provide *shariah*-compliant products. The number of Islamic finance services in the United Kingdom is also larger than in the US. Five of the services in the United Kingdom are *shariah*-compliant and are behind some of the biggest building projects in London (including the Shard, the Olympic Village, Chelsea Barracks, the Battersea Power Station site), the north-west and the Midlands (more than 6,500 new homes). In fact, although Islamic finance transactions constitute only 1 per cent of global financial assets, about a quarter of the world's population is Muslim, which is a leading indicator of the growth potential in the US. Another unexpected leading indicator that has already shown signs of an uptick in the US market is Brexit, whereby London's euro clearing market is expected to cut almost 40,000 jobs in its banking industry.

The same stringent licensing and supervision standards that are applicable to the conventional US financial institutions also govern financial institutions offering Islamic

finance services. Therefore, Islamic financial institutions (IFIs) operate as state-chartered entities subject to state and federal laws regulating corporate governance and banking and insurance operations.²

Conventional banking institutions typically use their subsidiaries for Islamic finance transactions. The principal challenge faced by Islamic finance service providers in the US is therefore to offer products that comply with both *shariah* and the applicable state and federal banking regulations. However, unlike conventional US banking regulation, regulation of Islamic finance in the US is market-driven; federal and state regulators respond on a case-by-case basis to applications and inquiries from IFIs that want to offer Islamic financial products in the US. Consequently, any organiser of a *shariah*-compliant bank in the US must confront the challenge of introducing new financial products or services to regulators, and must meet significant creditworthiness requirements.

Another regulatory challenge might be the limited number of permissible investments that commercial banks are allowed to make. In the US, any investment made by banks must be limited to fixed-income, interest-bearing securities, which *shariah* prohibits. Moreover, US consumer credit laws require that commercial banks have reporting and disclosure requirements that may be inconsistent with *shariah*. For instance, the Truth in Lending Act of 1968 requires that banks disclose annual interest percentage rates, which is strictly prohibited by *shariah* law. On the other hand, a US financial institution may have a hard time employing *murabahah* or *ijarah* structures to finance the purchase of an asset (e.g., a car or home) if required under the state law to qualify as a licensed leasing company or auto lender.

ii Regulatory and supervisory authorities³

As stated above, both federal and state laws regulate the banking industry in the US whether conventional or Islamic. The national regulators include the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), and the state regulators are responsible for banking activities in each state. A bank in the US must be licensed by either the OCC or an applicable state banking authority and is supervised by the Federal Reserve and the FDIC. All deposit accounts offered by US banks are required to be insured by the FDIC, which is intended to ensure the overall safety and stability of financial institutions.

US regulators have issued certain opinions applicable to the Islamic finance industry. Preliminarily, while the Federal Reserve approved *shariah*-compliant retail financing products in the US, the Federal Reserve focused on the substance of the products. The Federal Reserve subsequently influenced the OCC to issue opinions aimed at reconciling apparent conflicts between *shariah* and the federal and state laws, and their respective regulations. For example, the US National Bank Act of 1864 prohibits US financial institutions wishing to offer *shariah*-compliant lending services from purchasing, holding legal title to or possession of real estate to secure debts with terms over five years. The OCC issued two interpretive letters, which addressed the special concerns of clients who would otherwise be forced to choose either their religion or their home or business.

2 See the US chapter in *Getting The Deal Through: Islamic Finance & Markets*, 2017 (contributing editor John H Vogel), at 55.

3 The first two paragraphs here were adopted from the US chapter of the first edition of *The Islamic Finance and Markets Law Review*, written by Andrew M Metcalf.

Although certain types of *murabahah* and *ijarah* financing are allowed under US laws, the OCC reconciled *musharakah* and *mudarabah's* apparent violation of federal regulations that prohibited commercial banks from forming partnerships or holding common stock. The OCC allows commercial banks to take 'as consideration for a loan a share in the profit, income or earnings from a business or enterprise of a borrower'.⁴ This interpretation creates an opportunity for commercial banks to derive equity return from a loan deal without relying on interest, despite the still-intact prohibition against making true equity investment. US credit unions have also adopted a communal or partnership model that complies with *shariah*.

Savings associations can form joint ventures and own properties through a subsidiary servicing company. These institutions may easily obtain real estate financing through *murabahah* and *ijarah* structures as well as limited joint venture possibilities through *musharakah* and *mudarabah* transactions.

III COMMON STRUCTURES

i Home and other retail finance

Retail Islamic finance has been well established in the US since the OCC approved the *ijarah* structure for home lending in 1997 because it is 'functionally equivalent' to conventional secured real estate lending.⁵ Similarly in 1999, the OCC approved the use of the *murabahah* structure for home financial products as it was deemed to be functionally equivalent to conventional real estate mortgage transactions, or inventory or equipment lien agreements.⁶

The OCC opined that under such structures a bank's ownership of property is only for 'a moment in time' because of the simultaneous nature of purchase and sale transactions. Therefore, Islamic contracts, the OCC concluded, avoid the type of risk that existing restrictions aimed to limit. In terms of accounting, the bank records the loan as an asset on its balance sheet. The borrower is required to maintain the property and pay all expenses. If the borrower defaults, the bank may sell the underlying property to recover the amount owed, as in a mortgage transaction.

Musharakah is also used for home financing in the US. It is a rent-to-own financed sale of property, where the bank first purchases the property and the customer pays the bank over time the full price plus a cost. With each rent payment, the customer earns a portion of the property's ownership. Under this equity-based structure (also called 'diminishing *musharakah*'), when the customer sells or disposes of the property, losses are shared between the customer and the bank as co-owners based on their percentages of ownership. The bank's return is taxable income to the bank and deductible by the borrower.

ii Insurance

Deposit insurance, which banks use for stability, is inconsistent with *shariah* because a bank having insurance alters the risk-sharing structure required under *shariah*. Therefore, *shariah*, a cooperative form of reimbursement that comes from a fund to which entities contribute regularly, does not work in the US. Reinsurance is necessary in the US because

4 Code of Federal Regulations of the United States of America, 12 CFR Ch. 1 (1-1-00 Edition), §7.1006.

5 OCC Interpretive Letter No. 806 (17 October 1997), [1997–1998 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-253 (Islamic Home Finance Leases).

6 OCC Interpretive Letter No. 867 (1 June 1999), [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) 81-361 (Murabaha Financing Products).

of high minimum capital requirements, but there are not many *retakaful* services. Although structuring a product around this impediment in the US is technically possible, it has been a strong enough practical impediment to prevent further growth of the Islamic insurance market. Another serious obstacle to the successful introduction of *takaful* and *retakaful* in the US is the Establishment Clause of the First Amendment to the US Constitution. Establishment Clause challenges are analysed under a three-part test to establish that there is a secular purpose, religion is neither advanced nor inhibited, and it does not foster excessive government intervention.⁷

Each state has its own licensing requirements for insurance companies operating in the state, which generally prohibit the proliferation of *takaful*. To be licensed, an insurance company must prove its experience, management capability and sound finances. It must also justify its premium rates and meet or exceed the solvency requirements. Even after it becomes licensed, an insurance company is often limited in choosing the types and concentrations of fixed-income investments that it must make with its reserves. Moreover, if the insurer becomes insolvent, an emergency loan must be taken out of the shareholders' fund to help meet obligations arising out of the insolvency. This could be a problem in *takaful* insurance, because capital requirements imposed upon the insurance companies may not accurately reflect the separation between the fund for policyholders and that for shareholders. Nonetheless, some *takaful* are subject to a lesser degree of oversight from the state insurance regulators.

Despite the difficulties associated with *takaful*, American International Group Inc (AIG) first started to offer Islamic homeowner *takaful* insurance in the US in 2008. Currently, AIG's underwriting subsidiaries, Risk Specialist Companies Inc and Lexington Insurance Company, issue *takaful*. Zayan Finance, a New York-based Islamic financial services firm, is the exclusive broker that offers *takaful* in many states. AIG also maintains a *shariah* board made up of Islamic scholars who have given legitimacy to the *takaful* alternative to conventional insurance in the US market.

iii Real estate investment

Islamic finance has widely used real estate as a basis for *shariah*-compliant financial structures. Prime or trophy assets (e.g., hotels or large office headquarter buildings) have been its focus. Thanks to rental guarantees, stable demand and rising rental payments, dorms and other student accommodation have also effectively attracted Islamic funds. Further developments may be achieved by expansion of the scope of social infrastructure to include education, healthcare and social housing sectors. Since 2010, however, Islamic funds and banks that offer mezzanine finance have proliferated. Here, a conventional senior bank provides a loan with interest, the investors provide the equity and the mezzanine financing is placed in a *shariah*-compliant way. The senior conventional bank and the *shariah*-compliant mezzanine lender enter into an intercreditor agreement governing the way in which each of their loans is treated while conforming to the mezzanine lender's Islamic sensibilities.

Murabahah is the most popular type of structure used for real estate investment in the US. A typical *murabahah* structure contains an unconditional contract of sale with a cost price, markup and payment date predefined. The profit from the marked-up sales price is paid in instalments. One of the largest examples of recent real estate investments done

7 Known as the 'Lemon test': *Lemon v. Kurtzman*, 403 U.S. 602 (1970).

under *murabahah* is the US\$219 million syndicated construction loan for 45 Park Place, a luxury condominium tower in Manhattan, New York.⁸ It was led by Malaysia's Maybank and Kuwait's Warba Bank; Italy's Intesa Sanpaolo and MASIC, the investment arm of Saudi Arabia's Al Subeaei family, also participated.⁹

One advantage of *murabahah* is that it may not require credit support. Here, the bank pays the seller for the property for immediate sale to the buyer for the cost plus a profit pursuant to a *murabahah* agreement. A *murabahah* transaction has also been used to refinance a conventional loan to allow the borrower to withdraw cash to pay off interest-bearing obligations, subject to the advice of *shariah* scholars. For US tax purposes, the profit piece of the purchase price in a *murabahah* transaction is deemed to be interest, such that it is taxable to the IFI and deductible by the customer.

An *ijarah* is a lease structure used in acquiring real estate as well as in other acquisition finance contexts (e.g., aircraft, ship or project finance). Under *ijarah*, a bank purchases a property and places the ownership over the property in a holding subsidiary and then leases it to the buyer for its use pursuant to the *ijarah* lease. Typically, title to the property is only transferred to the borrower after full payment of the cost of the property. The customer pays rent to the bank, which consists of, among other things, the purchase price and the profit. Unlike in a conventional finance lease transaction, the bank, acting as an owner and a lessor, has obligations to insure and undertake major maintenance of the leased asset. These obligations may, however, be contracted out to the borrower, who acts as a lessee. The lessee is responsible only for payment of the rent while the lessee continues to use the asset, so the *ijarah* structure cannot become effective before completion of the leased facility construction. Unlike in conventional leases, under an *ijarah*, if there is a total destruction or condemnation such that the property cannot be used for its intended purpose, the rent payment will cease. The lease-to-purchase model (i.e., *ijarah wa iqtina*) is also frequently used in real estate investment in the US. Under the laws of most states, the transaction can be simplified by having the client immediately take title to the property at the initial purchase.

iv Investment funds

A *mudharabah* agreement is formed between two partners, with one contributing capital to invest in some form of commercial enterprise, while the other provides the expertise and management experience. The capital contributor is known as the *rab-al-mal* and the managing partner is known as the *mudarib*. This type of structure is typically used for funded participating arrangements and establishment of an investment fund. The *rab-al-mal* and the *mudarib* share the profit generated from the investment in accordance with pre-agreed profit sharing ratios. However, any loss of capital is assumed by the *rab-al-mal*.

8 Anna Nicolaou, 'Manhattan tower secures \$219m in sharia-compliant financing', *Financial Times* (19 May 2016), <https://www.ft.com/content/cf6c3a88-1c4d-11e6-b286-cddde55ca122>.

9 id.

v Other areas

There have been two major *sukuk* issuances in the US: the East Cameron gas *sukuk*, the first *sukuk al-musharakah* in the US, which was backed by oil and gas assets, and the General Electric *sukuk al-ijarah*, which was backed by aircraft leases. The East Cameron *sukuk* has gone into bankruptcy, but the General Electric *sukuk* is performing well. Both Illinois and New York have begun efforts to enact legislation to recognise *sukuk*.

For commodity trading, *tawarruq* is used, which essentially is a reverse *murabahah*. Under this structure, a bank buys freely tradable commodities such as platinum and copper (other than gold and silver, since they are considered currency) at market value for spot delivery and spot payment, and then immediately sells them, at an agreed price that contains the profit, to the customer on a spot delivery and deferred payment basis. The customer immediately sells the commodities at market value to a third party for spot delivery and spot payment. The end result is that the customer has received a cash amount and has a deferred payment obligation for the purchase price to the bank. Under the *tawarruq* structure, the profit piece of the purchase price also takes into account the bank's commodity risk and third-party supplier risk, in addition to the creditworthiness risk of the customer.

vi Combining conventional and shariah-compliant financing capital stack

A *shariah*-compliant lender may participate in a capital stack structure in a transaction that uses both *shariah* and conventional financing by delineating the assets and the cash flows in the transaction.

In certain circumstances, *shariah*-compliant and conventional lenders may enter into a formal intercreditor agreement that sets out the priority of payments and the ranking of security. This is most likely to occur when the structural subordination is not possible and the borrower under both the conventional and *shariah*-compliant finance is the same entity. The intercreditor agreement between *shariah*-compliant and conventional lenders is likely to address many similar matters covered in such an agreement between solely conventional lenders. Matters that could be addressed may include:

- a* allocation of the borrower's operating income;
- b* allocation of proceeds following acceleration on default;
- c* disputes and governing law; and
- d* what the different lenders can and cannot do in respect of their facilities.

IV TAXATION

Islamic finance raises many US taxation issues, including strong tax incentives for debt over equity, the tax treatment of sales and additional layers of transactions in certain instruments. In addition, differences in the tax treatment of Islamic and conventional finance could cause cross-border spillovers and encourage international tax arbitrage. For instance, the Internal Revenue Service has yet to issue official guidance on tax deductibility of the payments made under *ijarah* and *mudarabah* structures and on partial treatment of such payments as interest. Real estate transfer taxes and mechanic's liens present another challenge because the *shariah*-compliant financing structures often require multiple transfers of the property with heavy fees incurred by parties with each transfer (e.g., property being purchased by the bank first and then transferred to the borrower). The state of New York has abolished these fees for transactions executed under *ijarah* and *mudarabah* structures, but many other states do still charge.

V OUTLOOK

Globally, Islamic finance has grown in terms of asset size by more than 20 per cent annually since the 2007–2008 financial crisis. Islamic banks are not outperforming other banks as a rule, since what they gain in safety, largely as a result of restrictions placed by *shariah* principles, they may lose in efficiency. It is during crises that the differences appear to have a material effect on performance. Two independent studies by the International Monetary Fund and the Islamic Financial Services Board found that Islamic banks demonstrated superior performance following the 2007–2008 crisis.

Nonetheless, while the covid pandemic has slowed the Islamic finance market, many stakeholders in the Islamic finance industry are prioritising sustainability. According to Citi's Asia Pacific chief executive officer, Peter Babej, 'If there's one lesson to be learned from the covid-19 pandemic, it is that our economic and physical health and resilience, our environment and our social stability are inextricably linked'. The opportunity cost for the US dollar, especially in light of covid and Brexit, is quite large in not participating in this global market and opportunity at this moment in time. It is recommended that the US takes steps to introduce the rules and regulations required to engage in worldwide Islamic finance, *sukuk* and *takaful* business. Interest-free financing modes may enhance the system currently in use in the US and offer a chance for Americans to diversify their portfolios, attract global investors, enhance liquidity and compete in the global village.

ABOUT THE AUTHORS

MONA E DAJANI

Pillsbury Winthrop Shaw & Pittman LLP

Ms Dajani leads Pillsbury's Middle East practice, energy and infrastructure projects practice, and renewable energy practice.

Based in both New York and London, Ms Mona E Dajani has for over 20 years been counsel to many of the world's most prominent development and investment companies in connection with hundreds of successful infrastructure, real estate and energy transactions, and projects in conventional and Islamic equity and debt transactions. She represents sovereign wealth funds, private equity funds, export credit agencies, investment funds, governments, banks, developers, institutional investors, lenders, pension fund advisers, contractors and asset management companies with respect to a wide range of *shariah*-compliant finance and investment transactions across the core practice areas of banking, project finance, capital markets, restructuring, M&A, investment funds and dispute resolution. She has expertise in structuring, documenting and negotiating complex transactions and developing innovative *shariah*-compliant techniques, including finance, regulation, project and asset finance, hedging and swap transactions, funds and other structures, including *sukuk* issues.

Ms Dajani has repeatedly been recognised as a leading lawyer by *The Legal 500*, *IFLR1000*, *The Best Lawyers in America* (2013–2020) and other publications, and is hailed as a rising star by Law360. She was elected to the board of directors for the American Council on Renewable Energy in 2015.

Ms Dajani is a regular contributor and commentator for CNN radio, POLITICO, Bloomberg New Energy Finance, Fox News, *The New York Times*, *The Washington Post*, National Public Radio and *USA Today*, among others.

PILLSBURY WINTHROP SHAW & PITTMAN LLP

31 West 52nd Street
New York
NY 10018
United States
Tel: +1 212 858 1000
Fax: +1 212 858 1500

Tower 42, Level 21
25 Old Broad Street
London EC2N 1HQ
United Kingdom
Tel: +44 207 847 9500
Fax: +44 207 847 9501

mona.dajani@pillsburylaw.com
www.pillsburylaw.com