

TOWARDS A LARIBA (ISLAMIC) MORTGAGE FINANCING IN THE UNITED STATES PROVIDING AN ALTERNATIVE TO TRADITIONAL MORTGAGES

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This invited paper from the industry explores the size of the US market for home financing and the opportunities it offers for Islamic financial institutions. The paper also offers some strategic alternatives for effectively targeting this market.

1. Introduction

The instinct of owning a place to live in and to produce livelihood has produced a natural dream for every individual and family. The motor of economic development throughout history has been through helping people own a home and a means of transportation. In today's language; owning a house and an automobile. That is why the backbone of the major developed countries and societies has been the housing and automobile industries.

The development of mortgage financing in England, Germany and the USA has helped propel the economies directly and indirectly:

Directly by increasing demand for the products, industries and services associated with building homes, and

Indirectly by satisfying the natural instinct of ownership in the citizen. Feeling that he/she own a house; "a piece of the rock", makes the citizen proud of his/her citizenship, deepens the feeling of belonging to the country, enhances the real estate in general as owners strive to beautify their owned properties by continually maintaining and improving it. Finally, owning a home strengthens the feeling of responsibility towards the citizens' own families and the community at large.

That is why major economic policies in developed nations have been designed to essentially subsidize the mortgage industry and to a lesser extent the automobile industry. In the United States, a number of institutions were developed to act as a catalyst in the promotion and facilitation of owning a home. Examples are:

Federal National Mortgage: was designed to provide ongoing assistance to the secondary market for residential mortgages by providing liquidity for residential mortgage investments, thereby improving the distribution of investment capital available for such mortgage financing.

Federal Loan Home: was chartered by the US Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of home ownership and rental housing. The company purchases first lien, conventional, residential mortgages, including both whole loans and participation interests in such mortgages.

Government National Mortgage Association or GNMA: provides pass through certificates which have an interest in a pool of single family home mortgages that are insured by the Federal Housing Administration (FHA) or by the Veteran's Administration (VA)

In fact one of the important parameters used by the Federal Reserve System, (The Fed - America's Central Bank) in its decision regarding interest rate and monetary policy is the its impact on the housing industry.

Finally, in an effort to encourage Americans to own homes through mortgage financing, the US government has made RIBA interest paid through mortgage financing tax deductible. It is now one of the few deductions left to the average citizen that helps in reducing taxes.

This paper indirectly poses the question: how, in a world of increasing economic and political uncertainty, are we to envision means of strengthening civil society and community? We believe that LARIBA Financing is one such means, and it's eminently doable and practical one.

2. Home Mortgages in the United States

Approximately 66% of the residential properties in the United States are owner occupied. They represent about US\$7,000 billion in value. In fact, housing is the single biggest investment in the dream of a family; i.e. owning a home. Mortgage payment is the biggest monthly liability of a typical American household.

Typical homebuyer borrows up to 85 to 90% of the purchase price of a home. A typical mortgage has a 30-year term. Because of the mobility of the US employment market and the continued needs of American families to move to larger and more modern homes in more attractive suburbs and neighborhoods, many of these mortgages are closed way before the end of 30 years. California Home Financing Association 1996 statistics on the characteristics of homebuyers and sellers in California (Tables 1 and 2) indicate that the average number of years of owning a home is approximately 8 years. As the homeowner moves to another home, he/she closes the old mortgage, pays off the loan and applies for a new home mortgage. In addition, as interest rates have continued to decline in the past two years many homeowners have refinanced their homes more than once (sometimes once every 6 months to a year.)

3. The American Muslim Community and LARIBA (Islamic) Financing

The American Muslim Council (AMC) in a popular survey published in December 1992 estimated that the population of Muslims in the United States ranges between 5 to 8 million. A most acceptable figure is an average of 6 million. In the United States the State of California has the largest Muslim population among all states. It is estimated that there are at least 1,200,000 Muslims living in California. Following California are the States of New York (4.7% of total state population), Illinois (3.6%), New Jersey (2.5%), Indiana (3.2%) and Michigan. There is significant Muslim community living in other states like Virginia, Texas, Ohio and Maryland.

Most of the Muslims in the United States have been integrated in the RIBA conventional banking system prevailing in the United States. Most take advantage of RIBA interest based FDIC insured deposits in the banks, borrow money for buying homes using RIBA mortgages, use their credit cards and sometimes extend its use as a source of RIBA based credit and take home equity RIBA based line of credit. Most of the affluent members of the Muslim business community have used the institutional RIBA financing through the banking system in the USA and accumulated significant wealth through its use. Fatwas (Islamic legal opinions) based on Muslims being a minority and/or that RIBA is usury and not interest have been used by many leaders in some significant communities to justify RIBA. Most affluent and upper middle class members of the community have been used to and the beneficiaries of RIBA system. So, it was unconvincing for many to try to make them change over even in a small way because of the HARAM (forbidden) issue. A number of justifications were used to allow members of the community to continue participating in RIBA activities. Examples are: the fact that the laws of LARIBA cannot be upheld by a minority which lacks the credible institutions, which can offer HALAL (lawful) LARIBA, financing and banking. Another was the claim that RIBA and LARIBA are the same and that the difference is a matter of replacing the word interest with the word profit. A third excuse for not accepting LARIBA would be the failure of the Islamic financial institutions in Egypt.

For a newly emerging alternative system to prevail and succeed it is an understatement to say that it is a very difficult uphill battle. Unless the individual is motivated deeply by the strict adherence to the Shari'aa, the Quraan and the Sunna we found it to be almost impossible to capture people's interest and imagination. It is interesting to report, based on our experience that people thought that we are "silly" to try to bring a LARIBA concept in a world run by RIBA. We even were ridiculed by the closest of friends.

In all fairness, it is our feeling, based on first hand experience and our in-depth knowledge at the grassroots level of the community, that a large portion of the Muslim middle class households have accepted RIBA mortgages against their will. It is our feeling that many of these households would convert to LARIBA if available and competitive. There are many people, Muslims and non-Muslims, who feel disenfranchised by traditional methods of financing, or who feel - correctly or not - that they do not have adequate access to credit, or that the terms of the credit that is available to them are morally objectionable or economically unfeasible for them. We are reminded of the successes of the Credit Union industry among blue-collar workers in the U.S., many of whom simply cannot afford traditional bank accounts because they live from paycheck to paycheck and cannot maintain a minimum balance.

4. LARIBA (Islamic) Mortgages - The Market

The first and foremost market segment, which should be addressed, is the small minority of American Muslims who refused to participate in RIBA under any circumstance. Many of these households have reasonable cash savings but not enough to buy a home. Their balance sheets are clean of any debt of any sort. It is the moral responsibility of the LARIBA (Islamic) bankers and investment/mortgage bankers to cater to the needs of this "Puritan" segment of the community. It is important to note that the term Puritan is used here in American LARIBA on purpose. The term "Puritan" conveys the core principles of American democratic freedom and virtue through industriousness and property ownership.

It is estimated this segment represents approximately 1 to 2% of the professional segment of the community. If we assume that there are 1.5 million Muslim households in America and that 50% can afford buying and maintaining a home then the total number of households in the Muslim community that would buy homes is approximately 750,000 households. Further, if we assume that only 20% want to live according to Islamic laws; i.e. praying, attending Friday prayers and Eid prayers, paying Zakat and performing Hajj, then the number of households would be 150,000. If we assume that 5 to 10% of this number are "LARIBA Puritans" dedicated to deal only in LARIBA, then the number of households which is in need for LARIBA financing is estimated to be 7,500 to 15,000 households. We estimate that the market size is approximately 10,000 households in order to be on the safe side.

This almost 10,000 households represent the real successful puritans who are businessmen/ women, manufacturers, engineers, medical doctors, religious leaders and merchants.

They want to make sure of the validity of the LARIBA (Islamic) mortgage model and approach and they want to check it with their most respected and trusted religious scholar (usually back in Pakistan or other Muslim countries). The profile of this unique market segment is unique. They are extremely pious. They run cash only household. They use the banks for safe deposits of fund and refuse to accept money market interest. They carry no debt. They pay their obligations on time. They fulfill their obligations. They are honorable and extremely successful and reputable. They do not show off their success and accumulated saving because of their training to be humble. They are extremely particular about details of HALAL and HARAM. They are very difficult to give their trust. However, if one earns their trust, it will be given in full. They are devout members of the community. They can be classified as the best credit worthy members of a community. They only can be recognized if those LARIBA (Islamic) bankers are true community workers on a grassroots level.

The typical house price varies from one state to another. It is estimated to be \$250,000 in California and \$ 120,000 in Texas. We use an average of \$150,000 throughout this study for convenience. So, if we assume that 70% of the value of the home is to be financed using LARIBA (Islamic) mortgage, or the mortgage would be \$105,000. For a market of 7,500 households, it is estimated that the primary market size for LARIBA mortgages to be \$780 million. If one assumes a 25% turnover (which is a function of the term of finance assumed here to be 4 to 8 years), this primary market segment size is estimated to be approximately \$200 million. As the concept gains credibility and proven track record, we expect the concept of LARIBA mortgages to grow significantly to attract members of the middle class through refinancing, non-Muslims who will like the concept and the new generation of youths who are more sophisticated in evaluating alternative mortgage concepts.

5. The LARIBA Lease Purchase Model

The model is simple and straightforward. It consists of two parts:

The first is the return of capital. If the house price is \$180,000, the client pays \$60,000 and the balance is financed by LARIBA. In this case the client owns 33.4% of the house and LARIBA owns 66.6% of the house. The client agrees to buy back the share of LARIBA over a period of 5 years in monthly installments of \$2,000 per month. The title of the house is transferred directly to the client to minimize costs and taxes. LARIBA becomes the lien holder. The client owns the house and handles his/her property in terms of maintenance, upkeep and renovation in the same way a traditional mortgage holder would.

The second part is the lease of the house. The client agrees to lease the house for a period of 60 months; the term of the pay back. The lease is estimated based on comparable lease rates of houses in the neighborhood and is negotiated on an ad-hoc basis between the client and LARIBA. The lease income is distributed between the client and LARIBA. The client's portion of the lease is used in our computer model to expedite the buy back process.

6. The Strategic Approach to LARIBA (Islamic) Mortgages

A strategy is the art and wisdom of matching our goals with our available resources in light of the social, business and political environment we live in. Our approach to achieving our goals is to wisely "Start from The Possible to Achieve the Impossible". The following is a summary of our strategy:

The Need For Grassroots Community Involvement:

The primary market segment for LARIBA mortgages is large by the American Muslim community's humble means. A mere \$200 million is a "drop in the bucket" by American banking and financing standards. LARIBA (Islamic) banking and financing system does not have a proven track record in the United States. We found from experience that relying on our local resources is a must. That means that we should rely on localized grassroots community effort at every community center. So, in order to do this we must start small in order to achieve our ultimate goal. Also, we must have the flexibility and foresight in order to compete in the market.

The Laws of the Land:

Based on our 31 years experience as American Muslims we learned that it is difficult, expensive and essentially impossible to change the laws of the land. We tried to do it regarding marriage contracts. We settled for abiding by the civil code to protect the rights of the married couple and performing the wedding according to the Islamic rights. We encountered the same experience in cases of divorce. We concluded that the Muslims do not have yet the "critical" mass and the ways and means even to attempt to change the laws of the land.

From a strategic point of view, we decided that changing the banking and finances laws of the United States to fit the Islamic Shari'aa is not our goal in this stage of the American Muslim Community's experience. We believe that in the future the passing of the "Financial Services Modernization Act, or "HR10"; the act which will modernize the American banking industry and may soften the Glass Stiegel Act, will help the cause. However, it will take a long time. We are aware that others have tried at huge expense only to dress up the regular RIBA financing contract to make it look and sound proper from the Shari'aa Islamic point of view. We respectfully disagree with the approach and wish those who have tried and are still trying it the best and pray for their success.

We therefore decided and in the same time strongly urge that in dealing with banking and financing matters in the United States strict adherence to the letter of the law is required. We also believe that respecting the laws of the United States and abiding by them is our responsibility to God, the future of the community and the good of the alternative system we hope to lay the foundation of. We know from history that toying with financial, securities and banking laws of America is dangerous. We also know that the punishment is instant, terminal and irreversible. On the other hand many components of the American system represent years of human experience that cannot be thrown away. We simply cannot reinvent the wheel. The Community Re-investment Act (CRA), the laws against

usury, the equal lending opportunity laws, the Securities and Exchange Commission rules and regulations, the regulatory functions of the US banking regulators and the laws regarding full and complete disclosures are laws and regulations that reinforce basic human and Islamic values. We also know that the American financial, monetary and banking system is the most sophisticated and reliable in the world. It is our duty to uphold these laws. Our efforts should concentrate on providing an alternative not a substitute to that system. The reliability of that alternative system is in fact enhanced by the already tried and proven regulatory and legal system of America. We should abide by the Prophet Muhammad saying “God bestows peace and mercy unto those who know and who are realistic about their capabilities.”

Matching The Competition:

It is our responsibility to provide a product that competes in the free market place equally if not better than the traditional mortgage. Title and ownership should be given to the buyer and not delayed. Implied mortgage rates should be disclosed and explained in comparison to the market. Monthly payments should be within the ability of the customer and in light of the monthly apartment or house rent they are paying. Term of the LARIBA mortgage (5 to 8 years) being much shorter than the traditional mortgage (15 to 30 years) should be explained and the pros and cons discussed in great details. The administration and processing fees incurred in a LARIBA contract should be explained and compared to the “points” charged by traditional mortgages. Capital gains realized from the sale of the property before the expiration of the term should be competitive with the traditional mortgage. And most importantly, the LARIBA Puritan homebuyer should not be punished by not being able to deduct the implied interest as done in traditional mortgages. The tax issue is one of the most important. A letter from the IRS may be good but not enough as compared to the announced policies of mortgage RIBA interest deduction.

Marketing Approach:

Marketing of LARIBA services in general and mortgages in particular should not follow the traditional “marketing hypes”. It is a specialized product, at least at this stage of its product life aimed to meet the needs of the LARIBA Puritans. Using expensive media campaigns and other mediums is extremely expensive and may attract unqualified applicants who may take advantage of the general guidelines of LARIBA financing which does not believe in a time value for money. There is no substitute for a real grassroots effort of belonging to the community, knowing its members well and participating in its activities. That is why the LARIBA system should focus on serving local masjid (and later on church and synagogue) communities in order to achieve the real meanings of “know your client”, “community reinvestment” and touching the lives of each household in the community. This approach allows the LARIBA officer to perform a better due diligence and it will reduce cost as the percentage of non-performing loans becomes essentially negligible. In its effort to promote the concept, the LARIBA mortgage organization should rely on personal contacts, recommendations of the leaders and active members of the community and of course all the required due diligence tools of credit checking, salary confirmation, references, tax returns and financial statements. The credibility of the system is enhanced and deepened by performing excellent due diligence. As a result the major source of business becomes referrals and word of mouth about real experiences as compared to the traditional “marketing hype.”

General and Administrative Expenses and Other Costs:

The success of the LARIBA system in its infancy depends on a voluntary approach in which professional bankers, financing officers and entrepreneurs, who believe in the system, offer their expertise and services on a voluntary basis. This will reduce cost drastically. In fact if they cannot afford working for free they will be content with a salary that is much lower than what the competition offers. It becomes a mission and not a job. In addition, other expenses like travel, hotel accommodations, entertainment, postage and other costs should be kept to a minimum. For example instead of travelling business or regular coach a LARIBA officer would, on his/her own, look for the cheapest excursion fare. Instead of living in a hotel, a LARIBA officer would try to identify a friend or a relative to stay with at their home. Instead of going to expensive restaurants, a LARIBA officer would go to the community restaurant in order to minimize cost, show an example and in the same time network with the community. Another important byproduct is the sever reduction in non-performing loans.

Education:

Educating the public using simple and understandable language about the LARIBA and traditional mortgage facts is a must. For example, the fact that a 30-year mortgage is seldom kept to maturity due to the fact that the average American family replaces it with another once every 5 to 8 years. This is due to job mobility, the growth of the family, the growth in income and the proximity to school. The fact of not making an impact on the principal of the loan in a traditional mortgage should be publicized. Education is also needed to explain that paying rent to oneself is equal to investing in ourselves, tax free, and realizing a return that is competitive with the average return on stock market investments (approx. 10% - Yavas). Familiarization with the mortgage schedules and the time value of money used in traditional mortgages are needed for many that are doing it to “go with the flow.” The value of saving money for the children in a trust account (or a Roth IRA account) to save for a sizeable down payment for their future home as they grow up and get married should be made understood by the community. These investments can be used to finance the mortgages of today and benefit the generations of the future. All these will bind the community together, increase mutual trust and help in the economic development of the community. This education will help bring the real spirit of the Community Redevelopment Act (CRA) to life.

7. Conclusions

LARIBA financing is potentially in harmony with the best of American virtue and values. It offers many benefits for civil society and community in a world where many are excluded from credit and finance.

LARIBA mortgage financing is feasible in the USA if done strategically to satisfy the laws of the Shari’aa and those of the USA.

The initial market for LARIBA mortgage is that of the LARIBA Puritans who accumulated a sizeable down payment but is not able to afford the full price. The market size is crudely estimated to be 7,500 households in the USA.

Involvement with the community on the grassroots level provides the safest way to finance and put in effect the “know your client” rule.

Long term (15 or 30 year mortgages) may offer the buyer an easy monthly payment but it also indirectly enhances the clients going deeper in debt. It is the responsibility of the LARIBA banker to rid people of debt in order to live freely. The LARIBA model helps pay off the debt faster. It is the most suitable in the American mobile society that changes residences or refinances once every 5 to 8 years.

LARIBA mortgages and financing brings real life into the Community Reinvestment Act stipulated by the American banking regulations.

A savings program for the future generations is needed to save a sizeable down payment for the children first home. This approach is used for savings for Hajj (pilgrimage) in Malaysia (Tabung Hajj.)

LARIBA mortgage can best survive and grow under the protection and scrutiny of the American banking, monetary and financial laws.