# Islamic Finance and the Student Loan Market for Muslim-Americans

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November 24, 2014

**The First Amendment of the United States Constitution:**
*Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . .*

**Hussein Samatar, founder of the African Development Center in Minneapolis:**
*No one, regardless of race, ethnicity, gender, sexual orientation, religion, or nearly any other particular aspect of life, should be left out of the opportunity to create wealth and happiness for oneself or one's family here in Minnesota or the United States of America.*

The First Amendment distinguished the US by declaring that no religion should present a hurdle or shortcut to success. At present, that Constitutional principle is especially relevant for the higher education of America's young and increasing Muslim population. Postsecondary learning creates significant public and private value, and stands at the fascinating intersection of the public sector and Islamic finance, IF.[1] Private markets in the United States provide many IF products to Muslim-Americans but do not offer higher education loans. The United Kingdom, with a Muslim population resembling that of the US, found significant demand for IF education funding. The UK public sector will soon provide IF student loans for Muslims. The US public sector should analyze the extent of American demand for IF higher education loans. Existing markets may fail to provide Muslim-Americans and the US the wide benefits of postsecondary learning.

This paper begins with a global background of Islamic finance, continues with the public sector's role in IF, and concludes by suggesting changes to higher education loans in the US. The literature on Islamic finance in the US is thin at best. To my knowledge, this is the first academic exploration of IF student loans in the US.[2]

## Islam and the Emergence of Islamic Finance

Islamic finance is conventional finance that comports with Islamic rules and practices. As simple as that seems, Islamic finance is not simple because Islamic law, *sharia* in Arabic, is subject to interpretation. Like other large belief systems, Islam is not always internally consistent. Islam consists of many religious subgroups, with Sunni and Shia Muslims making up the majority of Muslims worldwide. Islamic scholarship is often concentrated by tradition and geographic region; so is Islamic finance. Accordingly, neither Islamic religious authorities nor IF professionals agree completely on the theory and practice of IF (Pollard Samers, 2013). Part of the reason is, while Islam has existed for centuries, IF was first institutionalized only in the 1970s with the Middle East's oil wealth and the growth of Southeast Asia.[3]

[1]"Islamic" is not a synonym for "Islamist." "Islamist" refers to militant or fundamentalist Islamic practices. Islamic finance and Islamist groups are, by and large, unrelated.

[2]I explored academic literature, news media, financial reports, and government publications, but no sources I found contain data allowing for econometric modeling of the market for Muslim higher education loans. Collecting such data is one important policy prescription in this essay's conclusion.

[3]IF's initial growth involved great public sector involvement of OPEC governments and the Islamic political parties of Southeast Asia.

Islamic finance emerged in the Middle East, Southeast Asia, and North Africa, the historical birthplaces of all of Islam's subgroups (Clark, 2003; Desilver, 2013). Islamic finance solidified at the Islamic Conferences of the early '70s, producing the Islamic Development Bank as the first transnational IF bank (Warde, 2010). Of the $1.3 trillion global IF assets in 2012, Malaysia controlled 32.3 percent, Saudi Arabia 21.2 percent, and Iran 14.5 percent (ICD and Thomson Reuters, 2013). The United Arab Emirates, Kuwait, Qatar, Bahrain, Turkey, Indonesia, and Bangladesh rounded out the top ten countries with the largest holdings of IF assets. The global IF market grew 30 percent from $1 trillion in 2010 to $1.3 trillion in 2012 (Ilias, 2008; Tacy, 2006). It does not seem to perform financially any better than conventional finance, however, and may perform worse. Still, "the gap between Islamic and conventional financial practices is shrinking" (Krasicka  Nowak, 2012). IF remains a growing asset class that attracts the interest of Muslim and non-Muslim governments.[4]

Islamic finance has quickly become more internally consistent and outward-facing during the half century of its existence. Two major bodies provide international regulation, the Accounting and Auditing Organization for Islamic Financial Institutions, AAOIFI, and the Islamic Financial Services Board, IFSB, but they have limited power (Warde, 2010). AAOIFI, based in Bahrain, sets the most widespread IF regulations in the Middle East. IFSB, based in Malaysia, partners with the International Monetary Fund to integrate Islamic finance with the Basel III international finance accords (IFSB, 2014). Still, IF operations occur mostly "through informal and semi-formal means" instead of a set of universal practices (Warde, 2010). Global Islamic finance relies on a loose collection of rules akin to a legal system, interpreted by a small number of juristic academies like AAOIFI and IFSB, as well as independent IF authorities. Instruments and institutions of Islamic finance must be certified as sharia-compliant by those agents to ensure their accordance with specific principles of Islam.[5]

### The IF Prohibition of Money-Based Interest Payments

The most ubiquitous principle of IF is the ban on *riba*, Arabic for usury. *Riba* is interest on money rather than the gains from use of physical assets. IF institutions address *riba* by buying and leasing physical objects, or offering collateralized loans, instead of charging interest on money. The amount of money that the customer pays is not different than what would be paid in conventional financing. The important difference is that a physical item backs the loan or lease (El-Gamal, 2006; Ingersoll, 2014). Arguing whether to call this interest or profit misses the point: Islamic usury is treating money as an asset in itself rather than merely a means of exchange. For that reason, physical assets underlie the financial transactions of many IF products. For example, General Electric issued $500 million of Islamic debt in 2009, anchored to leases on aircraft (Testa, 2013). Prohibition of *riba* is the most common differentiator of IF instruments from conventional products.

### The IF Prohibition of Excessive Uncertainty

Charging interest on money is one of the two main IF prohibitions. The second prohibition of IF is contractual uncertainty, *gharar* in Arabic. Financial agreements cannot be *sharia*-compliant when "there is uncertainty as to the fundamental terms of the contract, such as the subject matter, price, and time for delivery" (*Islamic finance: instruments and markets*, 2010). In practice, *gharar* is a matter of degree and not a prohibition of all uncertainty (El-Gamal, 2006). Interest rate swaps are an example of what is prohibited, because interest swap obligations are uncertain in their timing

[4]A small but vocal number of scholars believe that Islamic finance better resists financial crises because IF outperformed conventional finance during the global financial crisis of 2007 (Chapra, 2008). So far, those arguments are not widely convincing.

[5]AAOIFI, IFSB, and independent IF professionals have written extensively on the nuances of IF. This paper only analyzes its essence; the details require more space than available here. The AAOIFI and IFSB websites are greatly informative: www.ifsb.org and www.aaoifi.com.

and their price is disconnected from tangible assets.[6] Collateralized financial instruments with fixed liability are acceptable products to avoid *gharar*. Completely removing uncertainty from financial products is, of course, impossible. The *gharar* prohibition seeks to reduce, not eliminate risk. More extreme forms of risk-taking like gambling are expressly forbidden.[7] *Riba* and *gharar* result in IF products that resemble traditional financing but are structured to avoid those IF prohibitions.

### The Products and Practices of Islamic Finance

Four types of IF products make up the majority of IF: *murabaha*, asset-based loans; *ijara*, asset-based leasing; *sukuk*, corporate bonds; and *takaful*, mutual funds and collective insurance.[8] To understand the first two products, imagine a customer who would like to buy a food truck. At a conventional bank the customer would take out a loan, buy the food truck, and pay back the loan with interest. An institution offering *murabaha* would purchase the food truck and gradually sell ownership to the consumer at a mark-up, a form of asset-based shared ownership that seeks to reduce risk (Warde, 2010). An institution offering *ijara* would purchase the food truck and lease it to the consumer at a markup, another form of asset-based risk sharing (El-Gamal, 2006; *Islamic finance: instruments and markets,* 2010). Both these options avoid treating money as the asset for the financial transaction. In that way they are both interest-free options, though they do not cost less in repayment than comparable non-IF products. This is one of the most commonly misunderstood aspects of IF and it bears repeating: Islamic finance products are "interest-free" but do not cost less than traditional products.

*Sukuk* are Islamic corporate or governmental bonds. They resemble collateralized non-Islamic bonds, backed by tangible assets like infrastructure projects (Mardam-Bey, 2013). *Sukuk* are the largest form of Islamic finance, and the Dow Jones maintains Islamic market indices for *sukuk* offered by companies in the US and around the world. Assets underlying *sukuk* must be evaluated by an IF authority to ensure they comply with *sharia*. Bonds, loans, and leases are the instruments that provided most global IF growth over the last 30 years (Testa, 2013). An uncommon form of IF, insurance, is especially relevant in its extension to higher education funding, which I explore at the end of this paper.

*Takaful* is IF's insurance instrument, similar to *sukuk* in that it reduces uncertainty by diversifying risk across a large number of stakeholders. *Takaful* involves a "cooperative insurance contract, which is built on the principles of voluntary contribution and mutual cooperation" (El-Gamal, 2006; *Islamic finance: instruments and markets*, 2010). It differs from typical US insurance because it is owned and run by the policyholders rather than by a separate, private company (Baxter Jr, 2005).[9] US Muslims consistently avoid typical insurance since it is mostly not *sharia*-compliant nor community-orientated (Pollard  Samers, 2013). Although no institutions offer *takaful* in the US (Shayesteh, 2009), *takaful* does exist in other non-Muslim countries like the UK. *Takaful* is one of the least common forms of IF but has increased just as rapidly as loans, bonds, and leases. Islamic governments and institutions have influenced the growth of all IF products.[10] However, in this

[6] Islamic derivatives are a source of theoretical debate among IF authorities, remaining on controversial ground (El-Gamal, 2006). Derivatives trade in risk and are not always based on physical assets. Though there are a small number of Islamic derivatives, it is unclear whether they will gain wide acceptance. IF derivatives are a novel extension of Islamic legal theory.

[7] Islamic finance also explicitly bans assets involving pornography, alcohol, or pork; all are halal, Arabic for forbidden.

[8] As of 3 November 2014 AAOIFI's website lists 49 IF financial products and procedures (Accounting and Auditing Organization for Islamic Financial Institutions).

[9] Lloyd's of London bears a resemblance to *takaful*. However, Lloyd's operates as a mutualized marketplace that facilitates all sorts of insurance policies whereas *takaful* is, in itself, mutualized insurance. Lloyd's does not offer *takaful*, but has recently expressed interest in *takaful* due to the growth of economies like Egypt and Malaysia, which have domestic *takaful* (Lloyd's of London, 2009, 2014).

[10] The growth of *takaful, ijara, murabaha,* and *sukuk* in Muslim countries has involved a significant public sector

essay I focus on the relationship of non-Muslim governments with IF products and leave a deeper study of Muslim governments and IF for other researchers.[11]

### Non-Muslim Public Sector Involvement in International IF

Many non-Islamic countries have adopted regulatory statutes to enable Islamic finance and take initial steps into the market itself. Ireland, South Africa, the UK, and the US all have legally accommodated Islamic finance in the last three decades (Pollard Samers, 2013; Richardson, 2011; Vahed Vawda, 2008). Countries in Europe, and non-Muslim East Asia, have offered or are considering launching government *sukuk* bonds (Ilias, 2008; Taylor, 2002). Predicted *sukuk* offerings in the 2010s, from countries in sub-Saharan Africa, further demonstrate that non-Muslim governments around the world have become increasingly engaged with Islamic finance, if only IF bonds.

Still, Islamic finance in non-Muslim countries expanded slowly during the early 2000s. After 9/11, western governments conflated Islamic banks with Islamist groups, froze IF assets, and became wary of Islamic finance (*The Politics of Islamic finance*, 2004). As the decade progressed, IF regained its previous legitimacy and western governments relaxed their suspicions of IF banks and products. Saxony-Anhalt, a German state, became the first non-Muslim government to offer *sukuk*. It issued €100 million of Islamic bonds in 2004, and Great Britain followed suit in 2014 with a £200 million *sukuk* offering that attracted orders of £2 billion (Moore, 2014).[12] However, no federal, state, or local US government has offered an Islamic bond. Aside from updating regulations to permit IF, the US public sector does not participate in international markets and barely participates domestically.[13] Private, not public markets, have been the places the booming Muslim-American population turns to for domestic IF products.

### Serving the Growing Muslim-American Population: The Private Sector

In the next two decades, the domestic population of Muslim-Americans will continue to expand more, in percentage terms, than any other religious group. The private market for US Islamic finance has ridden that wave of growth. The 2000s set records for the number of new Muslim citizens and immigrants (Elliott, 2006). US Muslims are predicted to represent 2 percent of the population by 2040, a growth of more than 100 percent from approximately 2.5 million at present (Skirbekk, Kaufmann, Goujon, 2010; Smith, 2001). In 2003, the average Muslim woman was predicted to have 2.84 children over the course of her lifetime, the highest nationally and well above the 2.08 US average (Skirbekk et al., 2010).[14] The growing presence of Muslims in the US has increased the private US market for domestic Islamic finance.

Domestic IF growth and the number of recently founded IF institutions indicates that the IF industry serves swelling Muslim demand. Sharia-compliant home loans in the US increased from

role. The Muslim countries with the largest presence of IF tend to have considerable state support of IF (*The Politics of Islamic finance*, 2004). Separating Islamic governments from the success of IF in those countries is difficult because the legal framework of those countries involves *sharia* law itself. Additionally, the main IF economies "often lack a regulatory framework and tradition, and suffer from a wide array of structural problems" (Warde, 2010).

[11] *The Politics of Islamic Finance*, edited by Henry M. Clement and Rodney Wilson, is an excellent place for those researchers to start exploring Muslims governments and their interactions with IF markets.

[12] In response to the large excess demand, the UK Chancellor of the Exchequer, George Osborne, said: "I hope that the success of this government issuance will encourage further private sector issuances of *sukuk* in the UK" (Moore, 2014). It seems this move was mostly to stimulate private supply and not a signal of future government bonds.

[13] Investment bankers have suggested that US governments should offer sukuk for infrastructure projects, since the US "faces an infrastructure gap of US $1trn by 2020" (Curiel; Mardam-Bey, 2013). Islamic finance, focusing on physical assets, fits the bill for infrastructure projects. However, more financial supply would not necessarily help. US governance problems with public fund provision for infrastructure projects seem to cause the gap, not the supply of funding mechanisms (Pietroforte Miller, 2002).

[14] The total fertility rate is a prediction of how many children the average woman would have throughout her life given the prevailing fertility rates at the time of the prediction.

$2 billion in 2006 to an estimated $5 billion in 2010, mostly from private lenders (Mardam-Bey, 2013). In the same economically turbulent period, overall home loan originations decreased from $2.9 trillion to $1.5 trillion (Taylor, 2002). Private IF institutions in the US number around two dozen and have grown steadily since the late 1990s. They generally offer small loans for homes, cars, and business capital. Several companies offer Islamic investment services as well as sharia-compliant mutual funds. Guidance Residential, based in Virginia, launched its first home loans in 2002. Private markets supply the majority of domestic IF products in the US, with only two instances of public sector involvement, both in Minnesota.

### Serving Muslim-American Growth? The Public Sector

The two IF institutions that involve governmental partnerships are in Minnesota (Shayesteh, 2009) and illustrate the general dominance of the private IF sector over the public sector. Islamic finance and the US regulatory system remained out of step until as recently as 1997, when domestic IF received approval "by a Shari'ah Board and . . . a US regulatory agency" (Tacy, 2006). However, Minnesota still has the first and only public IF products, meeting demand from Muslim Somali immigrants (Campbell, 2014; Shayesteh, 2009). In 2007, the Minneapolis Federal Reserve Bank and local groups created an IF product through the City of Minneapolis. It was initially shut down due to criticisms that the product violated separation of church and state because the government was involved with the product (Baxter Jr, 2005; Samatar, 2007).[15] The City of Minneapolis and the State of Minnesota have since resumed two IF options, one for business finance and the other for home finance. Still, the public sector only participates in domestic IF in Minnesota, and even then to a small degree. Private providers serve most consumers in Minnesota and the nation. However, one area the public sector should reconsider its role in is Islamic higher education loans, for which significant demand may exist that the private sector has not met.

### The Public Sector and Islamic Higher Education Laws

Postsecondary education benefits students and society as those students contribute to broader wellbeing through greater productivity and informed citizenship. Therefore, loans for higher education are mixed public and private goods because they facilitate the acquisition of more schooling (Hyman, 2010; Psacharopoulos  Patrinos, 2004). Researchers still discuss how much of higher education's benefit is private or public; still, higher education does seem to be at least somewhat a public good (Wahl, 2002).[16] For that reason, funding higher education should involve both the public and private sectors. In the US, this has historically been the case, through a combination of public and some private funding mechanisms. Regardless, no private or public entity around the world offers IF higher education loans. This status quo may effectively eliminate the potential private and public benefits of student loans to US Muslims and US society at large.

Current scholarships and grants might meet a very small amount of the US Muslim demand for education finance.[17] Existing higher education loans charge interest on money, one of the biggest prohibitions of *sharia*-compliant finance. This may bar any number of the 2.5 million US Muslims from a college education not funded solely by grants or scholarships. An education funded in the

[15] In fact, no US financial regulation or aspect of the US legal framework prohibits Islamic finance domestically (Baxter Jr, 2005; El-Gamal, 2006).

[16] The degree to which higher education is a public or private good also depends on the skill level of workers (Viaene Zilcha, 2013). The US Muslim population is low-skilled, due to a high Muslim birth rate among waves of young, unskilled immigrants. In that light, higher education for Muslims may be an even more beneficial public and private good.

[17] Even in Malaysia, a Muslim-majority nation and IF leader, no institution provides Islamic higher education loans (R. Ismail  Fadzim, 2009; S. Ismail, Bakri, Ali,  Noor, 2014). S. Ismail et al. explore the potential of creating student-loan backed securities that are *sharia*-compliant. The securitization process proposed would be IF; the loans themselves are not IF. Ismail and Fadzim offer a Malaysian perspective on *riba* in student loans.

US without loans is very uncommon. Widespread discussion online suggests that interest-based loans are still a relevant concern for Muslims in the US (DebtFreeMuslims, 2014). Of course, online chat rooms do not accurately measure the level of actual demand. An IF alternative might widely broaden the educational opportunities of practicing Muslims. How could the US know whether Muslims are significantly restricted from higher education by the lack of IF education loans? The UK government answered that very question about its Muslim population this fall. The US should follow its lead.

### Comparative Educational Regimes: The UK and the US

The Muslim demand for interest-free student loans in the UK serves as a close proxy for the potential Muslim demand for interest-free student loans in the US.[18] Both the UK and the US contain young and quickly growing Muslim populations, both around 2.5 million individuals. Muslims in the UK and the US have IF options for financing homes, businesses, and cars, as well as IF investment banking and wealth management. Neither country currently offers Islamic student loans, but both the UK and US governments provide extensive higher education funding.

In response to negative Muslim reactions to recent increases in university fees, the UK analyzed Muslim demand for education loan services. In 2009 the UK university system increased the cost of tuition and lowered the income level at which loan recipients would pay interest (Coughlan, 2010). Muslim student groups protested, and debate ensued about whether Muslims demanded a *sharia*-compliant option. Anecdotes suggested that Muslim students held mixed opinions, some saying they would accept interest-based loans and others saying they would only accept an alternative, *sharia*-compliant option (Withnall, 2014). To approximate Muslim demand more accurately, the UK government completed an extensive consultation on Islamic student loans. The September 2014 report concluded that demand exists for sharia-compliant alternatives "although the extent is unquantifiable" (Department for Business, 2014).[19] It stated that the UK government would move forward with designing a loan based on the structure of *takaful* insurance.

### The *Takaful* Student Loan: A Possible Solution

*Takaful* is mutual insurance owned by the policyholders, which I explain in greater detail above.[20] The UK education loan version of *takaful* would also involve mutual contribution and benefit. As presently designed, the British *takaful* involves the same debt burden to the student as a comparable, non-IF student loan. As loanees pay *takaful* back, those funds would become loan money for future Muslim students. It is unclear how the fund would be started, but it would likely involve annual donations from other Muslims through *zakat*, yearly contributions furthering charitable Islamic causes. The UK *takaful* loans will likely begin in the fall of 2016. The *takaful* does not supplant UK statutory law with *sharia* law, a concern that many in the UK and the West have about Islam in the public sector.[21]

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[18]As I mentioned earlier, Islam contains many subgroups. The way the many subgroups and each of the four main traditions of Islamic jurisprudence view education loans may differ. That research would require extensive Islamic theological understanding that is not necessary for this paper.

[19]"The consultation ran for 10 weeks and offered respondents an opportunity to provide feedback on a Sharia Alternative Finance product for students . . . The consultation received 19,886 formal responses. In addition 68 comments were sent to the consultation email address."

[20]Like all other IF, it must be certified by a Islamic finance professional or *sharia* board. The *takaful* product presented by the UK report involved consultation with IF authorities. This application of *takaful* represents an Islamic finance innovation.

[21]As the British consultation reported, "some respondents have expressed concern that the introduction of an Alternative Finance Product [an IF student loan] would be an endorsement of Sharia law in a wider sense. This is not the case. Sharia law has no jurisdiction in England and Wales and the Government has no intention to change this position. Such a product would simply offer potential students whose religious beliefs mean they feel unable

The findings of the UK consultation suggest that the US should evaluate its own domestic need for Islamic student loans through a similar approach. Why? Like the UK Muslim population, the US Muslim population will continue to increase rapidly and has already resulted in a burgeoning private IF sector. Several online resources offer advice for Muslim-Americans on how to pay for education without interest, suggesting significant demand for a *takaful*-like product. The websites advise that Muslims pay loans before interest accrues, take a year off in the middle of college to work, or simply skip higher education altogether (Continuous Charity, 2014; DebtFreeMuslims, 2014; Islamic Society of North America, 2013; Unus, 2012). No resource found through this research gave any economic estimate of how much demand there is, another reason to encourage an accurate market evaluation of what seems likely to exist. The UK report notes that "prior to the consultation launch, there ha[d] been no direct evidence to help inform policy making" (Department for Business, 2014). Currently, the same lack of evidence exists in the US.

Would the results of a US consultation find similar results? In the UK survey, 94 percent of respondents believed there would be demand for an IF student loan, and 81 percent believed that *takaful* would be an acceptable alternative. With a similarly sized Muslim population, the US resembles the UK. However, the US remains unaware of whether Muslims and America are losing out on the substantial benefits of higher education.

### Religious Freedom and Economic Success

Private IF markets have consistently failed to offer higher education loans to US Muslims. Given the public and private benefits of postsecondary education, and the established role of the public sector in providing funding, the US should know whether Muslims demand *sharia*-compliant student loans. The US public sector can also improve on British efforts in a number of ways. It could explicitly evaluate demand for Islamic student loans, quantify potential public and private benefit from such loans, and provide a concrete demographic understanding of Muslim-Americans, the US' fastest growing religious group.[22] Future research should explore these topics and focus especially on procuring quantitative data that at this time do not exist. The US Constitution contends that government should not let religious beliefs block Americans from success. Understanding the demand for Islamic student loans would assure that the US and Muslim-Americans do not find themselves caught between the desire for the benefits of higher education and religious freedom. Without accurately knowing the demand of US Muslims for interest-based education loans, we remain ignorant of whether the public sector has deadened or enlivened the American dream. Future research can build off this initial exploration by further defining how much the public, businesses, and Muslim-Americans stand to benefit from IF education loans.

to take out an interest bearing loan the option to fund their higher education in a way that is compatible with their moral and religious beliefs while not putting them at any advantage or disadvantage to those who take out traditional student loans" (Department for Business, 2014). Islamophobia in the US has reached some of the highest levels since 9/11 and exceeds negative feelings towards any other religious group (Arab American Institute, 2014). I will let other researchers evaluate religious fears in regard to Muslim higher education loans.

[22]In the US, part of the problem with understanding Muslims' demand for higher education loans is that the US Census does not ask questions based on religion. The UK Census does ask such questions, making it easier for them to work with their Muslim population. A nationwide evaluation, perhaps integrated with the 2020 US Census, might also explore regional differences in the cost of education for US Muslims. Minnesota, for example, has the 5th highest incidence of student loan debt (Furst, 2014) and also the largest population of Somali immigrants, who are almost exclusively Sunni Muslim.

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