Islamic Housing Finance

by Douglas Diamond

INTRODUCTION

In most societies today, there is a distinction between the legal code and the moral code of the major religion in that society. Despite this, many individuals choose to order their personal and business relationships according to their religion's traditional moral code. For example, there is nothing in the civil laws of most countries restricting the consumption of most foods, yet many people follow dietary restrictions set by religions such as Hinduism, Islam, Judaism, and, until relatively recently, Catholicism.

Among some Muslims, there is a similar abhorrence for certain kinds of financial contracts which are otherwise both legal and common among many people, Muslim and non-Muslim. Broadly speaking, these contracts involve the payment of a specific return or interest for the benefit of the use of other people's money. For these persons, an issue arises whenever they consider borrowing funds for housing. That issue is how best to arrange the transaction to avoid violating key moral principles perceived by them to apply.[1]

Such arrangements are generally known as Islamic housing finance. The focus of this article is on the ways that Islamic finance is practiced currently. It includes a discussion of basic concepts of Islamic finance, a description of Islamic financial products generally available and their applicability to housing finance, and some case studies of Islamic housing finance in Jordan, the United Kingdom and the United States.

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BASICS OF ISLAMIC FINANCE

There are two basic Quranic concepts shaping modern Islamic finance: explicit prohibitions by God against *riba* and *maysir*. What are these things that are prohibited? The Quran, the divine word of God, does not explain in detail. This situation has resulted in a wide range of interpretations by Islamic scholars, some liberal enough to encompass most conventional forms of financial transactions.[2] However, the bulk of the traditional interpretation of the Quran and the associated Sunna (the authenticated accounts of the Prophet's activities and words) are relatively restrictive in ways that will be briefly discussed below.

In addition to these basic prohibitions, Islamic finance is guided by a huge, subtle and fairly controversial (there are at least four main schools of thought) body of interpretations of Quranic and Sunna prescriptions for all forms of contractual and commercial relationships. The self-imposed limitations of Islamic finance can only be fully understood within the context of the totality of classical Islamic law, not just the prohibitions on *riba* and *maysir*.

The simplest translation of *riba* is "usury." The concept of usury has a long and complex history in most forms of both civil and religious law in Judeo-Christian societies, so it is not surprising that it is unclear in Islamic law as well. However, the unequivocal condemnation of *riba* in the Quran stands in stark contrast with an explicit Quranic endorsement in general of transactions in which both parties agree and benefit from, and thus it has attracted great attention throughout the history of Islamic legal inquiry.

It is not possible for this author to properly describe all the aspects of the debate over how to implement a prohibition on *riba*. However, in summary, there seem to be three important conclusions shared by most proponents of Islamic finance. First, the basic restriction is very explicit and important for the pious to observe. Second, it is necessarily difficult to apply to the modern context and this makes for a difficult task for religious advisers to Islamic financial institutions. Third, given that this and related laws are based on divine revelation, and not codes of logically adduced corollaries of explicit premises, it is not surprising that there is a range (although often narrow) of scholarly opinion.

Within this context, most Islamic financial institutions (IFIs) today see their task as bringing the distinct benefits of modern finance to those who share their views without compromising these important princi-

ples.[3] They do not see it as a poor substitute for conventional secular finance, but as a challenge to their ingenuity to capture the advantages of financial intermediation and manage the risks noted above, all without resorting to immoral arrangements.[4]

One way of summarizing the general perspective taken by these proponents is as follows. "Thus, instead of a creditor and debtor relationship, the Islamic financial instruments envisage establishing a participatory relationship between the suppliers and users of finance. Inherently, the yield on these instruments is neither fixed nor predetermined. An Islamic financial instrument, instead of representing a claim, stands for a share in some real and productive assets. The yield . . . will depend, on the one side, upon the productivity of the asset whose share it represents, and on the other more important side, it will be influenced by the changing market conditions in the real sector. The exact nature of the relationship between yield of the instrument and productivity of the real asset shall depend, among other things, upon the nature of the contract on which the instrument has been based."[5]

Based on this description, the clearest form of Islamic finance is that of either a partnership or equity participation in a joint stock company. In both cases, the reward for investing depends entirely on the market reward for the venture. A good question is why all Islamic finance is not simply equity finance.

The answer relates to the basic distinction between debt and equity from the perspective of the saver and user of the funds. In preferring to not participate through equity ownership, either formally or informally, the saver wants to manage the agency risk involved and perhaps also bracket the range of uncertainty about the return, downside and upside. The borrower does not care about the agency risk (the risk that he will abuse his position of agent for the saver), but he does care about having his control of events limited by having equity partners. Thus, conventional debt finance was invented to meet these disparate goals.

Moreover, the borrower, if an entrepreneur, usually is motivated by a desire to sequester as much of the "upside" of an investment for himself. By doing so, he creates a greater congruence of effort and return (which simultaneously minimizes the agency risk to the investor). In addition to these considerations, tax and accounting considerations often also influence the actual division between debt and equity funding.

Having said that, the narrow interpretation of the Quranic prohibition on *riba* precludes participation in strictly debt-type financial transactions (money for money), by saver or borrower. Rather, there must be some amount (even if minimal) of joint participation in a real commercial transaction, rather than just the lending of money alone. It is this participation in a real commercial transaction in goods or services that causes there to be some degree of risk exposure and makes a financial transaction acceptable.[6] Given this, and given the desire of many savers to minimize all risks on at least a portion of their financial portfolio, the IFIs must attempt to remain involved to some extent in the outcomes of their borrowers while minimizing the loss of the advantages of debt finance. We will briefly examine the range of common financial instruments intermediated by IFIs, from those with the greatest equity (profit and loss sharing) element to those with the least.

INSTRUMENTS OF ISLAMIC FINANCE

At the equity end of the spectrum of IFI activities is the placement of funds with the IFI for their application to traditional equity investments, with a fee charged by the IFI for their **investment management services.** In this case, the IFI is simply acting as an agent in managing a portfolio of equity investments.

Next is the placement of funds solely for "safekeeping," which encompasses **current accounts** (qard hassan) and can come with a guarantee of repayment of the amount deposited, but no return in addition. Many IFIs have substantial funds placed with no monetary return (but with a return in the form of checking services) on current account, just as non-Islamic institutions do in some economies.

Most other IFI instruments, on both the asset and liability sides, fall under the category of "profit and loss sharing." We will examine the range of IFI assets first.

The next closest to conventional equity investment is where the bank, on its own, not acting as an agent of its depositors, contributes to the joint capital of an investment. Such an investment comes with the usual proportional voting rights in the enterprise and possible representation on the board of directors. This structure, called *musharaka*, is not commonly used (usually less than 5% of an Islamic bank's activities) but, when it is used, it is usually for long-term investments in enterprises, sort of like venture capital. (We shall see a case of this applied to housing finance, however.)

In *musharaka*, the IFI jointly owns the project, and thus takes part of risks, profits and losses. In fact, the client's contribution may be in kind, in some cases even just a good reputation. The bank is expected to closely watch the management of the project. Losses are proportional to each party's equity contribution, whereas profits may be distributed differently, if agreed upon in advance. The IFI's participation may also be permanent or temporary. In the latter case, its share may be declining *(iqtina)* as shares would be continuously bought out by the

client through this latter's own incomes and profits. The client may then become eventually the sole full owner of the financed assets. Meanwhile, he naturally cannot pledge or resell his own shares without the consent of the bank.

For investments in shorter term activity, such as trade credits or operating capital, the same sort of profit-sharing applies, but the investment is not jointly with other investors, and the entrepreneur is completely free to operate the business as he sees fit (barring provable mismanagement or negligence). This is called *mudaraba*. Return is expressed as a share of the profit or loss on the investment. However, in traditional *mudaraba*, the entrepreneur has no liability to make up for any loss. So basically, the share of the loss to the IFI is 100%, and the share of the IFI in the gain is fixed as an outcome of *ex ante* negotiation.

This arrangement is somewhat feasible in a world of perfect Islamic morality and is the sort of activity that some descriptions of pure Islamic finance seem to focus on. However, it is rife with informational costs and moral hazards in the current world, because there are so many ways that a borrower can "cheat" in revealing the true profitability of the investment. It is true that there is some incentive for the borrower to convey *ex post* at least the expected ex ante return, so as to be able to access credit again in the future. But the IFI is still, at best, likely to see overall profitability portrayed by the borrower to just barely yield this return even if the business is more profitable than expected, yet the IFI will be stuck with the entire loss when the business is not profitable. The overall risk and reward ratio is not as attractive as either a regular equity or *musharaka* funding, where the IFI has some degree of information and control.

So far, these activities of the IFI are practically indistinguishable from pure partnership or equity investments. In that sense, the IFI is, in all cases, acting effectively as an investment adviser, pooling the savers funds and managing equity investments. However, management is not on a fee basis, but rather the profit of the IFI itself is also dependent on the outcome of the investments and will then be shared with savers.

If the bulk of IFI activity was of this type, then Islamic savers would effectively be restricted to equity investments. The basic problem is that the Islamic savers are looking for less uncertain and problematic forms of assets when they turn to a bank. While it is true that Islamic savers, just as non-Islamic savers, may want to commit a portion of their overall portfolio to equity investments, they would tend to, just as non-Islamic savers, directly invest that in a stock market or mutual fund, or in business ventures of their own or of relatives, or perhaps go into a true *mudaraba* venture capital fund or partnership. There is little special about these arrangements that differs from conventional finance (other than avoiding prohibited activities like gambling and liquor) and little reason to involve a commercial bank in the transaction. The fact is that most Islamic savers look to IFIs to give them the services and stability of a bank, not an equity fund.

This conundrum could have undermined the growth of IFIs right at the start. However, various interpretations of the Sharia'a have permitted several forms of investment where the risk is reduced to a more symbolic level. Such approaches are a form of **installment sale** and a form of leasing.

The form of installment sale is called *murabaha* and involves the IFI buying the investment good (including producer inputs, producer durables and consumer durables) and marking it up for an agreed upon profit, with the total of cost and profit being paid in equal installments.[7] Although the buyer has title in this case, that title to the good that is sold is placed as collateral for the loan or other collateral may be provided. Risks are further minimized by having the transfer to the IFI and sale to the "borrower" occur at the same moment, and with no borrower recourse to the IFI for defects. The borrower may actually act as the IFI's agent in doing the buying.

Leasing is called *ijara* and is structured very similarly to conventional leasing, with the IFI retaining title and with the borrower having a choice of simple lease or **lease with purchase** *(ijara wa iqtina)*. In the latter case, the entrepreneur or "tenant" is paying an additional amount towards purchase, and is credited with progressively larger ownership as the lease proceeds, with a declining "rent" portion of the payment, just as in an amortizing mortgage.

There are a couple of different aspects of an Islamic lease. First, some Sharia'a advisers (every IFI must have one or more such Sharia'a scholars to review all practices) insist that the lessor (the IFI), as owner, must be responsible for providing all the services, and thus for major repairs. Thus, Islamic lessors may have to factor in a guess as to these costs, and face some uncertainty as to their net profit. Second, the lessee has some rights of cancellation if the services are significantly infringed on by factors beyond his control. Thus, the lessor must also carry all hazard and other property insurances.

In both cases, the effective return on the investment is nearly certain. The primary uncertainty is with respect to delays in repayments (and the usual potential for total default). Imposition of additional charges for such delays is generally forbidden by Sharia'a boards, and this introduces an uncertainty with respect to the effective **rate of return** (although not the eventual total nominal return). This distinction is viewed as being of the essence, since it implies that,

though the "profit" is fixed, the time dimension is not fixed and the investor is bearing some of the risk of the borrower having financial setbacks.[8]

Clearly, both *murabaha* and *ijara* perform in a manner much closer to a conventional debt instrument. To the extent that savers are looking to generate a relatively predictable return on their funds and not worry about moral hazard on the part of borrowers, these are the sorts of instruments that one would expect to see used. Thus, it is not surprising that Frank E. Vogel's *Islamic Law and Finance: Religion, Risk, and Return* reports (p.135) estimates that at least 80% of IFI investments are in the form of mark-up installment sales *(murabaha),* and at most 5% is in *mudaraba.*

A third important approach, really a variant to murabaha, is the "commissioned manufacture" of goods, combined with installment payments, called *istisna.* This is used for the financing of major capital goods, and can be applied to housing being constructed. The IFI is acting as an agent for the buyer (who is not a lessee, as under *ijara*) and takes a profit related to both contracting services and for the time value of money. As in the other cases, the important aspect of the transaction is that actual commerce or sale of goods or services is involved.[9] Strictly speaking, *istisna* is construction (or production) period finance, perhaps to be followed by an installment sale under *murabaha.*

How are these lending activities of the IFIs funded? The greatest share of IFI liabilities are investment accounts (similar to time deposits) placed with the bank on a profit-sharing basis *(mudaraba),* i.e., where the bank is offering to share in the profits in a banking business. Although *mudaraba* is offered relatively rarely by an IFI to a borrower, savers are willing to entrust their funds to the IFI on this basis, presumably precisely because they believe that the IFI is primarily using the relatively safe and predictable *murabaha* mode of seeking profits. Within the category of *mudaraba* accounts, there may be several variants, based on the ability to make withdrawals, just as there are in non-Islamic banks. The greater the degree of liquidity of the account, the lower the share in the profits. It appears that the bulk of these investment deposits are intended to be locked in for one year or more, and the typical rate of return is similar to that for time deposits in a conventional bank.

In addition to raising funds through regular investment accounts, some IFIs will raise funds through special *mudaraba* investment pools that act like limited partnerships. These special pools are usually associated with specific larger and longer-term development projects, including building out a large tract of land or financing a specific set of properties. The IFI is the general partner and investors share directly in the profits from that project, rather than from the total pool of business of the IFI.

ISLAMIC FINANCING AND HOUSING

What does all this mean for financing housing under Islamic law?

In cases where housing is an asset used in the production of income (i.e., rental housing), a classic profit-sharing instrument such as *mudaraba* can be used, with a sharing of profit or loss from the rental of the property to a third party. However, it appears that this is not common, perhaps both because the amount of entrepreneurial effort is low relative to the capital involved or because of concerns about being involved in socially problematic actions such as eviction of the tenant in case of rent default and civil suit against the landlord in case of abuse of management.

Another approach to financing rental housing could be having an IFI acting as a landlord directly, through a straight *ijara* deal without purchase. That runs into the same problem of eviction, but may also face additional problems of (1) fixing the rent for many years into the future (usually the payments under an *ijara* contract are fixed, but not necessarily) and (2) the IFI having to actively manage the real estate.

It appears that the primary mode of involvement of IFIs in housing finance is through leasing units to purchase or *ijara wa iqtina.* In general terms, *ijara wa iqtina* looks and acts very similarly to buying a house with a conventional mortgage. Of course, it applies only when the "lessee" is actually seeking ownership. *Ijara wa iqtina* has the advantage of the IFI retaining title to the unit until the lease terms are met, thus avoiding reliance on foreclosure laws, but leaving reliance on eviction laws in case of rent default.

Assuming that the lease rate is calculated to yield an effective internal rate of return similar to that on a conventional mortgage, *ijara wa iqtina* is an attractive approach for an IFI seeking to offer housing finance. There remain, though, a few drawbacks.

First is the one noted above that there is no penalty permitted on delays in payments, thus opening up the possibility of earning a significantly lower overall rate of return. However, it appears that some IFIs are less concerned about this and do invoke some form of penalty if the lessee cannot demonstrate financial hardship.

Second is the notion that the IFI, as lessor, must pay for any major repairs. In principle, the expected cost of such repairs can be included in the lease fees, but that leaves a range of uncertainty as to outcome. In the U.S. at least, the IFI could also buy a "household warranty" that would cover many of these sorts of repairs. However, as in the case of late payment penalties, most IFIs take the view that the lessee, as ulti-

mate purchaser, must bear the costs of maintenance.

A *musharaka* element is sometimes added to a leasing *(ijara)* arrangement in the case of housing. The housing asset is co-owned by both the financier and the client, pro-rata to their respective debt and equity contributions (this latter through the form of an initial deposit contribution). The bank leases its co-shared part to the client, who accordingly pays the bank its share of the would-be market rent (estimated according to the rental value, that may be periodically re-adjusted by appraisers) plus gradually buys out the financier's share through additional payments. Through time, the rent component declines while equity buy-out may rise. Just as in the case of pure *ijara*, by the end of the lease term, the asset is fully owned by the client. But under *musharaka*, in case of an agreed-upon early resale, each party receives its corresponding timely share (including possible capital gain or losses). In addition, the repayments over time and the eventual return to the IFI depends on the actual course of market prices and/or rents (see especially the MSI SHARE program in the U.S. on page 31).

Another popular mode of Islamic housing finance is the application of *murabaha* (mark-up) financing, primarily for the purchase of building materials. This is particularly apt in those developing countries where it is common for households to acquire land and build a home in increments over several years. It is also commonly used to finance the addition of a floor or room for rental income or the marriage of a son who will reside with the extended family. The term on such loans will usually be shorter than under *ijara,* and in some cases only payroll deduction and guarantors will be relied on instead of a mortgage because of the small size of the loan.

So there are several methods of financing a home purchase. There remains the important issue, however, of how to fund these longer-term financing activities. Most IFIs rely on deposits placed on the basis of *mudaraba*, and offering some degree of liquidity and variability of return. However, *ijara wa iqtina* for terms longer than a few years can pose serious liquidity and interest rate risks. Liquidity could be a problem because it is not simple for an IFI to raise funds using its illiquid assets. In fact, there is usually no interbank-lending market for IFIs. However, as long as such longer-term financing is not too large of a share of an IFIs portfolio, it does not appear that an IFI should have a problem that can not be met by adjusting the volume of short-term *murabaha* contracts that it is making. In fact, it appears that IFIs have an even more stable deposit base than do conventional banks, because most "investment accounts" are for one year or more and the current rate of "profit and loss sharing" is not announced regularly.

Interest rate (or rate of return) risk can also be a problem if that IFI's Sharia'a advisers rule that a *murabaha* or *ijara wa iqtina* contract requires fixity of returns. Funding for housing in this case based on offering a "market" rate of return may imply problems if market rates rise, or also prepayment (if permitted) problems if market rates decline.[10]

An alternative approach that offers some advantages in managing rate-of-return risk caused by the possibility of a rise in inflation is introducing co-ownership *(musharaka)* in a substantive way to ijara, as noted above. The advantage is the potential for "rent" payments in such cases to be set according to market rents and the change over time accordingly. In addition, the IFI would be benefiting from any rise in the value of the house if it is sold prior to the end of the lease term.

There are at least two theories of what a target market for Islamic housing finance, and the share of IFIs in the market, would look like. One theory emphasizes that IFIs would probably be willing to receive a lower return on equity on investments in housing, since it is a socially important sector. This could imply both a special management focus on this sector and perhaps lower risk-adjusted required rates of return. This situation could attract many housing borrowers. Alternatively, there could be an inverse correlation between household incomes and the degree of concern about avoiding *riba*. In other words, the heads of more wealthy households would be generally more secular and less religious. In this case, and given the positive correlation with home purchase and income level, it could be that IFIs would have a smaller share of the market for financing new housing but an advantage in the market for home improvement loans taken by moderate-income households.

The evidence discussed below is that the latter hypothesis applies in Jordan, where it appears that moderate-income households are more pious in this regard and the Jordan Islamic Bank specializes in financing home improvements for this segment. Fragmentary evidence from other markets also suggests this comparative advantage of IFIs housing finance with relatively lower-income households. This facet of Islamic financing makes the IFIs of particular interest to development agencies.

CASE STUDIES IN ISLAMIC HOUSING FINANCE

Jordan Islamic Bank

Within the Arab countries, the Jordan Islamic Bank (JIB) appears to be one of the most active in the area of housing finance. It was founded over 20 years ago, in 1979, and has always had a particular focus on lending for housing. This may reflect the fact that the general target customer base of the bank on the liability side has been relatively

modest-income households. Just working with this base, it has grown to be the third largest commercial bank in Jordan.

As in the case of most other IFIs, the JIB's funding is primarily (74% of deposits) in the form of medium-term investment accounts, based on *mudarabah*, with the remainder in either current accounts and more liquid savings accounts. Notably, the share of actual lending in the financial sector (about 12%) is greater than its share of deposits (about 8%), because the JIB, and IFIs in general, do not have the option of investing excess liquidity in government debt or even interbank lending.

Out of a base of about JD400 million in investment accounts, the JIB holds about JD60 million in total of housing-related financing.

The largest portion is for the purchase of a house, through an *ijara wa iqtina* contract for sale and leaseback. The JIB has been successful in adapting this product in an interest-based environment. The "profits" paid on such financing are considered eligible for the deduction from personal taxable income of mortgage interest up to JD 2000 a year. In addition, the effective sale nature of the *ijara* arrangement is recognized in the form of exemption from the large transfer fees that would otherwise be applicable to the final sale to the homebuyer in addition to the initial sale to the lessor.

The use of *ijara* has one small practical advantage as well. It is exempt from an Ottoman Law restriction still in effect in Jordan that total interest not exceed the principal. However, the term of such loans are limited to six to eight years anyway due to liquidity concerns.

In addition, there is a large business in home improvement loans for building materials done on a *murabaha* basis. This is especially useful for adding rooms to existing structures, something which is extremely common in both urban and rural areas, and is particularly practiced by relatively lower-income households.

Al-Baraka, Al Manzil (U.K.)

There are at least two major IFI housing finance schemes in the United Kingdom.

Dallah Al-Baraka Investment Co. has been offering Islamic housing finance for over ten years. It is a branch of the Dallah Al-Baraka Investment Company in Saudi Arabia, an IFI with over $7 billion in total global assets.

It appears that Al-Baraka offers both *murabaha* and *musharaka* financing. The *murabaha* financing is similar to that of the Jordan Islamic Bank, used for the purchase of building materials for home improvements or even new construction, but for relatively short periods (no more than two years), with a fixed rate of return.

The decreasing *musharaka* is designed to mimic a conventional floating-rate U.K. mortgage, with the rate of profit subject to following market rates (in fact, LIBOR) and the payment towards buying out the lender's equity increasing over time in order to maintain a level total payment. The net effect is similar to the leasing arrangement that Manzil offers (see below), but has the advantage of registering the title with the purchaser to begin with (there is no lease, but rather a partnership with lien) in order to avoid paying title registration fees twice. There is no element of revaluation of the property value, as appears in the SHARE product of MSI in the U.S.

Of special interest about Al-Baraka's financing is the imposition of fines in some cases of late payment. Fines are applied unless there is evidence that the borrower does not have the financial ability to repay. The fines are for the loss of the use of the funds and are calculated based on the average monthly profit of the IFI during the period.

Since 1997, the United Bank of Kuwait, a conventional U.K. bank for offshore clients, through its segregated subsidiary, Islamic Investment Banking Unit (IIBU), has been aggressive in expanding its Islamic finance offerings in the U.K. It now offers two forms of financing for home purchase, *murabaha* and *ijara*, both offered under the brand name of Manzil (home). Households can apply for these through the IIBU's website or a centralized-lender format (telephone or local representative).

There are some financial, legal and theological differences between these two approaches, as offered. The *murabaha* approach is an installment sale, at a margin that is fixed in advance. Financially, it is the equivalent of a fixed-rate loan, and because of this, the maximum term offered is 15 years. Legally, the borrower has no claim on the property until the installment debt is extinguished. Theologically, the Sharia'a board has not approved the use of *murabaha* to refinance an existing conventional mortgage, while *ijara* can be used for this.

Ijara is the usual lease with purchase. However, it appears that the rent component is subject to change over time as market rates of interest change. In fact, just as with Al-Baraka, the lease amount is reset annually according to changes in LIBOR. Terms up to 25 years are offered. It also appears that the lessee takes responsibility for maintenance costs.

In both cases, UBK requires a 20% downpayment. It is not in the position to obtain mortgage insurance from conventional insurers for these products.

IIBU is funding its financing efforts in general only through funds from off-shore institutional investors, including its largest shareholder, the social security fund in Kuwait. It has about $1.0 billion in aggregate in its investment portfolio (housing and non-housing).

MSI, Manzil, American Finance House (U.S.)

There are at least three significant Islamic housing lenders operating in the U.S. All offer some variation on an *ijara* approach. Notably, none of these IFIs operate as a licensed bank or thrift institution; instead, all operate as investment companies.

The oldest is MSI Financial Service Corp. of Houston, Texas. Founded in 1985, MSI (originally Muslim Savings and Investments) is a multi-service IFI, offering auto leasing and venture capital financing (*mudaraba* and *musharaka*) and housing finance (since 1989). It offers its SHARE program in Texas and in other states through authorized representatives. It funds these activities through issuing participations in limited partnerships. Its current portfolio of housing loans is about $8 million (about 150 houses).

The most distinctive aspect of MSI's lending for housing is that it combines *musharaka* with *ijara*, and in this manner produces a format that is closer to the Islamic ideal. The deal is structured as co-ownership of the house, and the monthly payment is the appraised current net rental value of its share in the house. If MSI has financed 80% of the cost of the house, it keeps 80% of the rent payment, and applies the rest towards the purchase by the resident of its interest. The value of its share and the level of rent is adjusted over time for actual market changes. This is similar to the shared-appreciation mortgage that was much discussed during the period of high interest rates in the early 1980s and has the advantage of that construct of permitting the repayment to be lower at the beginning and rise over time. Moreover, the change over time in rent and value is based on an appraisal of the particular property, not a general rent or house-price inflation index.

This structure is significantly different from straight *ijara wa iqtina*, where either (1) a level lease payment is calculated to yield a fixed return and amortize principal repayment over the term, or (2) the lease payment systematically varies with some market interest rate. By basing its rent and price adjustment on an annual appraisal of the property, MSI is actually partnering with the homebuyer significantly more than under straight *ijara*. Such a structure would be difficult to implement for housing in most emerging markets, where appraisal of market value or rent is quite problematic.

MSI requires a 20% downpayment. Rent levels are based on a market appraisal and then the cost of insurance and taxes is netted out. However, all maintenance is the responsibility of the buyer. The term of partnership is ordinarily between five and 15 years, and the buyer can buy out MSI at the current appraised value at any time. (It is reported that the cost of repeated appraisals is relatively low, about $100 a year, because of the small amount of work involved in updating a previous appraisal.)

The British bank for off-shore investors, United Bank of Kuwait, has also started up its Manzil program of floating rate *ijara* (with lease payments changing based on changes in LIBOR) in the U.S. It appears to be seeking to be a significant player through a network of representatives, primarily focused on the relatively large Muslim communities in California. Notably, it is offering terms up to 30 years in order to compete better with conventional mortgage lenders in the U.S. UBK has allocated $50 million initially for the U.S. effort and is not planning on U.S. fundraising.

California is the base of the third IFI home lender in the U.S., American Finance House Lariba (AFH).[11] Founded in 1987 in Pasadena, AFH offers products similar to those of MSI, through representatives in 12 states. Despite its age and geographic reach, it is relatively small, with about $3.0 million in all types of financing in 1999.

AFH's housing finance is in the *ijara* format, apparently with an additional *musharaka* element as with MSI. Its normal terms to completion of equity buy-out are between five and eight years. All maintenance is paid for by the buyer. In contrast to some other programs, though, AFH allows the title to be registered directly in the name of the buyer. This saves the buyer costs of transference later, but exposes AFH to some additional costs of legal action to recover as only a lienholder.

It is important to note that for all three IFIs, the U.S. Internal Revenue Service has agreed to treat the rent portion of the monthly payments as interest on housing debt that is eligible for deduction from taxable personal income.

NOTES

[1] It must be clearly stated at the outset that there is no unanimity among Muslims, as individuals or legal scholars, on several important aspects of housing finance. Nothing in this article should be construed as endorsing any particular views; it attempts to report an understanding of the relevant code of conduct as perceived by Islamic financial institutions in this area.

[2] A good reference for all aspects of how Islamic law shapes Islamic finance is the book, *Islamic Law and Finance: Religion, Risk, and Return*, edited by Frank E. Vogel,

Kluwer Law International, 1998. As noted there, there is a strand of thought that the prohibition against *riba* is primarily as an attack on the practice at the time of Mohammed of doubling the amount due if not paid at the due date. Moreover, there is an Islamic doctrine of breaking prohibitions "in cases of necessity," which could include paying interest in certain cases. Thus, even this basic premise of Islamic finance is open to multiple interpretations.

[3] In Iran, Pakistan, and Sudan, all banking is supposed to follow Islamic law. Otherwise, the IFIs market share seems to top out at about 10%. For example, in both Jordan and Yemen, the Islamic banks hold about 10% of all bank assets. In Malaysia, the IFI share is less than 10%. In Egypt, the major Islamic bank holds less than 3% of all bank assets.

[4] Most practitioners do not perceive this risk as in any way a game to legalistically skirt prohibitions. Rather, there is a deep belief that these restrictions were imposed in order to create a better society and that these benefits will be forthcoming if the prohibitions are embraced and observed wholeheartedly.

[5] Ausaf Ahmad, *Toward an Islamic Financial Market,* Islamic Development Bank, Islamic Research and Training Institute, Jeddah, Saudi Arabia, 1997.

[6] The Sharia'a does not demand risk-sharing *per se,* but rather that there be some link between the return and the actual economic activity being financed.

[7] Murabaha is apparently a variation on the principle of credit sale or bay *muajjal.*

[8] The other aspect of both *murabaha* and *ijara* that makes them desirable is the fact that the profit is associated with a sale of a good or the services of a good. It is a core principle of Islam that commerce is good, while just paying money on money is prohibited.

[9] Despite the presence of commerce, three of the four schools of Islamic law do not recognize *istisna* (Vogel, p. 146).

[10] But prepayment risk is moderated by the fact that an IFI never commits to paying a fixed rate of return to its investors (depositors).

[11] The word "Lariba" in its name is both Arabic for "no interest" and an acronym for "Los Angeles Reliable Investment Bankers Associates." It appears to have some ties to the Dallah Al-Baraka group of Saudi Arabia.