# Strategies for Financial Inclusion

## *Islamic Banking and Reaching Out to Muslims*

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## Introduction

In recent years, the Twin Cities area has experienced an increase of East African refugees and immigrants, resulting in an increase of the area's Muslim population. For this literature review, Wilder Research located six articles that focused on key components of Islamic banking as well as how some US and European financial institutions are engaging Muslim customers.

## Islamic banking

Traditional Islamic banking uses a Profit and Loss Sharing model (PLS), which intentionally highlights the communal relationship between a bank and the customer (Schmid, 2013). In short, customers provide capital for the bank to invest, and unlike conventional US or European banks, Islamic banks do not guarantee the depositor's capital. However, the bank only earns profits based on the success of its investments with the customer's money, rather than by charging interest or other fees – which acts as an incentive for bank staff to invest in profitable ways. In this way, banks using the Profit and Loss Sharing model resemble asset management agencies more than they resemble conventional US or European banks (Guidance Residential, 2012; Schmid, 2013).

Additionally, Shari'ah law forbids the payment or collection of interest, which is a major barrier for members of the Muslim community who may want engage in the US financial system (Guidance Residential, 2012; Schmid, 2013). The terminology typically used to refer to this prohibition is "riba." According to some Muslim scholars, any amount of interest paid or received violates Shari'ah law; however, other scholars claim that a "reasonable rate of return" is acceptable. In any case, many US and European banks are incorporating "interest-free banking" as a strategy to accommodate Muslim customers (Schmid, 2013).

## Strategies for financial inclusion

### *Islamic windows*

Articles outlined two approaches to including Muslims in the US financial system: starting Islamic banks, or creating "Islamic windows" within existing US financial institutions (Lloyd's Bank (UK), no date; Paulson, 2006; Schmid, 2013; Shayesteh, 2009). An "Islamic window" refers to US or European financial institutions offering fund management, services, or products that are Shari'ah-compliant. One article outlined three primary steps for creating Shari'ah-compliant products:

- Identify a product that is generally not in line with Shari'ah law

- Construct an Islamic analog to the product with an Arabic name, preferably from Islamic legal texts
- The Islamic analog must be somewhat comparable to an existing product (Schmid, 2013).

However, in order to fully include Muslim customers, banks must also acknowledge Shari'ah risk (Guidance Residential, 2012; Schmid, 2013). "Shari'ah risk" refers to the possibility that the initial capital that funds a service or product may not be Shari'ah-compliant. To alleviate concerns relating to Shari'ah risk, some banks have started separate LLCs to ensure that all aspects of the financing process are Shari'ah-compliant (Guidance Residential, 2012).

### *Home financing*

Articles noted a number of Shari'ah-compliant home financing agreements that banks may offer through an Islamic window, including:

- **Murabaha** refers to a process in which the financial institution purchases a house requested by the customer. The financial institution then sells the home to the customer over a stated number of installments. The final cost to the consumer includes a fee paid to the financial institution for its services (Paulson, 2006).
- **Ijara** also begins with the financial institution purchasing a house. Instead of selling it to the customer outright, however, the financial institution leases it to the customer. During the leasing period, the customer pays a monthly rental fee to the financial institution. At the end of the leasing period, the customer owns the house (Paulson, 2006).
- **Musharaka**, on the other hand, refers to a declining co-ownership balance, in which the bank and customer both own a share of the house. Over a stated period of time, the customer buys an increasingly larger share of the house until the customer owns the house outright. During the co-ownership period, the customer pays the bank a monthly fee in exchange for the exclusive right to occupy and live in the house (Guidance Residential, 2012; Paulson, 2006).

Each home financing agreement adheres to Shari'ah law in that no interest is paid or received; however, in each agreement model, the financial institution receives an additional payment, resulting in a profit for the bank. It should be noted that one article cautioned US and European financial institutions against "semantic wrangling" when creating Islamic windows, which may result in surface-level terminological modifications as opposed to truly culturally responsive services (Schmid, 2013).

Another prohibition within Islamic banking is gharar, which denotes uncertainty with respect to the content or price of a financial transaction. Although each home financing agreement results in a profit for the financial institution, it adheres to Islamic law in that all costs to the customer – including the bank's profit – is communicated upfront. To comply with gharar, US financial institutions reaching out to Muslim customers should be transparent with all aspects of a financial agreement (Schmid, 2013).

A number of other questions arise from using Shari'ah-compliant home financing agreements within the US financial system, including how to address property taxes, home insurance, profits or losses from selling the house, especially in a co-ownership agreement (Guidance Residential, 2012). Solutions to these concerns should be addressed upfront with the customer in adherence with gharar.

### *Shari'ah Supervisory Boards*

Some financial institutions have incorporated Shari'ah supervisory boards to oversee and provide guidance relating to Shari'ah-compliant services and products (Guidance Residential, 2012; Schmid, 2013). A major task of such boards is the issuing of fatwas, which are Islamic legal pronouncements issued by an Islamic scholar. In US and European financial institutions, fatwas from Shari'ah supervisory boards serve to verify that financial transactions offered by the institution comply with Shari'ah law. Another important task is calculating and paying Zakat, which is the practice of charitable giving based on accumulation of wealth.

A major barrier to forming a Shari'ah Supervisory Board, one article noted, is that few Muslim scholars also possess in-depth knowledge of conventional US or European banking. To address this, banks might consider instituting a Shari'ah Advisory Board, comprised of financial experts to advise the members of the Shari'ah Supervisory Board on financial practices and major players in the financial field. The same article also suggested employing Shari'ah auditors – external Shari'ah law experts to inspect the work of a Shari'ah Supervisory Board as well as Shari'ah-compliant products offered by financial institutions (Schmid, 2013).

## New refugees and immigrants

One article focused on recent Somali refugees, suggesting that financial institutions should take the "resettlement process" into consideration when reaching out to the Muslim community. Specifically, the article recommends that financial institutions or community-based organizations wait until six months after a refugee's arrival to begin financial education and outreach. Additionally, new refugees often have bank accounts started for them by case managers at resettlement agencies, but rarely fully understand the US financial system (Minnesota DEED, no date).

## Islamic banking in Minnesota

For examples of how Islamic banking is currently operating in Minnesota, financial institutions should look to:

- **City of Minneapolis Alternative Financing Program** offers real estate construction financing and micro-financing.
- **Minnesota Housing Finance Agency (State of Minnesota)** offers low-income residential real estate financial.
- **African Development Center** offers micro-financing and residential real estate financing.
- **Neighborhood Development Center's Riba-Free Program** offers micro-financing (Shayesteh, 2009).

It should be noted, however, that Shayesteh wrote his article in 2009. The Islamic banking landscape in Minnesota may have changed since then.

## Summary and recommendations

US and European financial institutions, particularly those in Britain, have shown considerable interest in engaging Muslim customers. To successfully incorporate Muslim customers into the US financial system, however, major players in the US financial industry should acquire a more thorough knowledgebase of Islamic banking and Shari'ah law. Wilder Research suggests learning components of modern Islamic banking in the US or European countries as well as how financial institutions operate in largely Muslim countries. Such practices will provide more in-depth context for offering Shari'ah-compliant products and services.

Additionally, in the Twin Cities area as well as throughout Minnesota, East African refugees and immigrants comprise a substantial portion of the Muslim population. Although much scholarly attention has focused on engaging new immigrants with mainstream financial services, Wilder Research found only one article relating to East African refugees or immigrants. More attention needs to be paid specifically to East African refugees and immigrants to fully understand how principles of Islamic banking interact with the challenges of immigrating to a new country.

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