

## The Islamic Mortgage: Paradigm Shift or Trojan Horse?

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All praise is due to Allah and may His peace and blessings be upon our Prophet Muhammad, his family and all his Companions.

During recent years there has been an unprecedented expansion in the range of commercial banking products labelled as “Shari’ah compliant” in many countries of the world. Popular interest among Muslims in the Shari’ah of financial transactions has increased likewise, and in the United Kingdom the permissibility of so-called “Islamic mortgages” is among the most frequent topics of enquiry. We therefore thought it appropriate to record here what we see as the main problems associated with this product class from the perspective of Shari’ah, knowing that many of our criticisms can be equally well applied to other types of product that are currently available from the Islamic banking sector. Scholars who have approved the main forms of Islamic mortgage will no doubt disagree with some elements of our criticism. We mean them no harm, and remind the reader that Allah has decreed the existence of differences among people, including Muslims, as one of the tests by which Paradise may be attained.

Although we conduct a purely contractual examination of the issues, it is important not to forget the socio-political context of the discussion. Muslims in the West are attempting to implement certain elements of Shari’ah within an environment that is frequently inhospitable, and the formulation of an appropriate strategy is therefore rather complex. The question is not limited to whether particular financial products are contractually valid. Wider concerns are also in play. For example, is it permissible to establish an Islamic bank that initially has some dealings with interest if the intention is eventually to become interest-free? Should we be content with a structure in which an essentially un-Islamic industry accommodates some Islamic products? Or should banking as an industry be avoided until a completely interest-free opportunity presents itself? If so, how will Muslims satisfy their banking needs in the meantime? Perhaps most fundamental of all, is the Western model of Islamic banking and finance something that can be ‘Islamised’ in the first place?

When approaching this subject some scholars of Islam may give greater weight to the surrounding context than they do to narrow contractual issues, particularly in Western countries where the institutional and legal framework is rooted in practices that are often prohibited in Islamic law. It is surely unreasonable to expect a wholly Islamic banking paradigm to suddenly sprout from un-Islamic foundations, and some sort of transitional phase is therefore to be expected when developing Islamic alternatives. Moreover, in many countries of the world, Islamic and non-Islamic, the Muslim community is not in a position to effect the wide ranging institutional changes that would be required if a genuine Islamic financing paradigm is to emerge.

Whatever approach is taken to dealing with the problems that face us, we feel that one key rule to be obeyed is that Islamic principles and teachings should not be twisted to fit preconceived solutions. The basic Islamic prescription for success in these matters is, as always, to deal with the causes of a problem and not its symptoms. If we are asked to

provide an Islamic solution to the economic problems caused by interest, without eliminating interest, then we say that Islam does not have that solution. To those who argue that “partly Islamic” financial products are an acceptable stepping stone towards an ideal solution, we respond that such products may already be part of the problem. Many of today’s Islamic financial products are neither presented nor perceived among the Muslim population as temporary solutions dictated by force of circumstance. Because of this, the drive towards improvement in the Islamic finance industry is being diminished. If existing products are already “Islamic”, why develop new ones?

Now referred to as "home purchase plans" by the UK Treasury and Financial Services Authority, Islamic home financing products usually adopt one of three basic forms of Islamic contract. These are murabahah, `ijara wa iqtina (sometimes referred to as ijara muntahia bitamleek) and musharakah mutanaqissa.

Murabahah is a sale of an item to a buyer at a disclosed profit margin over cost. In order to implement a murabahah mortgage, a bank will buy from the vendor the property that is desired by its home-buying client for the agreed price, and immediately sell it to the client at an agreed profit margin over cost. The home-buyer will pay the price of the property in installments over several years, and mortgage the property to the bank in order to secure the installments that are due. Banks that offer this form of finance usually borrow (at interest on the money market) the amount of money that they use to purchase the property in the first leg of the murabahah transaction. The installments paid by the client are therefore set at a level that is sufficient to repay the money borrowed by the bank from the money market, and provide the bank with a profit on the deal. The installments paid by the client must be fixed in total (since a contract in which the price is not specified is invalid under Shari’ah) hence a bank often uses the interest rate swap market in order to fix its interest costs. By fixing its own borrowing costs, the bank can fix its client's installment payments. Rises or falls in interest rates during the term of the murabahah will not then have an effect upon the cash-flows of either the bank or its client.

`Ijara is a rental of an item by its owner to a client, and `ijara wa iqtina is a rental of an item followed by its sale to the client. In the case of home financing using `ijara wa iqtina, the bank will buy from the vendor the property desired by the home-buying client at an agreed price, rent it to the client for a period of years, and then sell it to the client at the end of the period at a price agreed between them at the outset of the contract. The client's monthly payments to the bank will comprise two main payments. One is rent, the other an amount that is held by the bank as an assurance that the client will be able to pay for the purchase of the property when required to do so at the end of the rental period. The “assurance money” is loaned out at interest by the bank to the money market, producing a financial benefit for the bank. The client's monthly payment under an `ijara corresponds approximately to the payments under an amortising interest-based loan in which capital and interest are repaid in changing proportions over the term of the loan. This similarity allows a bank to easily adapt its interest-based lending processes to the requirements of an `ijara mortgage.

Musharakah mutanaqissa is a diminishing partnership between a financier and a homebuyer. There are several ways in which this partnership can operate. In the case of the Al- Buraq scheme in the United Kingdom, the bank purchases the property desired by the home-buying client using its own funds plus a deposit provided by the client. Although the property is registered in the name of Al-Buraq at the Land Registry, the diminishing partnership contract splits the so called "beneficial interest" in the property between the bank and the client so as to reflect the relative size of their contributions to the purchase price. The client now lives in the property as a tenant and pays rent to the bank. The amount of the rent is adjusted to reflect the fact that the client owns part of the beneficial interest in the property. In addition to the rental payment, over time the client buys the bank's beneficial interest in the property and eventually becomes the owner of all of that interest. At this stage, the client's total rental payment is zero and the final formal step is taken of transferring ownership into the name of the client at the Land Registry. It should be noted that in some other diminishing partnership contracts, the property is held by the financier in trust for itself and the client. Of itself, this modification need not affect the cash-flows described above.

Ahli United Bank in London offers products that are described as murabahah and `ijara. United National Bank, HSBC, and Al-Buraq offer what they call a diminishing partnership contract. The Al-Buraq contract has been adopted by Bristol and West, Lloyds TSB and Islamic Bank of Britain. Until recently, HSBC offered an Islamic home financing contract in accordance with `ijara wa iqtina principles, but this has now been replaced by its diminishing partnership product.

The Islamic principles of financial transactions are found within a part of Islamic law called Mu'amalat. As a rule, Mu'amalat states what is prohibited, not what is permitted. If a contract can be shown to contain a prohibited feature, it is deemed void or partly invalid under Islamic law. The onus is on the one who prohibits to prove his case, not on the one who permits. Hence, it is not for the bank to show that its mortgage product is halal (permissible). Rather, it is for detractors to show that the product contains a prohibited feature such as riba (usury, of which the charging of interest is one form) or gharar (deception or uncertainty in contractual terms). It is worth pointing out that the fashion of issuing religious judgements to approve financial products as halal goes against this basic legal approach. However, it seems that the spread of riba and unlawful features within most contemporary financial transactions has encouraged Shari'ah scholars to issue such judgments to signify conformity rather than non-conformity.

Islam defines riba in such a way as to prohibit any benefit received by a lender for the giving of a loan, no matter how big or small the benefit. (Riba can also occur in certain other forms of trading transaction that we do not deal with here.) The main point for our purpose is that modern interest falls under the scope of the riba prohibition. In contrast, a transaction in which goods are exchanged for money cannot contain riba. This is called trading. It is however possible that such an exchange will be invalid on other grounds, such as coercion or misrepresentation. Muslim merchants are therefore allowed to make a profit by selling goods for more than they purchased them, but they are not allowed to make a profit by lending money. This is the way in which we may understand the Qur'anic injunction that:

"... Allah has permitted trading and forbidden riba ..."  
from ayat 275, Surah al-Baqarah

Islamic law also prohibits hila (legal trickery) that can produce a usurious loan from otherwise permissible contracts. For example, a usury-free loan, a promise and a gift are each permissible in Islam. However, if Person A gives Person B a usury-free loan of £100 on condition that Person B promises to give Person A a gift of £10 upon repayment of that loan, then this is clearly a usurious loan when looked at as a whole. It is therefore prohibited by all schools of Islamic thought that we are aware of. In other words, combinations of Islamically acceptable contracts cannot be used to defeat the usury prohibition. In *E`lam al-Muwaqi`in*, ibn Qayyim al-Jawziyyah comments: "What matters in contracts is substance, not words and structure."

Speaking of such contracts in a more general sense, the late Arab scholar ibn Uthaymeen described modern day Islamic banking as the "usury of deception". This he viewed as more serious a sin than usury on its own, for the former entails deception as well as usury, while the latter does not attempt to present itself as anything other than what it is. Similarly, at a conference in Dubai during March 2004, Justice M. Taqi Usmani is reported to have said that: "What we are developing now is not *fiqh-ul-mu`amalat* (the jurisprudence of financial transactions), but rather *fiqh-ul-hiyal* (the jurisprudence of legal tricks)".

Contract combination has become very common in modern Islamic banking. For example, in the *murabahah* model, Person A (the bank) might buy a property for £100,000 from Person B (the seller of the property) and immediately sell it on to Person C (the home buying client) at a price of £150,000 to be paid in equal installments over 15 years. Person C must begin the process by promising in writing that if Person A buys the property from Person B, then Person C will immediately buy the property from Person A. The few Shari`ah scholars who approve this transaction say that it is trading (buying and selling of properties), not borrowing and lending money at interest, and that it is therefore *halal*. But viewed from the bank's perspective, as soon as the bank transfers £100,000 to Person B, the agreement with Person C automatically comes into effect requiring Person C to repay £150,000 to the bank at a later date. The transaction is referred to as "murabahah to the purchase orderer" in the Islamic banking literature.

The contractual documentation used in a *murabahah* to the purchase orderer transaction usually includes an offer letter which states that the bank does not agree to execute any one leg of the transaction unless all legs have been agreed among the relevant parties. In this way the bank avoids the situation in which it owns the property for any meaningful period of time, and from the bank's perspective the transaction is merely one of "money now for more money later". In effect, the property is used as a means of lending money at interest. The possibility that contracts of sale could be used in such a way was well recognised by ibn `Abbas. When asked about a piece of silk that was sold for a deferred price of 100 and re-purchased for a payment of 50 in cash, Ibn `Abbas commented: "dirhams for dirhams, with a piece of silk in between".

The use of an offer letter may maintain the appearance that the transactions (property purchase followed by property sale) are independent and therefore not similar in analogy to the combination of contracts described above as hila. However, we are not convinced by this structuring of documents, since the legal effect is identical to the inclusion of all legs of the transaction in a single contract. For example, a United Bank of Kuwait murabahah mortgage offer letter in 1998 states that: "We [UBK] will not buy the Property from the Vendor or sell it to you [the Client] until all the matters set out in the Schedule of Offer Conditions have been completed to our satisfaction".

We feel that if the obligations of the parties to a given financial product are to be spread among more than contract, then it is obligatory for jurists to look at the scheme as a whole rather than at its separate components before forming an opinion on its permissibility.

Turning our attention to the method by which rental levels are set in `ijara and diminishing musharakah mortgages, we note that in many such contracts rent is linked to the London Inter-bank Offered Rate (LIBOR). This rate is determined on a daily basis for specified periods going forward. For example, the six month Sterling LIBOR rate for 11 August 2006 was 5.07688%. This means that a person borrowing £100 for the six month period starting two days after 11 August will pay an annualised interest rate of 5.07688% for the period (approximately £2.54 for the contract in question). Given that we cannot know what LIBOR will be for any period starting tomorrow or on subsequent days, clients whose rental payments depend upon that interest rate are in a position of ignorance as to what their future rental payments will be. With regard to the rental payments, the Al-Buraq contract states that: "Before the start of each Rent Period, we will send you an Adjustment Notice notifying you of the adjusted Rent and Acquisition Payments which will be payable on each of the Payment Dates in that Rent Period. The rent payable on each of those Payment Dates will be found by applying the formula  $P\% \times AC/12$  where  $P\%$  = the percentage found by adding LIBOR to the Margin ..." [the Margin being an amount added to LIBOR in order to provide Al-Buraq with a profit]. Clause 6, Al-Buraq Lease Agreement, 2006

Scholars have argued that setting rental levels in line with market interest rates is not in itself haram. They argue this by analogy, on the basis that it is permitted for a Muslim shopkeeper to make the same percentage profit selling lemonade as the non-Muslim shopkeeper makes selling alcohol. However, we identify a rather different and serious problem arising in the link to LIBOR, namely one of gharar. This is because the client does not know what rental amount he must pay to the bank until the beginning of each new period, remembering that the client is contractually bound to rent the property for the subsequent period. If interest rates increase dramatically, then the rental payments will likewise increase and the client may find himself locked into the payment of rentals that he cannot afford. This is one basic reason that traditional scholars in Islam have made the specification of price a basic requirement of any sale contract. One cannot agree to buy or rent something without knowing the price one must pay. Wahba al-Zuhayli summarises: "... general conditions specify that the sale must not include any of the following six shortcomings: uncertainty or ignorance (al-jahala), coercion, time-restriction, uncertain specification (gharar al-wasf), harm (al-darar), and corrupting conditions (al-shurut

almufside)" Dr. Wahba al-Zuhayli, Islamic Jurisprudence and Its Proofs, Dar al-Fikr (2003), p. 33

"A sale without naming the price is defective and invalid"

Dr. Wahba al-Zuhayli, Islamic Jurisprudence and Its Proofs, Dar al-Fikr (2003), p. 56

If the home-buying client later decides that he can no longer afford the rental, both the HSBC and Ahli United `ijara contracts require that he or she must guarantee to repay the cash sum initially provided by the bank to fund the purchase of the property. In those cases where the property has to be sold to achieve this, the possibility arises that, if property prices have fallen in the meantime, the sale proceeds may not be sufficient to repay the financed amount. In this case, by requiring the client to make up any shortfall to the bank, the possibility of "negative equity" arises, a position in which the client owes more to the bank than the property is worth.

Clause 6.3 (d) of the United Bank of Kuwait `ijara agreement from 1998 provides an example of the way in which banks seek to protect themselves from capital loss. Here, the bank is allowed to sell the client's property in the event of default and to subtract such amounts as are necessary from both the proceeds of sale and the on-account payments made by the client in order to protect the bank from a loss on its investment.

From the Shari'ah perspective, it is clear that a client can only be renting a property if he doesn't own it. Yet if the legal reality is one of rental, a question arises as to why the client must bear the risk of a fall in the property's price. Those who rent cars from hire companies are not expected to compensate the hire company for a fall in the value of the car during the period of the hire. On the other hand, if the client is bearing the risk of a fall in property value precisely because he owns the property, then it must be asked why the client is expected to pay rental to the bank.

In answer to this question some Shari'ah scholars have argued that, in a modern `ijara agreement, the bank only buys the property and rents it to the client because the client has expressed a need for the property. It would be unfair, they argue, for the bank to suffer a loss if the client does not proceed to purchase the property at the price agreed at the outset of the `ijara.

Once again, we are not convinced by this argument. The essence of an `ijara contract is to free the tenant from bearing responsibility for loss or damage to the property (unless it results from the tenant's misuse of the property). A compensation for loss of capital value is a condition that defeats the purpose of an `ijara contract and this kind of condition is not permitted in Mu'amalat. Another example would be to sell a watch to a buyer on condition that the buyer must give the watch back to the seller after one month without compensation. Such a condition defeats the purpose of sale, which is that ownership passes permanently to the buyer in return for payment of the price to the seller. If such conditions are to be permitted on the grounds of intention, what is to stop Partner A in a partnership from asking Partner B to guarantee him against capital loss, on the basis that Partner A entered into the partnership merely as a favour to Partner B? Such an argument would be seen as invalid under Shari'ah because it defeats the purpose of partnership, yet

it is almost identical to the argument used by those scholars who defend the rights of the bank in the aforementioned `ijara agreement.

Furthermore, an `ijara mortgage typically requires that the client purchases the property from the bank at the end of the `ijara term as a means of protecting the bank's original capital contribution. This transaction, involving a deferred delivery of both counter values (property and price), has been prohibited by the four main schools of thought: "Delay from both sides is not permitted by consensus either in corporeal property or in liabilities as it amounts to a proscribed exchange of a debt for a debt." Ibn Rushd, *Bidayat al-Mujtahid* (English translation), Garnet (1996), p. 154

The final issue that we wish to address here is the purchase of shares by a home-buying client under the diminishing partnership form of contract. Here, the price and timing of share purchases is usually fixed at the outset of the contract. We are aware that in one particular case, the price of share purchases is related to the market value of the underlying property at the time of the purchase, and that in this same case such purchases are not forced upon the client contractually. This case is however an exception and the majority of financial institutions adopt the former model. For example, the Al- Buraq contract forces its home-buying client to purchase shares in the partnership at monthly intervals: "We agree to sell and you agree to buy Our Share of the Property for the Acquisition Cost on the terms of this Deed. The Acquisition Cost shall be payable by way of the First Acquisition Payment, which shall be paid on the date of this Deed; and the Acquisition Payments ... which shall be paid on each Payment Date ..." Clause 2, Al-Buraq Diminishing Ownership Agreement, 2006

It is worth noting that the Shari'ah standards of the Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) prohibit the purchase of shares in a diminishing partnership at a price that is fixed in advance. This is on the basis that partners in a contractual investment (in this case, a rental property) must share any losses on their investments in proportion to their capital contribution. If one partner forces another to buy his shares at a predetermined price, he may effectively be able to protect himself against loss, thus breaking the principle of loss sharing that must apply if an Islamic partnership is to be valid. For example, if two partners put £50 each into a business partnership, the partnership capital is £100 in total. If it is further agreed that the first partner will purchase the shares of the second partner in one year's time at a price of £50, then the second partner has assured himself, contractually, that he cannot make a loss on his investment in the business. AAOIFI clearly recognises the risk that a halal partnership contract can be transformed into a riba contract by means of pre-agreed share transactions: "It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share [sic] be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the institution) by the other partner, which is prohibited by Shari'ah." AAOIFI Shari'ah Standards 2003 - 2004, section 5. Diminishing Musharakah, p. 214

The diminishing partnership contracts that have come to our attention protect the bank from capital loss on its share of the partnership by various means and to varying degrees under English law. In the event of a deterioration in the United Kingdom property market, Muslims who default under such contracts may therefore find themselves required to guarantee the bank's original capital contribution to the property purchase. If property prices fall sufficiently far, the position of negative equity that was described earlier could become widespread. This would no doubt be an unexpected surprise for many clients, given the language of "risk sharing" that typically accompanies Islamic home finance products.

In summary, we believe that any Islamic home financing scheme in which the financing organisation stipulates conditions to protect itself from a negative return on capital is equivalent to an interest-bearing loan. Contracts in which the financier buys a property for a client while requiring the client to buy it back at a higher deferred price are the most common (but not only) means of implementing such loans. In these cases, the property is used firstly as a tool to transact the loan, and secondly as a means of securing it.

Given that it is possible to produce genuinely Shari'ah compliant Islamic property financing contracts under English law, we feel that to permit the present range of products on contractual grounds is a flawed strategy for the Muslim community to follow. The risk is that the benefits possible under a proper implementation of Islamic finance will not emerge, and that what could have been the beginning of an interest-free economic renaissance will in fact become a mechanism for its suppression.

Allah knows best and may His peace and blessings be upon our Prophet Muhammad, his family and all his Companions.