Islam and the free-market economy

A CONFLICT OF INTEREST: ISLAMIC HOME FINANCING IN AMERICA

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*The rising Muslim population in the USA has fuelled an increase in the domestic demand for '*shariʿah*-compliant' finance. One of the prominent restrictions that* shariʿah *imposes on financial practices is a prohibition on the payment and collection of* riba*, interest on loans. This paper examines the home financing models of three prominent Islamic financial institutions. It identifies the transaction models that these institutions use, explains the differences among these models and illustrates how each institution 'sells' its chosen approach to the public.*

Keywords: Islamic finance, usury, mortgage products.

Introduction

The recent increase in America's Muslim population – and specifically in its Muslim population's wealth – has created a new market for banking and financing alternatives that fall in line with the principles of Islamic law, *shariʿah*. This demand, in addition to the rise of Islamic finance on the global scene through financial transactions with many Muslim countries, has spurred the rise of numerous '*shariʿah*-compliant' banks and institutions in America: the Institute of Islamic Banking and Insurance (IIBI, 2009) names 20 such institutions on its website, and new ones emerge every year. Georgetown University International Affairs and Islamic Studies Professor John Esposito (Esposito, 2008) also notes that the 'ten largest Islamic finance institutions are European and American banks', not banks in Muslim countries.

In the sector of home financing, three such institutions have achieved particularly notable popularity and significance amongst American Muslims: Guidance Residential, University Islamic Financial Corporation, and American Finance House LARIBA. Although other Islamic home financing organisations exist, this paper will focus on these three because they either have widespread national popularity (Guidance and LARIBA) or a long history (LARIBA and University), and thereby can serve as the major examples leading the way for Islamic home financing in America. The growth of these groups has not gone unnoticed, as each of their websites includes a section devoted to media coverage. Such attention has only increased due to the current economic crisis facing America, and also in the wake of claims by some Muslim scholars that a *shariʿah*-based economic system would not have faced such a downturn.

This paper aims to describe this recent phenomenon of Islamic home financing by providing a brief summary of the traditional reasoning behind Islamic finance, examining the models of three institutions in particular, considering objections to the industry as a whole, and finally offering a few thoughts on the growth of this market.

A brief summary of the principles of Islamic finance

We begin by introducing the basic concepts that are needed to understand the workings of *shariʿah*-compliant lending institutions. For a more comprehensive introduction to Islamic finance, see El-Gamal (2006), Usmani (2002) and the various *fatawa* (legal opinions) presented on the websites of the institutions mentioned in this paper.

Key principles

Generally speaking, modern Islamic finance deals with two major prohibitions: that of *riba* (commonly defined as ‘interest’ or ‘usury’) and that of *gharar* (commonly defined as ‘risk’ or ‘uncertainty’). Since the question of *gharar* arises mostly in the context of investments and seldom in the realm of home financing, this section will focus solely on the prohibition of *riba*.

Islam’s prohibition and condemnation of *riba* is found in various places in the Qur’an (see 2:275–280, 4:161 and 30:39 for examples) and also in various *hadith* (sayings of the Prophet Muhammad), which cite instances wherein the Prophet explained what qualified as *riba* and what did not, such as ‘the selling of wheat for wheat is *riba*, unless it is exchanged from hand to hand and is equal in amount’. Based upon these sources, traditional Islamic jurists determined that there are in fact two types of *riba*: *riba al-fadl*, in which unequal quantities of the same product (such as wheat or, in modern times, money) are exchanged, and *riba al-nasi’ah*, in which the same product is exchanged but with a delay or deferment of payment on one end. According to this traditional understanding of *riba*, modern conventional finance is impermissible since it incorporates the lending of money for a later repayment that includes a premium (i.e. interest) for the time elapsed between disbursement and repayment.

From principles to models

As a result of this prohibition, traditional Muslim scholars created several models that avoided the use of *riba*. In the realm of home financing, three models prevail: (1) *murabaha*, (2) *ijara wa iqtinaa* and (3) *musharaka*. In the *murabaha* (cost-plus sales) contract, the seller acquires the desired product at a price known to both parties and then agrees to sell the product to the buyer for the original price plus an additional premium. In the *ijara wa iqtinaa* (lease and acquisition) contract, the buyer contracts to buy the use of the product for a certain period of time with the option to buy the product at the end of the lease period. Finally, in the *musharaka* (joint venture) contract, both parties jointly purchase and co-own the product in question, while the buyer can simply buy the seller’s share of the product over time.

The role of scholars

Lastly, a crucial component of Islamic finance is the approval of a recognised Islamic scholar, who provides religious legitimacy to any transaction. In the home financing market, only a handful of scholars end up serving on ‘*shariʿah* advisory boards’, which judge the permissibility of various contracts drawn up by the Islamic finance institutions: scholars such as Muhammad Taqi Usmani, Nizam Yaquby and Yusuf Talal DeLorenzo are emerging as the leading authorities in this regard.[1] While their approval is not essential to the transaction itself, they do serve the important role of allaying the fears of consumers who might wonder if these institutions are misrepresenting Islamic law for financial gain. Sceptical Muslims also might seek the opinion of another scholar to confirm the permissibility of the financial transaction. In both cases, the authority of a traditional Islamic scholar remains the key factor in determining the legitimacy of a financial transaction.

Islamic home financing in America

Having laid the foundations for a discussion comparing the *shariʿah*-compliant options that are available to potential homeowners, we now proceed to compare the three financial institutions upon which our study is based.

Guidance Residential, LLC

We begin by looking at Guidance Residential, LLC (from now on referred to simply as ‘Guidance’), which is a wholly-owned subsidiary of Guidance Financial Group. Both of these institutions are based in Reston, Virginia. The information in this section is drawn primarily from Guidance’s website at http://www.guidanceresidential.com.

Background information Guidance probably is the most well-known provider, among American Muslims, of *shariʿah*-compliant home-financing solutions. It offers its home-financing product to potential clients in over 20 states. Its model was developed under the oversight of its *Shariʿah* Board, which includes such renowned Islamic scholars as Abdul-Sattar Abu Ghuddah, Mohamad Daud Bakar and Muhammad Imran Ashraf Usmani, as well as the aforementioned M. T. Usmani, Yaquby and DeLorenzo.

Business model Guidance’s model is a declining *musharaka* scheme, which Guidance calls the ‘Declining Balance Co-ownership Program’. In this programme, the client and Guidance jointly purchase the property. Their initial ownership stakes are determined by the size of the client’s down payment. In most cases, the title will be shared between the client and Guidance according to ownership shares, but, in states where having multiple co-owners incurs extra taxes, the client will be the sole titleholder.

Based on the initial ownership shares held by the client and by Guidance, the client makes monthly payments that are composed of two sub-payments: a profit payment and an acquisition payment. The profit payment is one that the client makes in exchange for the right to have exclusive access to the property, which Guidance co-owns. Guidance determines the size of the profit payment with the goal of achieving a competitive rate of return: hence the size of the payment may be adjustable and also may be linked to an interest rate index. For clients that make a down payment of less than 20% of the value, Guidance does not require private mortgage insurance as is customary, but Guidance will demand higher profit payments to compensate for the higher default risk that it assumes. The second sub-payment – the acquisition payment – goes towards building the client’s equity in the property. Payment terms can be 15, 20 or 30 years, but there is no penalty for prepayment. There also are no interest penalties for late payments, but there is a $50 charge for the ‘collection costs’ that are associated with a late payment.

The client will be entitled to all capital gains and will bear all capital losses that may result from a voluntary sale of the property. In other words, the amount that the client owes Guidance is based on the ownership shares and on the property's original purchase value; it does not vary with the property's market value. In this sense, the client assumes all market risk. In the case of a forced sale, however, the risk will be shared between the client and Guidance according to their ownership shares.

Marketing strategy Guidance's high visibility certainly is related, at least in part, to its frequent presence at large Islamic conferences, such as that of the Islamic Society of North America (ISNA). Aside from visibility, however, Guidance makes an effort to allay the concerns of potential clients who may have doubts about whether Guidance's approach is truly *shariʿah*-compliant. One notable way in which Guidance has sought to establish the credibility of its commitment to following the principles of *shariʿah* is through the assembly of its *Shariʿah* Board, which comprises esteemed traditional Islamic scholars. Guidance also has a fairly extensive 'Frequently Asked Questions' (FAQ) section on its website that addresses some concerns that potential clients may have about Guidance's approach. In particular, in its description of the monthly profit payments, Guidance states explicitly that the fact that profit payments may be calculated using an interest rate index does not turn the profit payment into an interest payment. The interest rate index, they argue, is merely a benchmark by which a 'competitive rate of return' may be determined.

University Islamic Financial Corporation

University Islamic Financial Corporation (from now on referred to as 'UIFC') is a subsidiary of University Bank, which is based in Ann Arbor, Michigan. The information in this section is drawn primarily from the websites of University Bank and UIFC.[2]

Background information According to University Bank, UIFC is 'the first Islamic Banking subsidiary run entirely on *shariʿah* principles'. In addition to its mortgage alternative products, UIFC also offers *shariʿah*-compliant bank deposits through University Bank and *shariʿah*-compliant mutual funds as well. UIFC currently offers *shariʿah*-compliant home financing options in the states of Indiana, Maryland, Michigan, New Jersey, Ohio, Texas and Virginia. It has the approval of two well-known Islamic scholars (both of whom also serve on Guidance's *Shariʿah* Board): Yusuf Talal DeLorenzo and Nizam Yaquby.

Business model UIFC offers two types of mortgage alternatives: an 'instalment sale' (*murabaha*) option and a 'redeemable lease' (*ijara wa iqtinaa*) option.

Instalment sale: Under this option, the client chooses a property. University Bank (with any of its partners that may choose to be joint investors in the transaction) determines a desired profit rate based partially on prevailing market conditions. This desired profit rate naturally determines a certain mark-up on the property, and these terms are presented to the client, who can either accept or reject the offer. If the client accepts the offer, UIFC (acting as an agent for University Bank) purchases the property. The client is required to make a down payment of at least 5%. A client that opts to pay less than 20% is required to have private mortgage insurance (UIFC purchases private mortgage insurance on the behalf of such a client and presents the fee as part of the initial offer to the client). Upon the client accepting the offer and UIFC purchasing the property, the client receives full title and is responsible for making equal instalment payments towards the difference between the down payment and the home's total marked-up value. This option is available for properties whose values are as high as $417,000.

Under this scheme, there is no penalty for prepayment; if anything, prepayment has incentives, as a certain portion of the mark-up is forgiven if the debt is paid earlier than required. If the client sells the property, he or she is entitled to the profits but is still responsible for any outstanding payments.

Redeemable lease: This option entails a lease and a subsequent acquisition. Here, the client makes a down payment of at least 20% of the value of the property. Since ownership stakes initially are determined according to the size of the client's down payment as a percentage of the total value of the property, the client does not receive the title at the time of purchase. The client is responsible for making monthly payments, each of which is composed of a rent component (which pays for the use of the portion of the property that UIFC owns and may be determined using standard – albeit interest-based – benchmarks such as the five-year Treasury yield or LIBOR) and an equity component (which goes towards increasing the client's ownership share). The original purchase price is not adjusted during the payment period. This option is available for properties whose values are as high as $1.3 million.

Marketing strategy UIFC's website contains a short Frequently Asked Questions (FAQ) section. One of the important issues that the section addresses is how UIFC's mortgage alternative schemes differ from typical interest-based mortgages. UIFC notes that the instalment sale model involves a simple mark-up on a base sales price, and that the redeemable lease model involves the collection of rent for property. In particular, UIFC characterises *riba* as payment for the use of money over time. Since no such payments are made in either of UIFC's mortgage alternative solutions, it follows that both are free of *riba*.

Wherever appropriate, UIFC draws attention to features of its model that echo Islamic legal principles, especially related to contracts. For example, the description of the instalment sale model – in which the client has the option to either accept or reject UIFC's price proposal – refers to the Islamic legal principle of *al jabah wal qabool* ('offer and acceptance').

Similarly, in the description of the redeemable sale model, UIFC notes that the purchase price of the home is not adjusted during the payment period, and that *gharar* ('uncertainty') is thus eliminated. UIFC also admits that its use of interest-based benchmarks in computing the rent is, according to the consensus of the Islamic jurists, less than ideal but still maintains that it is not problematic enough to negate the transaction's compliance with *shariʿah*.

American Finance House LARIBA

The third institution that we examine is American Finance House LARIBA (from now on referred to as 'LARIBA'), which is based in Pasadena, California, and is an affiliate of the Bank of Whittier, which is based in Whittier, California. The information in this section is drawn primarily from these institutions' websites.[3]

Background information On its company website, LARIBA lists a number of services that it offers. These services include home financing, auto financing, business financing, trade financing, equipment financing, and '*riba*-free banking' through the Bank of Whittier. As their websites indicate quite clearly, the Bank of Whittier was established in 1982, and LARIBA was established in 1987 (we return to this point later.) Together, LARIBA and the Bank of Whittier serve clients in all 50 American states.

LARIBA was founded by Dr Yahia Abdul-Rahman, who is also the Chairman and CEO of the Bank of Whittier. Although LARIBA does not disclose the identities of its *shariʿah* board members, some of the works of Yusuf Qaradawi and Muhammad Taqi Usmani are referenced on its website.

Business model Although its website includes little history about the firm, LARIBA is very transparent about its principles and – in particular – about its approach to home financing. LARIBA's model is based upon a 'lease to purchase' concept (*ijara wa iqtinaa* and diminishing *musharaka*). Under this arrangement, the client and LARIBA first work together to determine a 'fair' lease value for the property. In particular, LARIBA requires that the client ask at least three real estate agencies for independent assessments regarding a fair lease value for the property. LARIBA also checks with a different set of three real estate agencies. Using these figures, the client and LARIBA agree on a lease value. They also agree on the size of the client's down payment (which can be as little as 5% of the total value of the property, although clients that put less than 20% down are required, by law, to purchase private mortgage insurance) and on a repayment schedule (which can have a duration of up to 30 years).

After the preceding arrangements have been made, the client and LARIBA jointly purchase the property, which is then registered in the client's name. At this point, both the client and LARIBA are co-owners of the property, and the ownership shares are based upon the percentage of the cost of the property that the client covered with the down payment. Following purchase of the property, LARIBA leases to the client the portion that it owns; the client purchases it from LARIBA over the period of time to which both parties agreed in advance.

The client makes fixed monthly payments, each of which comprises two sub-payments:

- *Return on capital*: this component is the lease payment. Naturally, as LARIBA's share of the property decreases over time, these payments become progressively smaller.
- *Repayment of capital*: this component goes towards increasing the client's equity. Since the total payment is a fixed monthly value and the return-on-capital payments shrink over time, these payments grow over time.

There is no prepayment penalty, so the client is not deterred or otherwise discouraged from making larger monthly payments.

On the surface, this arrangement seems like a conventional mortgage, since it is a fixed monthly payment that includes a portion that goes towards increasing the client's equity and a portion that represents the institution's profit, but there is an important difference between this scheme and a typical mortgage: payments are made not for the loan of money but for the rental of property – specifically, LARIBA's diminishing share in the co-owned property – that is being rented. Hence, as LARIBA argues, the Islamic ban on *riba* is not violated. Furthermore, market interest rates are not explicitly used as benchmarks in determining payments.

A final notable feature of LARIBA's model is that it limits the client's potential losses, since capital losses are shared between LARIBA and the client. Capital gains, on the other hand, are left completely to the client.

Marketing strategy In a brief telephone conversation that took place on 1 December 2008, Dr Yahia Abdul-Rahman explained to us that, as a matter of principle, LARIBA does not do any explicit marketing or advertising. Furthermore, in the FAQs section of its website, it is stated clearly that LARIBA does not use Islamic centres and organisations as 'platforms for business'. While LARIBA may not have a true advertisement campaign, its website is clearly designed to build the confidence of potential clients. As we mentioned previously, LARIBA is extremely transparent about its methods and principles; on top of that, it goes to great lengths to portray itself as a bona fide partner to its clients. This objective is evident from the slogan that appears in the website's banner: 'Serving the community since 1987'. The Bank of Whittier has a similar slogan in the banner on its own website: 'We Do Not Rent Money, We Invest in You: Socially Responsible, Faith Based and Riba Free'. The Bank of Whittier's banner also mentions the fact that it was founded in 1982. The reason for mentioning age is clear: longevity (especially in a sector as volatile as that of financial services, and particularly in a fledgling sub-sector such as that of Islamic finance in the USA) suggests stability and thus confers a certain amount of credibility.

With the recent economic downturn that has at its core a large number of mortgage defaults, a number of questions have arisen regarding the questionable practices that were employed by some lending institutions during the housing boom in the early to mid-2000s. Perhaps in direct response to such questions, LARIBA mentions that its financing model is robust enough to detect housing bubbles. Specifically, LARIBA claims that its model would be able to predict an intolerably low return on investment, and that, in such a case, LARIBA would be able to inform the client that the property is overpriced. LARIBA claims, moreover, that the models of two competitors – Guidance Financial and HSBC – do not detect overpriced houses and also notes that, unlike those two institutions, LARIBA does not use market interest rates – it instead uses market property rental rates – in the determination of payments. LARIBA's model certainly is unique and creative, and its website draws attention to the strengths of its approach. Dr Abdul-Rahman also mentioned in the phone conversation with us that LARIBA's rate of delinquency is extraordinarily low and has remained so even in the wake of the mortgage crisis, although he did not share any concrete financial data. Based on the set of principles and the description of the financing process that is outlined on the website, though, it is clear that the company takes very seriously its commitment to due diligence and towards upholding a core set of principles in its lending practices, so it would be surprising if it were strongly affected by borrower defaults as a result of lax or questionable lending practices employed during the housing boom.

Conflicts and controversy

One would expect that, with the variety of models and approaches that are in use for *shariʿah*-compliant lending, some sort of disagreement, or even controversy, would be inevitable. This is certainly true, but the conflicts often involve much more than mere disagreement about details of the models. Despite (or perhaps because of) its increasing popularity, the version of 'Islamic financing' represented by these institutions has provoked a number of criticisms from academics and observers who claim that such efforts actually misrepresent or even abuse the actual aims of Islamic law.

The central objection advanced by such critics is that the 'Islamic financing' of these institutions does not accurately represent the principles of the Qur'an or of traditional Islamic jurisprudence. Their arguments normally begin by questioning whether the *riba* prohibited in the Qur'an can actually refer to modern notions of 'interest': Ahmad (1993), for example, argues that, while definitions of *riba* may vary amongst scholars, the actual usage of the term in the Qur'an and *hadith* is not exactly the same as 'pure interest'. University of Toronto law professor Mohammed Fadel (2008, pp. 680–688) additionally demonstrates that, from as far back as the early twentieth century, some Islamic scholars have doubted the notion that the Qur'an's condemnation of *riba* extends to modern financial practices of lending at interest.

These criticisms of mainstream definitions of *riba* expand into a broader scepticism of Islamic finance's claim to a firm basis in the *shariʿah*. In his study of legal texts, Fadel (2008, p. 691) notes that, from the view of pre-modern jurisprudence, 'there is no basis to conclude that Islamic law has a bias toward equity-financing rather than debt-financing', and furthermore argues that even those who consider the profit–loss-sharing model to be the most 'Islamic' inconsistently support models that do not live up to their own standards. Rice University economics professor Mahmoud El-Gamal (2007) takes another angle by arguing that modern Islamic finance models do not fulfil the overall aim of Islamic jurisprudence, which is to enhance human welfare, and reasons that 'abandoning the outdated contract-based approach' would more faithfully follow the example of early Muslim jurists.

Most importantly, these criticisms normally conclude that Islamic finance, as practised by modern jurists and institutions, is useless and unnecessary. El-Gamal (2007) argues that modern Islamic finance in effect mimics a conventional mortgage 'with some added cost for spurious trading and various fees', thereby making the whole programme just as, if not more, harmful than conventional models. Halliday (2008) believes that, historically, 'Islamic finance' simply meant 'sound capitalist principles' at the time. Indeed, sceptical scholars tend to view the insistence on an 'Islamic' finance as exploitation of religion and of religious markets: El-Gamal (2007) casts the entire process as one of imposing a prohibition to necessitate an 'Islamic' alternative, using various techniques to 'synthesise' the prohibited practice, and then attaching an Arabic brand-name and getting the approval of a few religious scholars to establish Islamic legitimacy. Not only do he and other sceptical scholars find the whole process a troublesome refashioning of conventional financial models in Islamic garb, they also find it highly problematic that the Islamic scholars who do advise these organisations benefit financially by taking up positions on the boards of these various institutes and banks. This argument implies that the whole enterprise of Islamic financing, worse than being merely ineffective and redundant, could very well be little more than the exploitation of piety for financial gain.

While it remains outside the scope of this paper to judge among the various opinions on what the *shariʿah* actually intends, this debate does highlight a central dilemma within the Islamic financing endeavour as a whole, as noted in a piece that appeared in *The Economist* (2008): 'If the industry introduces too many new products, cynics will argue that sharia is being twisted for economic ends . . . but if it fails to innovate, the industry may look too medieval to play a full part in modern finance'. Regardless of the direction that these Islamic financial institutions take, scepticism will certainly follow.

Conclusion

Despite the various challenges and complexities facing each institution, Islamic home financing appears to be thriving, and Guidance, UIFC and LARIBA are among the leaders of this movement, at least for now.

This growth does not indicate, as some commentators have suggested, some sort of hidden agenda to take over the US legal or financial system, but rather it represents the increased financial power of the Muslim American community as a whole. Much like Muslim lifestyle magazines (Sacirbey, 2008) and the emergence of *zabihah* meat (meat of animals slaughtered in accordance with *shariʿah*, similar to kosher meat) on a national scale, the increased availability of Islamic home financing is yet another indicator of the Muslim community's presence in the USA. While the absolute necessity of such 'Islamic' alternatives might be questioned by Muslim and non-Muslim observers alike, they do more than simply cater to orthodox interpretations of Islam: crucially, they allow for greater community cohesion and help Muslims navigate their way through the various conflicts of identity and morality that plague all religious minorities.

That is not to say, however, that the success of these institutions is a given. So long as they walk the fine line between the demands of modern finance and the demands of the Islamic tradition, these institutions must be quick and clear in addressing the concerns of potential consumers that Islamic home financing is either impractical or un-Islamic. Indeed, the Frequently Asked Questions section of each institution's website hints that the institution has had its fair share of consumer scepticism, and the Islamic authenticity of 'Islamic financing' has been challenged at least twice in British courts (El-Gamal, 2007). While potential consumers may question the *shariʿah*-compliance of these institutions, the major obstacle to Islamic home finance remains its effectiveness *vis-à-vis* conventional models. To really sell their products, these institutions must convince the greater public that their options in the long run have some advantages over alternative financial institutions, otherwise they may simply be dismissed as unrealistic avenues only for the pious and rich in the US Muslim community.

1. Nizam Yaquby and Yusuf Talal DeLorenzo are on the *shariʿah* boards of both University Islamic Financial and Guidance Financial. Muhammad Taqi Usmani is on Guidance Financial's *shariʿah* board, and his work is cited on the LARIBA website, but LARIBA prefers not to list the members of its *shariʿah* board and says only that it uses his work as a reference.
2. See http://www.university-bank.com and http://www.universityislamicfinancial.com, respectively.
3. LARIBA's website is http://www.lariba.com and the Bank of Whittier's is http://www.bankofwhittier.com.

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