

Methods of Islamic Home Finance in the United States
- **beneficial breakthroughs** -
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Publisher, *The American Journal of Islamic Finance*

Introduction: The domestic Islamic community in the United States is increasingly demonstrating the depth of its numbers. Unlike any other newly emerging community, a consistently large block¹ of Muslims seeks to regulate their affairs according to Islamic rules (*Sharia'a*²). This young and affluent population³ has progressively investigated means to apply Islamic concepts to their financial lives, including the acquisition of homes. Despite their efforts, only now are vendors emerging which seek to meet these needs. Such service bodies are still searching for the best tools to apply, how to use those applications within the existing real estate process. Prior to 1997, the absence of banking regulatory support meant that all US efforts to provide Islamic home finance have been ad hoc and capital constrained. To a lesser degree, they have had limited integration to either *Sharia'a* scholarship and the international Islamic capital market. The pioneering regulatory interpretations obtained by the United Bank of Kuwait⁴ (UBK) have begun to open both the door to scalable funding for Islamic finance in America, the development of securitization, including participation by the government sponsored entities. With a growing universe of real estate and finance professionals comforted by the regulatory change, the field has now begun to open up to a plethora of solutions and problem solvers, domestic and foreign.

Regulatory Change: Although a major international bank worked with both a US mortgage bank and a key Islamic bank to structure an Islamic home finance program as early as 1993, no formal regulatory framework or authorization existed for such a program prior to 1997. Once the Office of the Comptroller of the Currency (OCC) granted authorization to UBK to take title to property for the purpose of facilitating an Islamic lease to own relationship, the ability to bring scale and order to the field of Islamic home finance was achieved. The OCC later also approved installment sales with the bank taking title to property as a banking instrument in 1999. More recently, the OCC granted an interpretive ruling to Key Corp. in 2000. The rulings turn upon a series of common factors: First, the regulators examined the bank request and evaluated its similarity in risk and purpose to existing banking powers; Second, the regulators reviewed whether or not the interpretation would result in making banking more inclusive. What these changes mean is that any professional party, investor may now take comfort in the fact that the Islamic transactions have been reviewed and are safe enough for application by banks. This conclusion allows downstream (state or

¹ AJIF, First Takaful, UBK, CAIR and Falaika surveys coalesce around 25% core consumer base seeking Islamic products with a similar number open to conversion to Islamic products based upon competitiveness and clarity of presentation.

² *Sharia'a* technically is Islamic law, but in the context of a Muslim minority like the US community, it is more a consumer elected restriction. For service providers, it is an additional layer of compliance. Rather than allowing what local laws and regulations forbid, the *Sharia'a* almost uniformly is more restrictive.

³ Same surveys as in note one.

⁴ The United Bank of Kuwait, PLC secured the following interpretations to engage in Islamic transactions as banking transactions. Interpretive Letter of October 17, 1997 No. 806 from the Northeastern District of the Comptroller of the Currency Administrator of National Banks governs *ijara* and Interpretive Letter of June 1, 1999 No. 867 governs *murabaha*. Both letters respectively are posted at the Comptroller's website <http://www.occ.treas.gov/interp/dec97/intdec97.htm> and <http://www.occ.treas.gov/interp/nov99/int867.pdf>.

municipal) regulators, vendors and investors, including banks and agencies, all to find it reasonable to examine engagement in the newly emergent product class.

US Legal Concerns: The conventional business of mortgage lending is highly efficient and regulated in the US. Part and parcel of the formality in mortgage lending is a very strong culture of disclosure and consumer protection codified by the Congress and the various states, and enforced by various Federal and state departments as well as law enforcement. Thus, layered over the real estate process is a specific flow of paper and documentation that is designed to present to consumers the cost of lending, the terms of lending, and the overall timeliness of communication as well as quality.

Islamic Concerns: Likewise Islamic jurists and scholars place a similar premium on disclosure and consumer protection. Several leading jurists were involved in different aspects of the development of the Committee for Islamic Home Finance contract, sponsored by the Samad Group, Inc. and applied by UBK in the US and UK. All were in agreement with the style and philosophy of US consumer disclosures and protections. In cases where the Islamic jurists objected to the words, which were required by law, the jurists were amenable to advising consumers of the purpose of the law and avoiding a controversy over matters that are non-contractual.

Islamic scholars, however, have a number of issues, which are significant to them when determining whether or not a contract complies with the rules of *Sharia'a*:

- ❑ **Single contract – no hybridization:** The majority of schools of Islamic jurisprudence do not allow the combining of more than one contract into a single contract. For instance, a contract of sale and lease may not be combined into a single contract. In the United States it is possible to combine contracts.
- ❑ **A Promise is not equal to a Contract:** Although most courts in the US will find a promise to be a contract, the Islamic scholars distinguish between the two. The result is that an Islamic financial relationship may be entered into in the US with a greater legal bond than if it were entered into in a purely Islamic environment.
- ❑ **Form and Asset Orientation:** Although the Islamic scholars are very concerned with the substance of a contract, their initial point of evaluation is the form. This has, in part, to do with the categorization of commercial contracts in Islamic legal analysis. The convergence between form and substance is that a for profit financial transaction must involve an asset, not money.
 - Hence, an installment contract to sell cars is permissible, but one to sell money is not. Both have similar substance to a loan, but different forms. But, for the *Sharia'a* the distinguishing substantial matter is the existence and sale of a non-monetary asset.
- ❑ **Property Taxes and Assessments:** Islamic rules require that the owner of property pay property taxes. In the case of leased property, the cost to the owner may be recovered in the rent, even as a form of supplemental or additional rent. In a US consumer transaction, the borrower or lease-to-own tenant is normally responsible for paying taxes. There is no regulatory barrier

- to structuring payments as mandated by the *Sharia'a*. Custom, however, has strongly influenced many business styles of US Islamic organizations.
- **Casualty Insurance:** As with taxes and assessments, Islamic rules require that the owner of property pay the cost of casualty insurance. Flood, hazard and liability insurance have the same treatment in Islamic law and US custom. On the face of it, such insurance, in the absence of *takaful*⁵ is contrary to *Sharia'a*. But, neither securitization, nor investment will occur without some form of protection of the property from various hazards, natural or man-made. The Islamic scholars have permitted conventional insurance in this circumstance on the basis of *darura* or necessity.
 - **Escrow Accounts:** It is custom in the US to take supplemental or advance payments of taxes and insurance and place them in a segregated account. With scholarly forbearance, this custom has been tolerated for a number of Islamic home financiers.
 - **Statutory Interest:** In a number of states both escrow accounts as well as certain pre-paid expenses must accrue interest. Typically, it accrues at a very low rate. The ruling of the Islamic jurists is that the Islamic consumer must donate this to charity with no personal benefit. Therefore, the consumer is may not count the donation as either *zakat* or *sadaqat*⁶.
 - **Private Mortgage Insurance:** Payment for guaranties of payment is unacceptable to *Sharia'a* scholars. Hence private mortgage insurance as is frequently imposed upon higher risk or small down payment borrowers is not acceptable. But, the establishment of reserves or the determination of a non-Muslim investor to insure itself are different matters.
 - **Real Property Sales Contracts:** The nature of many Islamic contracts means that instead of a consumer to consumer sales contract subject to financing, there is a consumer/seller to financier/investor sales contract. This is non-standard.
 - **Notes:** A standard real estate loan note is assignable allowing a transfer of the right to receive payment. In the *Sharia'a*, the buying or selling of rights to payment are not normally permitted as akin to the buying and selling of debts. Hence, the creation of notes that represent participation in the ownership of property and with it the right to a payment of rent is permissible as *suk al ijara*⁷. Such activity is not yet well developed in the US and there is evolving awareness of and attention to this issue among Islamic jurists working on US financial issues.
 - **Mortgages:** There is no objection in the *Sharia'a* to the granting of a mortgage or deed of trust to secure a creditor or investor in their rights. Clearly, the language of such documents must flow with the underlying *Sharia'a* compliant agreements and procedures.

⁵ Mutual insurance structured to comply with *Sharia'a*.

⁶ *Zakat*, literally 'the purifying dues', is the mandatory wealth tax that Muslims pay, equivalent to 2.5% of assets above a minimum threshold. *Sadaqat*, literally 'the righteous dues', is a voluntary contribution to charity.

⁷ Literally 'lease paper' or lease participation certificate. The Arabic word *suk* is the root word of the English word 'check'.

- **Late Payments:** The concept of penalty interest is forbidden in the *Sharia'a* as identical to the forbidden *riba*⁸. But, the scholars have permitted that lenders and lessors may charge a flat fee commensurate with their costs of collection. There may not be any compounding of the fee: it is assessable one time per instance of tardiness.
- **Rent:** The payment of money for the use of real or personal property is permissible. The rate or basis for the rent should be freely negotiated in a manner that is transparent to both lessor and lessee.

By God's grace, these and many other considerations have been addressed by a number of organizations, and tens of Muslim Americans now enjoy an Islamically permissible contract whereby they occupy or acquire their homes.

Successful Experiments: If the best conclusions are drawn from a number of experiments, then the numbers of Muslims benefiting from Islamic home acquisition programs will increase exponentially to the tens, if not hundreds of thousands.

- **Al Manzil:** From May 1998, UBK's New York Branch offered an *ijara wa iqtina* product in the US and UK. The US program was focused on California with some activity in other states. The program was built on UBK's path-finding first regulatory approval for an Islamic concept to be used as a banking product. UBK's most significant achievement was the presentation of the Islamic contract and concepts to a wide array of real estate service vendors and convince them that the Islamic concepts fit into the conventional real estate sales process. As a result, most US title insurance and casualty insurance underwriters have at least a rudimentary understanding of Islamic contracts and willingness to underwrite the relevant risks.
- **CAIR Minnesota:** In 2000, the Council on American Islamic Relations (CAIR) through its branch office in Minneapolis highlighted the plight of Somali refugees in that city to the County of Hennepin, the local branches of Fannie Mae and the Department of Housing and Urban Development (HUD). The local Somali refugees were rapidly integrating into the economy, losing their qualification for subsidized housing. But, their family sizes meant that they could not find suitable non-subsidized rental housing; and, the community was not willing to pay interest to buy houses in a subsidized lending program. CAIR worked with HUD, Fannie Mae, the State and County to structure an installment sales project whereby the county sold tax foreclosed houses to Somalis and others. The contract was reviewed and approved by eminent scholars of Islam residing in the US and Qatar. The benefit of this project has been to bring *Sharia'a* concepts and the needs of Muslim Americans in a positive light to the attention of the highest level of the American mortgage industry and its regulators.
- **LaRiba:** American Finance House long ran a localized Islamic finance boutique. Like UBK, LaRiba has used a form of *ijara wa iqtina*. In February 2001, LaRiba successfully sold a small portfolio to Freddie Mac via its cash window. This fits into a project at Freddie Mac to expand homeownership

⁸ *Riba* is the forbidden profit mentioned in the Holy *Quran* that is most like interest in a conventional loan of money.

where it is lowest⁹. The meaning for the Islamic community is that there is now a buyer or buyers for Islamic instruments that are underwritten to 'conforming' standards. This development should prove a significant impetus to open the market.

Methods & Structures: Four processes have been utilized to assist Muslim Americans to acquire their homes in a manner consistent to with *Sharia'a*. Only two have been applied in a manner to achieve significant scale. Each has a merit or attraction to sub-segments of the Islamic community. Only a few have clear adaptability to the real estate sales process as linked to the banking and securities markets.

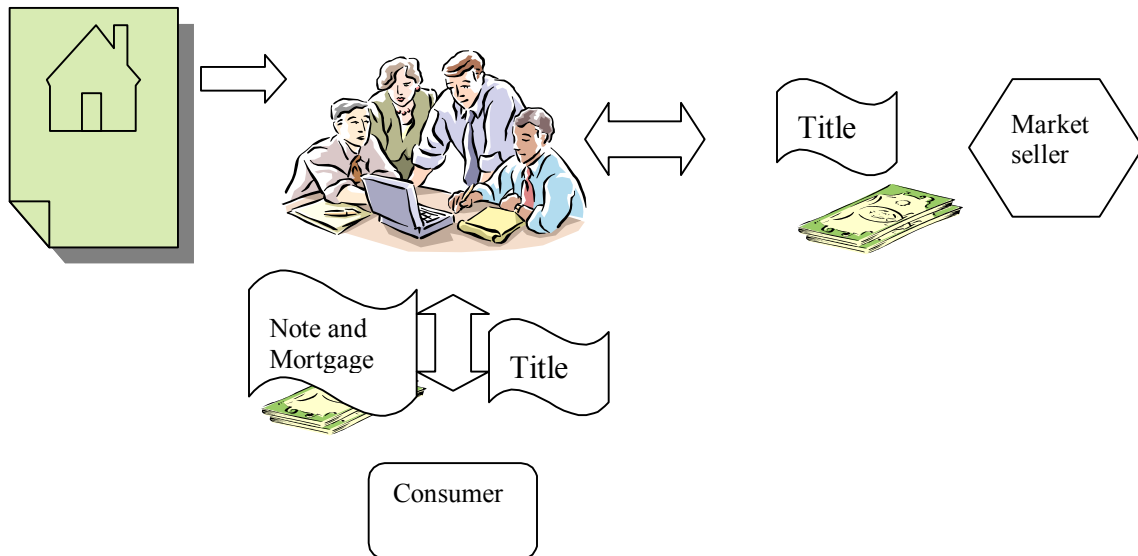
***Murabaha*:** Literally, this means a profitable sale and is also called *bai bi thamin al ajil* meaning deferred payment sale. This is essentially an installment sales contract for real property. Of all Islamic approaches to the question of leveraged home acquisition or investor funded home acquisition, this is the method, which is most consistent with the standard real estate processes. For security purposes, there is no objection to issue a non-negotiable note and mortgage.

The general concept is permitted for use by bank's with title transferred from seller to bank to consumer at the initial closing or a later date as agreed (insert diagram).

A strength is that the consumer may deduct the payments over the base cost of the property as interest for tax purposes. A significant weakness is that the practice has a poor perception among many Muslims relating either to abuses overseas of the term, or an inability to distinguish from a conventional loan of money secured by a note and a mortgage. Perhaps more significantly, the consensus of the Islamic scholars is that debts should not be traded or sold at discounts or premia. This latter point would make a structured securitization of the Islamic notes issued under a *murabaha* program non-permissible according to *Sharia'a* as opposed to US codes which would permit it. In this process, the investor profits from a mutually agreed mark-up over its basis, and the consumer pays installments on a fixed schedule.

⁹ Muslims according to various surveys have a homeownership level of less than 60% compared to the US average of 69%.

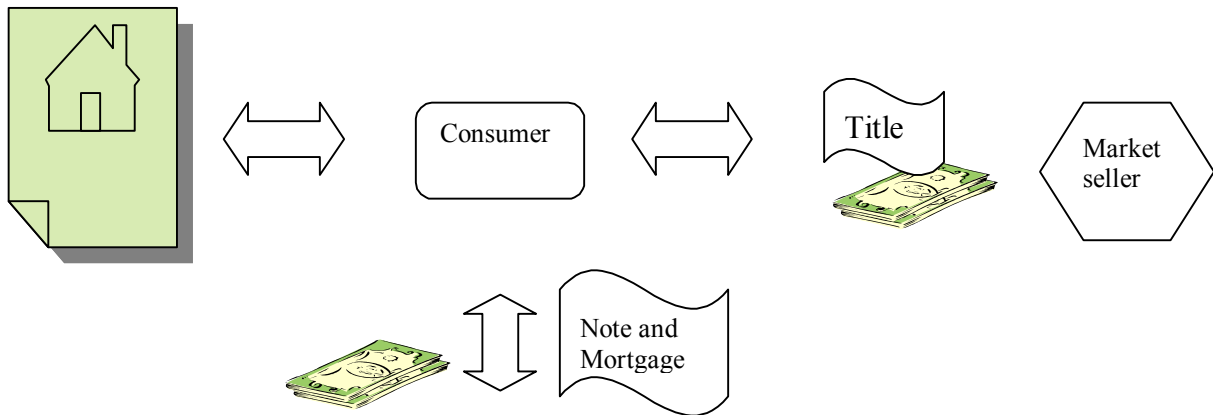
Diagram 1: Murabaha Transaction Flow:



1. Consumer selects house and applies to financier.
2. Financier approves consumer and house.
3. Financier pays seller and obtains title.
4. Financier sells on deferred basis to consumer:
 - a. Financier transfers title.
 - b. Consumer makes monthly payments and
 - c. Grants mortgage and signs note.

Agency Sale: Termed in Arabic as *bai al wakala* this concept has been applied in the UK, but not the US. Ideally, it should proceed in a manner identical to the general concept of *murabaha*, except that either the consumer or the investor never comes into the chain of title as one acts as an agent for the other.

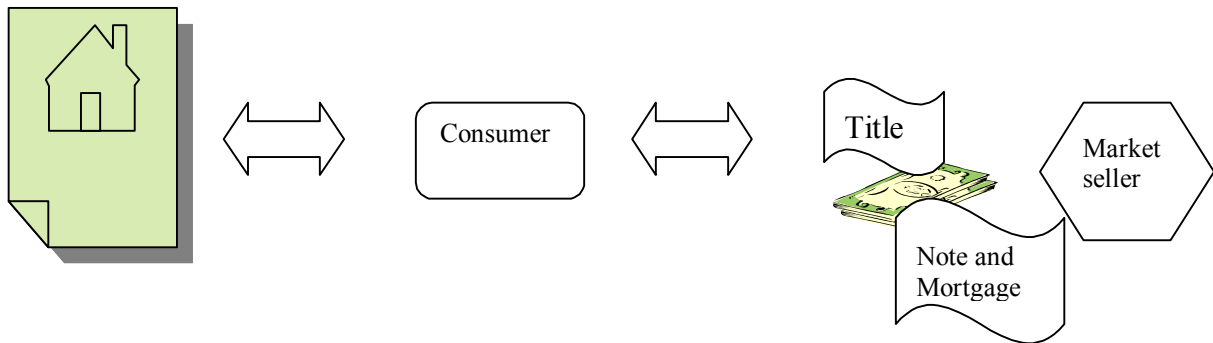
Murabaha Agency Transaction Flow:



1. Consumer selects house and applies to financier.
2. Financier approves consumer and house.
3. Financier pays consumer to act as financier's agent.
4. Consumer pays seller and obtains title.

Land Contract: This is in essence the CAIR Minnesota program. A local law land contract in the US provides for the owner to sell property directly to the consumer and act, effectively, as the financier by extending the consumer terms. The normal implementation of this concept is informal. Although the OCC has permitted banks to become holders of title and sellers of property for the purpose of engaging in a land contract [National Bank of Michigan citation], the process is too cumbersome and the direct risk of liability to make this a desirable mass market program to be offered by a bank or funded by the government sponsored entities.

Land Contract Flow:



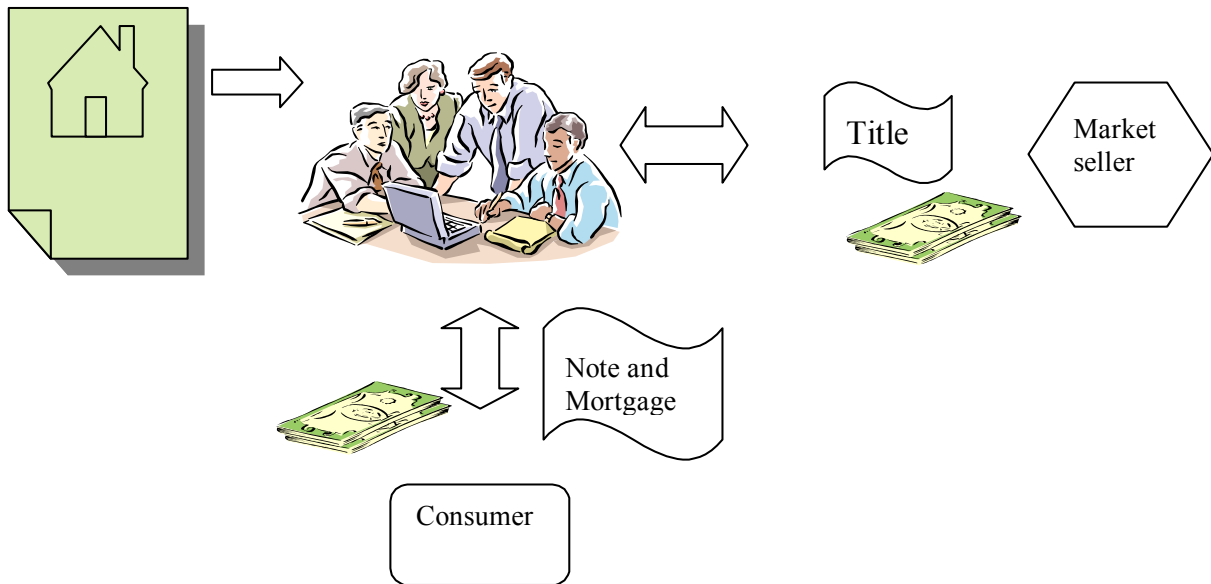
1. Consumer negotiates directly with seller for house.
2. Consumer pays seller a down payment and obtains title.
3. Seller agrees to deferred terms for sale to consumer:
 - a. Consumer obtains title.
 - b. Consumer makes monthly payments and
 - c. Grants mortgage and signs note.

In all forms of *murabaha*, it is customary for the consumer to make some form of down payment.

Ijara wa iqtina: The words mean 'leasing and acquisition' and it is variably called *ijara muntahi bitamlik*, 'leasing ending in ownership' or lease to own. The United Bank of Kuwait and LaRiba as well as others have applied this concept. It has a history of informal application as well as program application dating to the 1920's.

In this transaction, the consumer selects a property and the investor buys it. The investor engages in an operating lease of real property with the consumer. The investor promises to sell and the consumer promises to buy the property. The consumer pays rent, as well as contributing to a savings fund, which is structured to accrete to a level allowing the consumer to buyout the estate from the investor. The savings fund may be initiated with a large initial payment similar to a conventional down payment. The concept also allows for the issuance of a note or mortgage as a form of security to the investor.

Ijara wa Iqtina Transaction Flow:



1. Consumer selects house and applies to financier.
2. Financier approves consumer and house.
3. Financier buys house and obtains title.
4. Financier leases house to consumer for monthly rent.
5. Consumer promises to buy house and financier promises to sell house.
6. Consumer contributes to account to buy out the lease.
 - a. Consumer may grant mortgage against consumers leasehold estate.

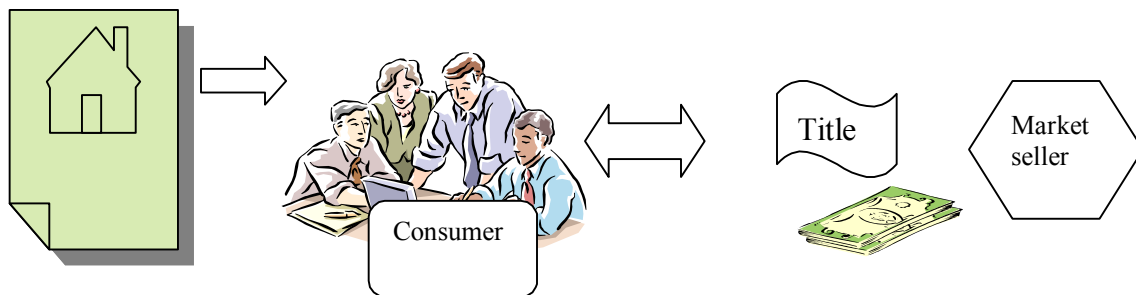
The concept requires a modest modification to the real estate process to allow the investor or bank to take the place of the consumer in the purchase contract. The strengths of this approach is that the *Sharia'a* scholars are comfortable with the securitization of leased assets and a variety of investors, including one US government sponsored entity are willing to buy such assets. In the case of securitization, the note representing an interest in the property is the primary tool and it may be secured by a mortgage or deed of trust.

A weaknesses is that tax deductibility is likely, but not explicit. Another issue which is not tested in this emerging area is to what degree to landlord – tenant issues like rent control or eviction rights which may be fixed by state and local laws may apply to this transaction as a lease distinct from a means to acquire a home. To now these issues have been viewed as subordinate to the interpretation of this process as a financing. Generally, the applications and opportunities for this concept appear to be very board given the regulatory approvals and growing application of the process. In this process, the investor

profits from the consumer's rental payments for use of the property, and the consumer makes monthly payments on account to buy out investor's estate according to a pre-agreed schedule.

Declining Balance Partnership/Shared Equity: This concept may variably structured as a *mudaraba* – limited partnership - or *musharaka* – joint venture – according to *Sharia'a* concept and terminology. A number of businesses and cooperatives have applied the basic concept in the US. In essence a corporate entity or partnership buys a property and the consumer rents it from the entity in which he or she is a partner. The portion of the consumer's payments that is tantamount to mortgage amortization is used to increase the consumer's share in the owning entity until such as time as the consumer has bought out the investor. To now, such projects have had trouble fitting in the real estate process, particularly among the title insurance¹⁰ companies. The heretofore process issues may reflect presentation and organization, and may in fact be overcome. Although many consumers feel that this is the most Islamically pure method, the track record for these types of non-standard transactions to fit into the real estate process has been poor given the volunteer, not professional character of some investors. Moreover, the US and UK banking regulators have been loath to consider such transactions as permissible for banks, and the US government sponsored entities are also not permitted to directly own property. In this process, the investor profits from the consumer's rental payments, and the consumer buys out the investor according to a pre-agreed schedule.

Diagram 5: Declining Balance Equity Transaction Flow:



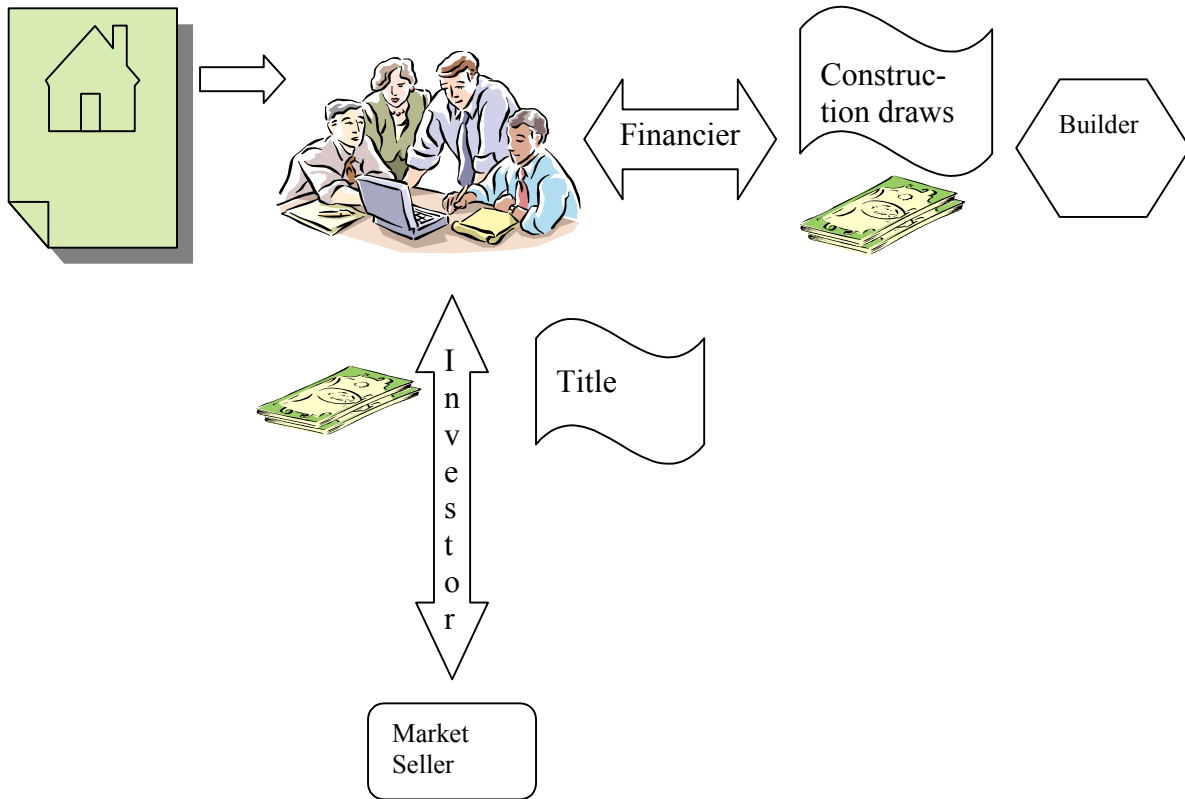
1. Consumer selects house and applies to financier.
2. Financier approves consumer and house.
3. Financier and consumer jointly buy house and obtain title in common tenancy.
4. Consumer leases house from common tenancy for monthly rent.
 - a. Consumer's portion of rent buys out financier
5. Upon buy out, title is solely in consumer's name.

¹⁰ Title insurance is a third party guaranty of clean title and transmission thereof to the buyer of a property.

There is an alternative vision of the declining balance equity model in which the consumer pays his partner for the sole right of disposition, and pays taxes and insurance in exchange for exclusive occupancy. In this version, the payments are implicit rent, but there is no lease and no rent. Rather there is a partition of rights and payments are made by the party acquiring specific rights during the life of the partnership.

Istisna'a: This term means 'manufacturing' and is applied for construction finance. Although Key Bank has secured a regulatory approval for this concept and is believed to have applied it to commercial property, it has not formally been used for funding the construction of primary residences. In this process, the consumer asks the bank to fund construction of a house. The bank engages either a builder or the consumer to build with the bank's funds the desired structure on property that the bank has purchased. Upon completion of the development, there may be an outright cash sale, a *murabaha* sale, an *ijara wa iqtina* process or a declining balance partnership. There is no reason to believe that this would fit into the real estate process any differently than with *ijara wa iqtina*. In this transaction, the consumer pays a premium to the bank's basis in the property.

Diagram 6: *Istisna'* Transaction Flow:



1. Consumer selects site and contractors, then applies to financier.
2. Financier approves consumer credit, contractors, plans and permits.
3. Financier buys site and engages contractors, then funds construction draws.

Securitization: The securitization process provides liquidity to an industry or company allowing it to expand its business. The success of the American home finance industry in expanding homeownership to 69% of the population is built upon securitization. This is the process of turning an obligation or an asset into an instrument with transferable ownership between investors. In a standard mortgage, the note, representing the obligation to pay principal and interest, is the securitized document. The mortgage securitization business has been buttressed by the involvement of the two government sponsored entities Fannie Mae and Freddie Mac.

In an Islamically permissible securitization, the ownership of an asset is effectively what is cut into pieces and distributed in a manner similar to shares in a mutual fund. This is distinct from an Islamically non-permissible securitization of a cash flows whereby investors might by shares of interest, principal, both or margin as compared to base interest. In the recent developments with Freddie Mac, an *ijara wa iqtina* process has been securitized. In this case, the obligations of the lessee have been structured into a note by the holder and sold to Freddie Mac and the holder of the property has granted a mortgage to secure the note. If in the Islamic perspective, the note represents an aspect of property ownership, then the relationship is permissible.

Prospective Developments: Perhaps the greatest issues for the Islamic mortgage alternative process are double transfer taxation and income tax deductibility. Although these are not apparently issues with the installment contracts, they are significant in the lease based methods as well as the declining balance partnerships.

In the *ijara* or leasing programs, were a consumer to lease the property to the lease term, the consumer would be obliged to pay a second transfer tax for title to move from the lessor. It is a second tax as the consumer would have reimbursed the lessor for the costs of the initial transfer tax when the property was acquired. Such taxes are local and no uniform or legislative approach exists reduce this prospective burden.

To date, many of the lease to own programs have documented the mortgage interest deduction and the consumers have taken it without challenge from the tax authorities. Nonetheless no ruling exists to make this decision secure.

Whether or not these problems are solved, it is already clear that new players intend to enter the US market for Islamic home finance. Their participation is expected to be invigorating to the market, bringing liquidity, ideas and coverage to the market.

With new players and a growing market, we may expect new instruments. Perhaps these will be derived from existing instruments marking refinements and improvements. Or, they will represent original thinking along the same concept lines. Or, maybe concepts not yet well developed elsewhere will find an expression in the home acquisition finance market for Muslims in America.

Conclusions: In the mid 1980's a small number of Muslims dreamt of implementing the means for Muslims to live free from *riba*. Over the next 15 years, experiments were performed and regulatory work completed. Now, the first securitizations of Islamic home finance instruments presents a wonderful opportunity to expand the market rapidly. The result is a new infrastructure to support multiple solutions in the real estate market for the disparate tastes and interpretations of the Muslim market. As multiple investors contemplate entering the market, the young, growing and affluent population of Muslim Americans shall find it much easier in coming years to live in conformity with their religious values.

* Currently, Mr. Thomas is a member of the management committee of Guidance Financial Group, LLC in McLean, Virginia. He was previously CEO of the United Bank of Kuwait's Islamic Investment Banking Unit in London and General Manager of that bank's New York Branch. In both capacities, he was involved with regulators to approve the banking application of Islamic instruments as well as the introduction of Islamic home finance as a banking program in the US and UK. He has published *The American Journal of Islamic Finance* since 1989. Activities have included founding the Committee for the Islamic Home Finance. He has 20 years of diversified financial services experience in the US, UK and Bahrain.