Islamic Banking and the Housing Industry

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Introduction

Individuals and families today have many forms of finance options available for the purchase of their house. Traditionally banks have provided the majority of this. This paper outlines the features of banking based on Islamic principles. The paper also outlines the growth of Islamic banks, and the role these play in the area of housing finance. While Islamic banks began in conventional Islamic countries around the Middle East, they have spread to all parts of the world.

Growth of Islamic Banks

Islamic banking is a relatively new concept, and has grown enormously world-wide since the late 1960's. Today Islamic banking has been adopted in more than 50 countries many of which are Western[1].

Islamic banking has grown in many Western countries primarily because the Islamic population has also grown. In response to the needs of this large and growing community, many Islamic financial institutions have begun in countries such as the USA, UK, and Australia[2]. The International Directory of Islamic Banks and Institutions (2000) published by the "The Institute of Islamic Banking and Insurance" lists these financial institutions[3]. All these institutions cater for the needs of Muslims looking for banking type services based on religious principles. The directory also lists the conventional banks with "Islamic Windows".

According to the International Association of Islamic Banks, at the end of 1996 the number of Islamic financial institutions totalled 166 (up from 133 in 1994) worldwide. These institutions had a total of US $137 billion in assets (up from US $101 billion in 1994) and produced profits of $1,683 million. In 1997, the Islamic banking market was estimated to be growing at an average rate of 15%[4].

Features of Islamic Banking

Islamic financial institutions are governed by Islamic laws known as Shari'ah Islami'iah. These laws are mainly based on the holy Quran. The essential feature of Islamic banking is that all operations are interest free. The Quran forbids the collection of riba (sometimes also referred to as "usury"), in Surah 2:275, 2:276 and 30:39 and the following hadith (38), where Ibn Masud said[5]

"The Apostle of God cursed the one who collected usury, the one who paid it, the two witnesses to the transaction and the one who recorded it"

Prohibition on the use of usury is the central feature that distinguishes Islamic economic system from its Western counterpart. The Qur'an forcefully prohibits the payment and receipt of riba. The term riba refers to the addition to the principal amount of a loan on the basis of time for which it is loaned, or of the time for which the payment is deferred. In Islam, all rewards must be the result of effort whereas riba-based transactions lead to rewarding people without them making the effort. Allah says:

"Those that live in riba shall rise up before God like men whom Satan has demented by his touch; for they claim that riba is like trading but God has permitted trading and forbidden riba" (Qur'an, 2:275).

Islamic verses Traditional Banks

The entire banking system in Western societies is based on the use of interest. Customers' deposits are channelled into a variety of short and long-term loans and the rates of interest are dependent upon the period of time. The interest rates are pre-determined and are guaranteed. The borrower must pay the interest that applies to the loan and the lenders will receive the interest promised in addition to the return of their initial deposit. The bank's profitability depends greatly upon the margin between the borrowing and the lending rates. The actual operation of a conventional bank is a complex one but basically, this is the core of the banking principle.

In contrast to conventional banking, Islamic banking operates on a profit sharing basis. The bank invests depositors' funds in various types of businesses. A portion of profit earned is paid to depositors in a pre-determined profit and loss ratio. The profit is not and should not be determined ex ante. In the case of conventional banking, the rate of interest is determined in advance regardless of the end result. Islam does not deny that capital deserves to be rewarded, however investors have no right to demand a fixed rate of return.

There are three major sources of funds for an Islamic bank. Besides the bank's own capital and equity, the main sources of funds are likely to be two forms of deposits – transaction deposits and investment deposits. Transaction deposits are guaranteed the nominal value, the bank would pay no return on this type of liability. Generally speaking, funds mobilised through this source cannot be used for profitable investment by banks. As such, banks are likely to levy a service charge on deposit holders to cover the cost of administering this type of account.

Investment deposits constitute the principal source of funds for Islamic banks and they more closely resemble shares in a firm, rather than time and saving deposits of the customary sort. The bank offering investment deposits would provide no guarantee on their nominal value, and would not pay a fixed rate of return. Depositors, instead, would be treated as if they were shareholders and therefore entitled to a share of the profits or losses made by the bank. The only contractual agreement between the depositors and the bank is the proportion in which profits and losses are to be distributed. The profit-or-loss-sharing ratio has to be agreed in advance of the transaction between the bank and the depositors, and cannot be altered during the life of the contract, except by mutual consent.

As far as the lending operations of Islamic banks are concerned, the banks also are required by the Shari'ah to apply the principles of profit-or-loss sharing in their loan operations. Two methods that satisfy the requirements of the law on the lending side are murabaha and mudaraba and arrangements.

(a) Murabaha (Cost-plus financing). Here the Islamic bank purchases the goods (for example a house) from depositors accumulated funds, takes title of the asset and then re-sells it to a member at a mark-up, as agreed to by both parties; and

(b) Mudaraba (profit sharing). This is a business finance arrangement where the Islamic bank provides capital for an entrepreneur's business venture from the depositors' funds. The capital providers receives a percentage of the businesses profits according to a pre-determined ratio. In the case of losses, these are borne by the institution and the providers of the funds. In mudaraba contracts the agent (e.g. a bank) receives a specified share of the 'profit' arising from investing the funds provided.

Housing Products – two examples

Housing finance is an important function of Islamic providers. This paper will outline two such Islamic providers of housing finance in the USA.

a). A major Islamic financial institution in the USA is the American Finance House – LARIBA. (Los Angeles Reliable Investment Bankers Associates). This institution was established in 1987 in California. In terms of housing finance, the model used to finance a by LARIBA is the Lease-To-Purchase (LTP) Model.

In the words of the LARIBA bank "we start by determining the monthly rental/lease rate of a similar house by contacting real estate agents. We request the client to do the same. The client and company finance officer compare the results of the survey and agree on a monthly lease/rental rate. We never start from an interest rate".[6] Further "We start from the utility value…... this concept is called 'Marking the item to the Market'. Interest rates are the same through the USA regardless of the economic condition of the city, locality or state. When we mark things to the market, we directly reflect the utility that is a function of the economy of an area"[7].

The model calls for the financing entity to purchase the property jointly with the client. The client owns title to the property with the Company holding a first-position lien. The financing agreement consists of two parts: the first is a loan agreement in which the client returns the capital to the company (Return on Capital); the second is a lease agreement based on an agreed lease rate, calculated based on the declining equity stipulated by the Return-of-Capital pay back agreement. In summary, LARIBA Financing is not based on interest rates but on the Utility Value of the asset/service to be financed as reflected by the rent/lease rate that the asset/service commands in the market[8] b). MSI (Muslim Savings and Investment) Finance Service Corporation was founded in 1985, and in terms of housing finance has a product called SHARE (Shared Home Appreciation in Rent & Equity). It works in a similar manner to the American Finance House. With the SHARE product, both the potential buyer and MSI purchase the house and own it jointly, with the buyer providing around 20% and MSI 80% housing capital. Since the home is used as residence, the buyer will pay fair market rent. A portion of this rent will go towards the rent of MSI's ownership, and another portion will go towards the buy out of MSI's share. The rent will decrease each month as the house ownership increases. [9]

The key feature of both the American Finance House – LARIBA, and the MSI Finance Service Corporation is that repayments are not based on pre-determined interest rates.

Future Directions?

While there has been growth in the number of funds that offer investments to all Muslims, a number of problems exist for these institutions in Western countries such as the USA. There are a very few Islamic Investment companies in the US because of the following reasons [10]:

Islam is a relatively recent development in the US; Islam faces inherent difficulties when operating in a non-Islamic country, for example "the operation of most businesses in the US involves borrowing money and paying interest. Banks borrow from the US government at a lower rate of interest, and lend it out at a higher interest rate. An Islamic bank because of Shari'ah restrictions is cut off from this source of funding" [11]. Further, Islamic institutions need to develop more in house expertise, as many Islamic banks out source management of investment funds to non-Muslim countries.

Conclusion

Islamic banks are growing throughout the world even though certain pressures exist. They have differences which stand them out from conventional banks, in that they are based on profit sharing and community involvement. With growth in investors, asset base and profitability, throughout the Western world, Islamic banks are having success in serving the needs of their growing communities. In terms of housing finance, Islamic banks are already having a presence in Western countries and this paper has outlined some products available in the USA. These products appeal because they do not have an interest component, commonly associated with Western banks, and have been designed based on the holy Quran.

References

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6, 7 & 8. see http://www.americanfinance.com/financing/home.shtm, accessed 8 February, 2001

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10 & 11. Wilson, M "Why is there a lack of Islamic Investment Companies in the USA? at http://www.islamiq.com/news/features/article.php3?news=1_16012001, accessed 3 April, 2001