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Islamic loans turn profit for banks in USA

By Paul Wiseman, USA TODAY

A customer showed up at little Devon Bank on Chicago's North Side, asking for a loan to open a neighborhood shop. But there was a hitch, the would-be borrower explained: "We can't pay any interest. Can you help?"

At the time, seven years ago, the answer was: "Nope," recalls David Loundy, Devon's vice president and legal counsel.

That was then. Since fielding that first request, Devon Bank has transformed itself into a specialist in the kind of no-interest Islamic financing the customer was seeking. Islamic financing now accounts for more than 75% of the bank's mortgage portfolio, and Devon has made mortgages compliant with Islam's sharia law in 36 U.S. states, Loundy says.

Devon Bank, responding to local customers in a neighborhood filled with Pakistani and Middle Eastern immigrants, stumbled onto something big: Islamic finance is booming worldwide, fueled by the windfall from sky-high oil prices and a return to a more strict interpretation of the holy Quran across the Islamic world. Once Devon Bank introduced sharia-compliant mortgages and other loans, "People started coming out of the woodwork," Loundy says.

In a report last month, credit-rating agency Moody's Investors Service said that the global Islamic finance market has grown about 15% in each of the past three years and is now worth about \$700 billion worldwide. The heavyweights of global finance have taken notice: Citigroup, HSBC, Deutsche Bank and others have affiliates devoted to Islamic finance.

Giant mortgage investor Freddie Mac began buying sharia-compliant mortgages in 2001. Freddie Mac today continues to buy from four banks that together originate mortgages nationwide. In addition to Devon, Freddie Mac buys mortgages from Guidance Residential in Reston, Va.; University Bank in Ann Arbor, Mich.; and American Finance House Lariba in Pasadena, Calif.

Freddie Mac spokesman Brad German says the company bought more than \$250 million in Islamic mortgages in 2007, but volume is slipping as the housing market declines. The mortgages are "a steady, if modest, niche," German says.

Somewhat of a dispute

There's some dispute about exactly where the Quran comes down on finance and interest.

Scholars at the Al-Azhar Institute in Cairo — influential in Islam's chief Sunni denomination — declared in 2002 that the Quran did not prohibit all interest payments and charges, just those so exorbitant that they crossed the line into usury. Conventional banking has been widespread for years in the Islamic world.

A stricter interpretation — barring all interest — has been gaining ground over the past decade and driving the growth of no-interest Islamic finance.

Islamic banks get around the prohibition on interest by treating loans more like leases or profit-sharing arrangements.

An Islamic mortgage, for instance, looks like a lease-to-own deal. The bank, not the borrower, buys the house. The borrower makes installment payments to the bank for a period of years, at the end of which he or she gets the title to the house.

The bank's profit technically comes from renting the house, not lending the money. Loundy notes that Islamic mortgages are more costly than traditional mortgages because they involve paperwork for two home sales: the first by the bank, the second by the borrower after the installment payments are finished.

In business loans, the bank essentially shares profits with the borrower, making Islamic financing more like an equity investment than a loan. Even depositors at Islamic banks are supposed to share profits and losses with the bank, instead of receiving interest payments — an arrangement that U.S. banking regulators have so far balked at approving. "The FDIC is not anxious to see any bank agreeing in advance to share a loss," Devon Bank's Loundy says.

Booming bonds

Islamic bonds — known as *sukuk* — are booming: Nearly \$33 billion of Islamic bonds were issued last year, up from \$5.5 billion in 2001. Islamic bonds work something like Islamic mortgages. For instance, the German state of Saxony-Anhalt, which issued the first Islamic bond in 2004, sold government property to bond investors and then leased it back from them. The investors technically earned money from the rent, not interest.

Determining exactly what is and isn't a sharia-compliant transaction can get tricky. HSBC and Citigroup each have their own sharia advisory boards, made up of well-credentialed Islamic scholars. Devon Bank, which has assets of just \$250 million, leans on opinions from the Sharia Supervisory Board of America.

Kuala Lumpur, capital of predominately Muslim Malaysia, has emerged as Islamic finance's global capital, thanks partly to tax breaks that encourage Islamic banking. But Singapore and Hong Kong are eager to catch up. "If Hong Kong truly wants to be a major international financial center, not just in the region, but globally, then Islamic finance must be amongst our portfolio of products and services," John Tsang, Hong Kong's financial secretary, said last year.

"It's here to stay," Loundy says of Islamic finance. "You're talking about one-fifth of the planet's population."

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