An Overview of Sharia Compliant Home Financings in the US, with a Background on Islamic Finance Principles

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By Jim Milano and Allyson Keslar

Introduction

Merriam-Webster defines usury as, “interest in excess of a legal rate charged to a borrower for the use of money.” Although this is the definition that society accepts now, it has not been the standard definition for all religions. Catholics, Jews, and Muslims, at some point in history, believed all types of interest to be outlawed usury. Over time, Catholics and Jews changed their definition of usury to only include illegally high interest, but many Muslims still believe all interest is illegal.

Islamic financial institutions, like Guidance Residential, have created contracts to avoid interest for their Muslim clientele. This paper explores the different types of Sharia compliant contracts developed over the years. Furthermore, the case study section looks at a product offered by Guidance Residential, the Declining Balance Co-Ownership Program, which successfully mimics all aspects of a traditional home mortgage without the labels of debt and interest. This paper will also address the issues that Islamic financiers face in Texas with its strict homestead laws, and the complex nature of intermingling property, contract, and religious law.

Religious Background on Usury

Catholicism

“You shall not demand interest from your countrymen on a loan of money or of food or of anything else on which interest is usually demanded. You may demand interest from a foreigner, but not from your countryman, so that the Lord, your God, may bless you in all your

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undertakings on the land you are to enter and occupy.”

In medieval times, the Church’s council defined usury, or taking of any interest, as a crime, a sin, and something that would deny a Christian a proper burial. However, even during this time the Church believed that Christians could loan money to Jews, and vice versa.

During the 16th century, capitalism and the movement of goods took off, and merchants needed a way to make trades safely. At the time, merchants hauled large amounts of bullion across long distances to make trades which created a certain level of danger. Merchants started using bills of exchange or lettre de change (later known as the ‘acceptance bill’ and the draft), a simple informal letter to the merchant’s bank in another city, to release funds for the trade on the merchant’s behalf. Over time the merchant was allowed to make money on the credit extended. Theologians gradually started to accept this idea, because of the amount of risk the banker took on when lending money and risk deserved compensation.

In 1745, Pope Benedict XIV formally articulated the Church’s stance on charging lawful interest on loans in the papal encyclical *Vix Pervenit*. He wrote that, “entirely just and legitimate reasons arise to demand something over and above the amount due on the contract.” However, he put constraints on the ability to charge interest by saying “only contracts with

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3 Deuteronomy 23:20-1.
7 Woodward supra note 5 at 198.
8 Id.
10 Woodward supra note 5 at 198.
11 Woodward supra note 5 at 200.
12 Id.
interest that were made in the spirit of upholding the common good avoided the usury prohibition."\textsuperscript{14}

The modern Catholic Church has followed a very similar vein of thought as Pope Benedict XIV.\textsuperscript{15} However, the Church has looked to modernize the concept by writing on issues involving credit unions, financial regulations, microfinance, and pawnbrokers.\textsuperscript{16} Pope Benedict XVI in 2009 wrote in his encyclical \textit{Cartias in Veritate}, “[a]bove all, the intention to do good must not be considered incompatible with the effective capacity to produce goods.”\textsuperscript{17}

\textbf{Judaism}

During the outright ban of usury in the Catholic Church, Jews started to specialize in money-lending and other practices that were forbidden to Catholics.\textsuperscript{18} The Catholic Church in the Middle Ages adapted the law of their religion to only apply to “thy brother” as referring to other Catholics and the “foreigner” as non-Catholics.\textsuperscript{19} Applicable Jewish law also made it permissible to loan with interest to non-Jews if limited to the level required for existence if there are no other ways to survive.\textsuperscript{20}

Although Jewish law allows Jews to lend to Christians, Judaism made it very clear that Jews should not lend to other Jews unless it was a “free” loan, a loan with no interest.\textsuperscript{21} Talmudic rabbis held that among Jews the term “usury” and “interest” were synonymous, and strictly forbidden.\textsuperscript{22}

\textsuperscript{14}Id.
\textsuperscript{15} Woodward \textit{supra} note 5 at 200.
\textsuperscript{16} Id.
\textsuperscript{18} Yaron Brook, \textit{The Morality of Moneylending: A Short History}, 2 OBJECTIVE STANDARD 3 (2007).
\textsuperscript{19} See Deuteronomy 23:20-1: “Thou shalt not lend upon interest to thy brother: interest of money, interest of victuals, interest of anything that is lent upon interest. Unto a foreigner thou mayest lend upon interest; but unto thy brother thou shalt not lend upon interest; that the Lord thy God may bless thee in all that thou puttest thy hand into, in the land whither thou goest in to possess it.”
\textsuperscript{22} Id.
The Hebrew word for usury is *neshek*, which means “bite.” Jewish law does not make any distinctions between a “small bite” or a low rate of interest or a “big bite” or a high rate of interest. The rabbis even prohibited any benefit to the borrower including a greeting or a thank you if that was not the lenders usual practice.23 Furthermore, Jewish law applied the ban equally against the lender and the borrower.24 Even further, if you witness a transaction that bears interest, it offended the religion.25 Jewish law, *halakhah*, classifies charging interest as one of the worst sins, and denounces it as an abomination.26 The Book of Ezekiel portrays usurers as people “who have shed blood.”27 The Gemara of the Babylonian Tamud quotes Rabbi Jose saying, “[c]ome and see the blindness of those who lend at interest:…get together witnesses, a notary, a quill and ink, and then write down and seal (a contract): so-and-so has denied the God of Israel.”28 Some rabbis even went as far as saying that selling one’s daughter into slavery was less self-defeating than a usurious deal.29

Over time, the *hetter iskah* (permission to form a partnership) developed.30 A *shetar iskah* (deed), would be drawn up in conjunction with the *hetter iskah* that stipulated the lender would provide a certain amount of money and in exchange the borrower would manage the business, guarantee the lender’s investments against all loss and provide a fixed minimum profit to the lender.31 The deed would also stipulate that the two shared the losses and the borrower would receive a salary.32 In order to make this agreement to share losses basically null, the deed would require unobtainable evidence to prove a loss.33

This practice became so well established that today all interest transactions are freely carried out in Jewish communities just by simply adding to the note or contract the words *al-pi*
heter iskah. 34 All remnants of the prohibition of interest have been lost, and the idea has been relegated to where it originated, friendly and charitable loans. 35

Furthermore, Jewish money-lenders still charge interest to the Gentile (non-Jewish), and they are encouraged to charge interest.36 However, modern rabbis believe the concept of charging a Gentile interest came from the fact that Gentiles did not have a law forbidding charging interest.37 Therefore, modern Jewish money-lenders may not charge a Gentile a higher interest rate than what is fixed by law.38

Islam

The ban on usury in the Islamic faith has been around since Prophet Mohammed’s life, and the Quran reinforces these teachings of Mohammad dating back to 600 AD.39 The Arabic word for usury is riba which translates to “excess or addition.”40 What riba truly means has been a source of struggle in Sharia law, and many Muslims take contradicting positions.41

The Quran forbids riba in four separate revelations.42 The first revelation states, “[t]hat which you give as riba to increase the people’s wealth increases not with God; but that which you give is charity, seeking the goodwill of God, multiplies manifold.”43 This revelation stresses that riba benefits an individual instead of benefitting society as a whole, but it does not outright forbid riba.44

The second revelation uses harsher language to show a stronger stance against riba. The second revelation states, “[a]nd for their taking riba, even though it was forbidden for them, and

34 Wayne A.M. Visser supra note 30.
35 Id.
37 Id.
38 Id.
40 Id.
43 Surah Ar-Rum 30:39
44 M. Umer Chapra, supra note 42.
their wrongful appropriation of other people’s property. We have prepared for those among them who reject faith a grievous punishment.”45

The third revelation iterates, “O believers, take not doubled and redoubled riba, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy.”46 Early commentators of the Quran, al-Tabari (d. 923 A.D.), Zamakhshari (d. 1144 A.D.) and Ibn Kathir (d. 1373 A.D.) argued that the Quran’s interpretation of riba actually meant Riba-al-Jahiliya (usury practiced in pre-Islamic times) and did not include all forms of interest.47 During this time, if a borrower could not pay back his original loan, the lender would extend the loan a year, but double the amount that the borrower owed.48 If at the end of the second year, the borrower had yet to pay, the lender would double the amount the lender owed from the combination of the first and second year easily quadrupling the amount the borrower owed.49 The third revelation supports the view that riba-al-Jahiliya is forbidden by the Quran. However, many Muslims believe that it is not the only form of riba banned.

Several Hadith (narrations written describing the words and actions of Muhammad that act as a guide for Muslims in the Islamic faith) urge against the practice of riba.50 However, Sharia law does allow trade, but Muslims must not commit riba al-fadl.51

Riba al-fadl refers to “all excess over what is justified by the counter-value” in trade.52 Sharia law allows trade, but one cannot benefit in excess from trade.53 Muhammad provided four examples of riba al-fadl: (1) exploiting others through unfair means such as rigging an auction; (2) accepting a kickback for a referral; (3) bartering; and (4) exchanging similar commodities for different weights hand to hand.54 One exception to riba al-fadl does exist.55

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45 Surah al-Nisa’ 4:161 (emphasis added).
47 M. Raquibuz Zaman, Usury (Riba) and the place of bank interest in Islamic banking and finance, 6 Int’l J. Banking & Fin. 1, 3 (2008).
48 Id.
49 Id.
50 M. Umer Chapra, supra note 42.
51 Id.
52 Id.
53 Id.
54 Id.
55 Id.
long as the counter-values are of different commodities, all Muslim jurists agree that the parties can make their own terms of exchange. However, many modern Muslim jurists believe that treating currency as a commodity is strictly prohibited by Sharia law.

Finally, the fourth revelation, adamantly denounces all practices of *riba*:

“That those who benefit from *riba* shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say ‘Trade is like riba’ while God has permitted trade and forbidden riba. Hence those who have received the admonition from their Lord and desist may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of fire and abide therein forever.”

Some scholars believe Sharia law and the fourth Revelation of the Quran prohibit *riba al-nasía* or *riba* in delay, which basically translates to interest on a loan. There is no distinction between excessive and simple interest. It is all prohibited. This prohibition of interest on a loan and the strong language of the fourth revelation leads many Muslims to eradicate all forms of interest from their lives which has led to the creation and growth of Islamic finance.

**Islamic Finance**

Practitioners of the Islamic faith use different financial products to compete in today’s financial market, but still remain Sharia compliant. These include: (1) contracts of partnership; (2) contracts of exchange; and (3) contracts of safety.

**Contracts of Partnership**

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56 M. Umer Chapra, * supra* note 42.
57 Id.
58 Surah Al-Baqarah 2:275.
60 Id.
61 Id.
These contracts allow two or more parties to share both risk and return and develop wealth.

*Mudaraba*

*Mudaraba* translates loosely to profit and loss contract. However, there is no loss sharing in a *mudaraba* contract. *Mudaraba*, a trust financing contract, allows an investor to invest wealth in a fund manager. The financier is known as a *rabal-maal* while the fund manager is known as the *mudarib*. In order to make the contract Sharia compliant, the parties share the profit. However if there is loss, the investor bears the entire loss, while the fund manager loses his time and effort that he put into the fund. Some characterize the *mudaraba* as the “sleeping partnership,” because the *rabal-maal* does not have discretion on how the *mudarib* manages the capital. However, the *rabal-maal* may put conditions on his financing that ensures efficient money management.

This contract is commonly used by Islamic banks. The Bank acts as the *rabal-maal*, or the person providing the infusion of capital, and another party acts as the *mudarib*, or the person managing the business. If there are losses that the *mudarib* did not negligently cause, the losses fall on the Islamic bank who in turn passes the loss to the depositors.

The bank can also act as *mudarib*, because individuals can provide the bank with capital. Then the bank can be charged with investing the money for the benefit of the *rabal-maal*, the customer who provided the funds.

*Musharaka*

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65 Id.
66 Id.
67 Id.
68 Id.
69 Id.
70 Mudarabah on Shari’ah Ruling, supra note 64.
71 Id.
72 Id.
73 Id.
74 Id.
75 Id.
76 Mudarabah on Shari’ah Ruling, supra note 64.
Translated literally, *Musharaka* means sharing.\(^{77}\) Under Sharia law, a *musharaka* is a contract between two individuals who agree to share the profits in a specified ratio while also agreeing to share the losses to the same ratio.\(^{78}\) This arrangement can be constructed in one of two ways. A broad partnership where both individuals have the right to manage the business, and both parties share in liability like a general partnership.\(^{79}\) Or a more limited liability version exists where the parties can contribute to a capital fund (money, in kind, or labor).\(^{80}\) In this version, the parties are agents, but not guarantors.\(^{81}\)

The *musharaka* is used in Sharia compliant mortgage lending.\(^{82}\) In a *musharaka* mortgage, the bank and the potential homeowner enter into a contract to purchase a home.\(^{83}\) The potential homeowner puts a certain amount down on the home which reflects his percentage of ownership in the property while the bank owns the rest of the property.\(^{84}\) Throughout the lifetime of the contract, the potential homeowner would pay the bank rent for the portion of the home the bank owns while also paying extra to gain more ownership in the home until eventually the potential homeowner owns the home.\(^{85}\)

**Contracts of Exchange**

These three contracts allow for the transfer of a commodity for a commodity, commodity for money, or money for money.\(^{86}\)

*Murabaha*

In a *murabaha* contract, similar to a rent to own arrangement, the bank buys an item from an individual for a predetermined amount over the cost of the item, and then sells it back to the individual in installments.\(^{87}\) The *murabaha* is Sharia compliant, because the bank does not


\(\)\(^{78}\) Id.

\(\)\(^{79}\) Id.

\(\)\(^{80}\) Id.

\(\)\(^{81}\) Id.

\(\)\(^{82}\) Hussain G. Rammal, supra note 77.

\(\)\(^{83}\) Id.

\(\)\(^{84}\) Id.

\(\)\(^{85}\) Id.

\(\)\(^{86}\) Faleel Jamaldeen, supra note 63.

\(\)\(^{87}\) Murabaha, INVESTOPEDIA, (Nov. 4, 2016), http://www.investopedia.com/terms/m/murabaha.asp.
charge *riba*, because the amount over the cost of the item is predetermined.\(^88\) A *murabaha* deal requires two contracts, because it involves two transactions: the bank purchases the item the individual is selling, and then the client agrees to repurchase the good on an installment plan.\(^89\) The major issue for Sharia compliant banks is default, because additional charges may not be imposed after a client misses a due date.\(^90\) To curb willful default, banks blacklist defaulting clients.\(^91\)

*Murabaha* is used in a similar way to the *musharaka* in mortgage lending.\(^92\) In a *murabaha* deal, the consumer alerts the bank on which property he would like to purchase.\(^93\) The bank then in turn goes and purchases the property for the consumer, and sells it to the consumer at a predetermined marked up price.\(^94\) Again, the consumer puts down a deposit which reflects his initial investment in the property.\(^95\) The monthly payment is split into acquisition and profit payments.\(^96\) As the consumer pays monthly, the acquisition balance reduces and the client’s ownership in the home increases.\(^97\)

*Salam*

In a *salam* contract, the seller obliges to supply a specific good to the buyer at a future date, and the buyer pays for the good on the spot in full.\(^98\) This contract creates a moral obligation for the seller to supply the goods promised.\(^99\) Furthermore, the contract cannot be cancelled once signed.\(^100\)

The *salam* contract has been developed over the years as parallel contracts to be used in banking, stock markets, and capital markets.\(^101\) In a parallel *salam*, the bank pays for a

\(^{88}\) **Id.**  
\(^{89}\) **Id.**  
\(^{90}\) **Id.**  
\(^{91}\) **Id.**  
\(^{93}\) **Id.**  
\(^{94}\) **Id.**  
\(^{95}\) **Id.**  
\(^{96}\) **Id.**  
\(^{97}\) **Id.**  
\(^{99}\) **Id.**  
\(^{100}\) **Id.**  
commodity with a future delivery date. The bank then sells that commodity on the same date to another independent person. For this to be Sharia compliant, the second contract cannot be contingent on the first delivery. The contracts must be completely independent of one another.

Istisna

In an *istisna* contract, the Sharia compliant bank can purchase a project under construction, and deliver the finished project on a future date. This contract differs from the *salam* contract mentioned above, because (1) the product that the bank is purchasing has yet to be created, (2) the future delivery date does not have to be fixed; (3) full advance payment is not needed; and (4) this contract can be cancelled if the person creating the product has not yet started manufacturing the product.

Sharia compliant banks have yet again developed a parallel version of the *istisna* contract for the expanding marketplace. In a parallel *istisna*, the bank stands in the place of the manufacturer promising a consumer a product that has yet to be made. Then, the bank goes and finds a manufacturer who will produce the product as they act as the consumer purchasing the product. The contracts will be Sharia compliant if the two contracts are not interdependent. For example, if the manufacturer fails to make the product for the bank, the bank still owes the product to the consumer in the first contract.

*Ijara*

Under the *Ijara* structure, a party leases property to a lessee. An *Ijara* contract can take on the form of or seem similar to an installment lease. Under an *Ijara* contract, a party that owns

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102 Id.
103 Id.
104 Id.
105 Id.
107 Id.
109 Id.
110 Id.
111 Id.
112 Id.
property leases it to another party, but the lessee has the rights to use (and/or occupy) the property. If fixed assets are the subject of the lease, the assets can be returned to the lessor at the end of the lease. In this case, the lease appears to have features similar to an operating lease and only a part asset leased amortizes over the lease term. Alternatively, the parties (lessor and lessee) can agree at the consummation of the transaction for the purchase and sale of the asset at the end of the lease term, in which case the lease takes on the nature of a hire purchase known as *ijara wa iqtina* (literally, lease and ownership). Some Islamic scholars do not approve of this latter arrangement because it may appear to represent or resemble a guaranteed financial return to the lessor at the outset of the transaction, similar to a modern interest-based finance lease.

Some Islamic home finance companies in the U.S. have described a *ijara wa iqtina* as a lease with an option to purchase where a person desiring home ownership selects a property and an independent trust acquires the property and rents it to the home occupant. At the closing of the transaction, the home occupant makes a down payment toward the acquisition price, which may be as low as 30% or as high as the consumer chooses. The consumer’s monthly payments include “rent” and further payments to acquire the property, thereby increasing beneficial rights in the property over time, with acquisition of the property when the sum of the consumer’s payments equals the original purchase price of the home.

**Contracts of Safety**

These contracts allow Sharia compliant banks and consumers to keep their funds safe while still observing their faith and not participating in *riba*.

**Wadia**

Banks use *wadia* contracts much like savings and checking accounts. The consumer contracts with the bank to give the bank money for safekeeping. The bank can charge service charges for the benefit that it provides the consumer, but must give all of the money back upon

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114 Id.
115 Id.
116 ISLAMIC BANKING AND FINANCE 36 (Mondher Bellalah Bellalah & Omar Masood eds., 2013).
117 Id.
demand.118 Also, the bank may use the funds while it is in the bank’s safekeeping.119 If the consumer does not want the bank to use the funds in any way rather the consumer wants the bank to simply hold onto the money, the consumer should use an amanah contract which is similar to the wadia, but the bank has no right to utilize the funds.120

Kafala

The kafala contract works much like a guarantor relationship in modern commercial contracts.121 A third party takes on the liability of a contract someone else entered into, in order to provide protection to the bank.122 If the consumer fails to pay the debt of a contract, the Sharia compliant bank may then collect on this kafala contract.123

Al-Rahn

The al-rahn contract resembles a traditional pawn shop arrangement.124 A consumer gives a piece of property to another to hold as collateral in exchange for money.125 If the consumer cannot pay back his loan, the bank may keep the collateral.126

The al-rahn provides another way to create a Sharia compliant home mortgage.127 In this contract, the financed house serves as the marhun (collateral) to secure the payment obligations to the bank.128 The consumer does not have the ability to sell the home without the bank’s permission.129 However, if the consumer cannot make his payments, the bank has the ability to

118 Id.
119 Id.
120 Id.
122 Id.
123 Id.
125 Id.
126 Id.
127 Id.
128 Id.
129 The Concept of al-Rahn from the Shariah Perspective, supra note 125.
sell the home to satisfy the debts. If there is a surplus from the sale, the bank may only take what is owed to it and give the consumer the remaining.

Other Residential Funding Contracts

Another arrangement that Muslims may use to purchase a home includes “co-op financing.” In co-op financing, a community pools their funds to purchase a home. A cooperative corporation is formed, and the corporation has ownership of the property. The corporation then divvies out shares based upon contribution, and this entitles the contributors to lease a portion of the property.

Finally, a variation that is common in real estate is the shared appreciation mortgage. In this arrangement, in exchange for the down payment or a monthly payment obligation, a non-occupant mortgagee shares in the appreciation of the home at a later date (agreed upon date or the sale of the property).

Although these contracts work in home lending, they do not provide the same rights and incentives as a traditional home mortgage. However, Islamic financial institutions like Guidance Residential have developed mortgage like products for the Muslim community.

Past U.S. Law Review of Islamic Home Finance Structures

In 1997, the Office of the Comptroller of the Currency opined that the U.S. branch of a foreign bank could, under its banking powers, permissibly could enter into transaction that had the form of a lease to own transaction, but the substance of a home finance transaction.

Under this program, a potential home buyer would, as lessee, contract with a seller of property to buy a single family residence and tender a down payment towards the purchase price.
Before funding the remainder of the purchase price, the bank and the lessee will enter into a Net Lease Agreement and a Purchase Agreement. The lessee accepts the property “as is” and the bank, as lessor, will make no representations or warranties regarding the property or its suitability. Then, the bank will supply the remainder of the funds to purchase the property from the seller under the sales contract. The bank has “legal title” to the property and will record its interest in the property in the same manner as it would record a traditional mortgage.

The bank was not going to purchase or maintain an inventory of properties to sell to customers. Instead, the customer will be required to find the property that he or she wishes to purchase and negotiate the terms of the purchase with the seller. The bank also was not going to serve as a real estate broker or agent.

The lease would convey to the lessee occupancy rights in and to the property for a specified number of years. The lease would require that the lessee maintain the property, and pay charges, costs and expenses attributable to the property that an owner or purchaser would ordinarily otherwise pay. Monthly lease payments would be sufficient to cover principal and interest, and pay insurance and property taxes. The lessee would amortize the entire principal by the end of the lease term.

The lessee would automatically become the legal owner of the property upon fulfilling the terms of the lease. Once the lessee pays the final lease installment, the lessee would not have to take any additional steps to acquire title to the property. The purchase agreement would also provide that the lessee could acquire title to the property any time before the expiration of the lease by prepaying the remainder of the purchase price. In case of a material default under the lease, the bank will have remedies against the lessee for nonpayment similar to those available to a lender on a “traditional” nonrecourse mortgage.¹³⁹

The OCC opined that the bank’s proposal was the functional equivalent to or a logical outgrowth of secured lending, and thus was authorized banking activity under the National Bank Act.¹⁴⁰

¹³⁹ Id.
¹⁴⁰ Id.
In an Advisory Opinion issued by the New York Department of Taxation and Finance, the Department held that an assignment of a contract by purchaser of real estate and a “resale” of a property to Purchaser under a certain transaction was not subject to the real estate transfer tax as the transactions were entered into solely to effect and secure a financing of purchaser’s acquisition of the property.\(^{141}\) In this matter, a property "Purchaser" acquires an "Asset" from an "Original Seller," and there is a "Financier" who pays the Original Seller for the Asset. The Purchaser identifies the Asset, but the Financier buys the Asset from Original Seller, and Financier then resells the Asset to Purchaser at the cost paid by the Financier plus an agreed-upon profit. Purchaser’s payment of the resale price may be made at the time of the sale or, subject to agreement with the Financier, in installments over time, or in a lump sum at a future date.\(^{142}\)

**Case Study: Guidance Residential’s Declining Balance Co-Ownership Program**

*The Problems*

All of the different contracts mentioned have been used in Sharia compliant finance for many years, and will continue to be used moving forward. However, the aforementioned contracts fail to provide the same protection from liabilities, the ability to sell on the secondary market, or the tax benefits that a traditional mortgage provides.\(^{143}\) Furthermore, the contracts are cost prohibitive.\(^{144}\)

For example, the lease to own option (*murabaha*) may not provide the same tax deductions that owning or renting the home may provide.\(^{145}\) The renter’s tax deduction may not exist for the consumer, since the consumer arguably does not own the home.\(^{146}\) Furthermore, the rental receipts may be taxed as rental income to the financier, while rental payments are not deductible as qualified residential interest.\(^{147}\) There is also difficulty in selling the securities associated with the home on the secondary market, because the financier holds the title to the

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\(^{142}\) Id.

\(^{143}\) Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, *supra* note 133.

\(^{144}\) Id.

\(^{145}\) Id.

\(^{146}\) Id.

\(^{147}\) Id.
property. Furthermore, holding the title to the property, opens the financier up to additional liabilities and complexities.\textsuperscript{148}

\textit{The Product}

Guidance Residential has addressed these issues, and created a Sharia compliant product that shields the financier from liability while also allowing the financier to sell the securities on the secondary market.\textsuperscript{149} The Declining Balance Co-Ownership Program has been extensively reviewed by a Sharia Supervisory Board comprised of distinguished financial scholars from around the world.\textsuperscript{150} The Board is responsible for “certifying every product to ensure strict adherence to the principles of Sharia.”\textsuperscript{151} From time to time, the Board will issue a fatwa (a ruling on a point of Islamic law given by a recognized authority).\textsuperscript{152} These rulings allow flexibility in creating a product that is similar to a traditional home mortgage while still making sure that the product follows strict Sharia compliance.\textsuperscript{153}

The Declining Balance Co-Ownership program developed by Guidance Residential creates a tenants in common relationship between the consumer and co-owner, each with an undivided interest in the entire property to the extent of the agreement between the parties and each respective share.\textsuperscript{154} The Declining Balance Co-Ownership Program is unique, because technically the financier is a removed party.\textsuperscript{155} With this product, the financier creates an LLC registered in a low-cost jurisdiction, such as Delaware, to become the co-owner of the property.\textsuperscript{156} The LLC can be created by and an affiliate of the financier, or can be a third party, such as a charitable trust.\textsuperscript{157} By creating an LLC, the financier insulates itself from exposure from liabilities created by owning property.\textsuperscript{158} The financier needs to observe and maintain all

\begin{thebibliography}{9}
\bibitem{148} Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, \textit{supra} note 133.
\bibitem{150} Id.
\bibitem{151} Id.
\bibitem{152} Id. See also, \textit{What is a “Fatwa”?}, ABOUTRELIGION, (Nov. 4, 2016), http://islam.about.com/od/law/g/fatwa.htm.
\bibitem{153} \textit{The Declining Balance Co-Ownership Program: An Overview, supra} note 150.
\bibitem{154} Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, \textit{supra} note 133.
\bibitem{155} Id.
\bibitem{156} Id.
\bibitem{157} Id.
\bibitem{158} Id.
\end{thebibliography}
formalities of an LLC to avoid corporate veil piercings, but it protects the financier from the liability that the other aforementioned contracts could not.\textsuperscript{159}

The monthly payments made by the consumer to the co-owner, the LLC, are separated into two parts: the acquisition payment and the profit payment.\textsuperscript{160} The acquisition payment goes toward the consumer’s ownership interest, and these monthly payments theoretically increase the consumer’s ownership interest every month and decreases the co-owner’s interest.\textsuperscript{161} The consumer will receive a statement every year that reflects the amount of ownership the consumer currently holds and the amount of ownership the co-owner currently holds.\textsuperscript{162} The profit payment is made to the co-owner for the benefit of using its portion of the property, much like a rent payment.\textsuperscript{163} However, this payment is based on the secondary market, and can fluctuate much like an interest payment.\textsuperscript{164} These monthly payments would be comparable to a traditional mortgage.\textsuperscript{165}

Once, the consumer obtains one hundred percent ownership, the deed to the property is transferred to the consumer.\textsuperscript{166} The deed can also be transferred if and when the consumer chooses to refinance.\textsuperscript{167}

Funds required to be placed in escrow, such as property taxes and insurance, will preferably be placed in non-interest bearing accounts.\textsuperscript{168} However, US law may require funds to be placed in interest bearing accounts which is strictly forbidden \textit{riba} in Islamic law.\textsuperscript{169} To overcome this issue, the interest accrued in these accounts is separated out, and is given to the consumer as a separate payment.\textsuperscript{170} The consumer, if he wishes to purify the interest received may donate it to a charity.\textsuperscript{171}

\begin{footnotesize}
\begin{enumerate}
\item The Declining Balance Co-Ownership Program: An Overview, supra note 150.
\item Id.
\item Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, supra note 133.
\item The Declining Balance Co-Ownership Program: An Overview, supra note 150.
\item Id.
\item Id.
\item Id.
\item Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, supra note 133.
\item Id.
\item Id.
\item Id.
\end{enumerate}
\end{footnotesize}
Furthermore, in order to be Sharia compliant, the Islamic financial institution cannot charge interest on late payments. However, the Sharia Supervisory Board has approved a fee that covers the expenses involved in pursuing collection of the late payment.

*The Contracts*

At the beginning, the financier and co-owner are generally not involved. However, the financier can provide the consumer with a pre-approval letter much like a standard mortgage lender. Once the consumer finds his home, the financier provides the consumer with a rider to the standard home purchase sales contract that puts the seller of the home on notice that a co-owner will be involved in the purchase of the home. Once the financier receives the application, the financier provides all the standard disclosures that a mortgage lender provides required by federal and state law. These forms may reference an ‘interest rate’ which does not correspond to the Sharia compliant nature of the Declining Balance Co-ownership Program. However, the government has yet to approve modifications to the standard forms, and the lender is required by law to provide these forms. The Sharia Supervisory Board concluded that the disclosures do not modify the Sharia compliant nature of the contract, and the Board issued a fatwa to this effect.

The deed will normally reflect the tenants-in-common ownership structure and reference the Co-Ownership Agreement, discussed further below, with an attached schedule of changing respective ownership percentages as monthly payments are made. However, if transfer taxes make this cost prohibitive, the deed remains in the consumer’s name, and the co-ownership is reflected in the agreements alone.

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172 *The Declining Balance Co-Ownership Program: An Overview, supra* note 150.
173 *Id.*
175 *Id.*
176 *Id.*
177 *The Declining Balance Co-Ownership Program: An Overview, supra* note 150.
178 *Id.*
179 *Id.*
180 *Id.*
181 Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, *supra* note 133.
At closing, the parties, the consumer and the co-owner, the LLC, execute four documents: (1) Co-Ownership Agreement; (2) a consumer’s Obligation to Pay; (3) a Security Instrument; and (4) an Assignment Agreement and Amendment of Security Instrument.183

The Co-Ownership Agreement sets out the respective rights of the co-owner and the consumer in the property.184 The Agreement gives the consumer the sole right to occupy the property, and, where allowed by statute, the consumer agrees to treat the property as his principal residence.185 Also included in this agreement, is the right for the consumer to purchase the co-owner’s interest in the property.186 The buy-out amount reflects the amount the co-owner has spent on the property, and no more.187 This Agreement will also lay out the monthly payment split between an acquisition payment and a profit payment.188 According to Guidance Residential, the consumer pays all of the real and personal property taxes and general assessments levied against the property.189 Sharia law permits this, because the consumer occupies the property, and reaps the benefits that these taxes incur.190

The Obligation to Pay contract lays out the consumer’s responsibilities to make payments, and the terms for making these payments.191 It will also explain the penalties for failing to pay on time, if any, and that the consumer may pre-pay the loan if he chooses.192 This contract also addresses the co-owner’s rights if the consumer defaults.193 A unique feature of the Declining Balance Co-ownership Program that Guidance Residential incorporates is the “non-recourse” clause which protects the consumer’s other assets besides the property from being exposed during foreclosure.194 The Obligation to Pay contract also reflects the fact that this obligation is secured by a Security Instrument.195

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183 Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, supra note 133.
184 Id.
185 Id.
186 Id.
187 Id.
188 Id.
189 The Declining Balance Co-Ownership Program: An Overview, supra note 150.
190 Id.
191 Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, supra note 133.
192 Id.
193 Id.
194 The Declining Balance Co-Ownership Program: An Overview, supra note 150.
195 Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, supra note 133.
The Security Instrument further describe the payment obligations of the consumer, the consumer’s obligations to the property, and the protection of the co-owner.196 Many provisions in this Instrument overlap with the other contracts provided to the consumer.197 This is to protect the co-owner and its later assignee together in a legally enforceable document while also complying with Sharia law.198 The Security Instrument provides that the consumer is required to make payments at certain times and obligated to make certain payments for items, such as taxes, that could take priority over the Security Instrument in the case of default.199 Along those lines, the Security Instrument alerts the consumer that they must clear any liens that take priority over the Security Instrument, except in limited circumstances, much like a conventional mortgage.200 This contract mainly protects the co-owner’s interest in the property by allowing the co-owner to do and pay whatever is reasonable or appropriate to protect the co-owner’s interest in the case of default or abandonment by the consumer.201

Finally, under the Assignment and Amendment Agreement, the “co-owner assigns and transfers to its assignee (i.e., the financier) all of its right, title and interests that it holds as beneficiary under the Security Instrument, and further irrevocably grants and conveys a power of sale in the co-owner’s interest in the property.”202 The Assignment and the Security Instrument will be recorded along with the deed, where applicable.203 Notwithstanding this agreement the co-owner, the LLC, still retains legal title and the indemnity rights as to third party claims concerning liability arising from the use and enjoyment of the property by the consumer.204

This Assignment Agreement allows Guidance Residential to sell the securities from these Co-ownership Agreements on the secondary market, like to Freddie Mac.205 Freddie-Mac creates Sharia-compliant securities, and these securities are offered to Islamic banks and other Islamic capital market participants around the world.206 According to Sharia law, debt cannot be

196 Id.
197 Id.
198 Id.
199 Id.
200 Id.
201 Mohamad L. Hammour, Harvey E. Weiner, & James M. Milano, supra note 133.
202 Id.
203 Id.
204 Id.
205 Id.
206 The Declining Balance Co-Ownership Program: An Overview, supra note 150.
traded for anything other than its value.\footnote{Id.} By constructing the Co-Ownership interest in a way that passes through a deemed interest in the property and the analogous benefits and burdens, while retaining title and indemnity rights in a limited liability co-owner, pricing efficiencies are formed and the co-owner and financier and secondary investors and others are not barred from transferring or otherwise trading their interest in the financed property from a Sharia perspective.\footnote{Id.}

While the Declining Balance Co-Ownership Agreement works in most US markets, Texas provides unique challenges.

**Texas Perspective**

In the past the author has consulted with Texas local counsel revolving around the issue of Sharia compliant finance products. Texas is unique, because of the restrictive nature of Texas’ constitutional homestead and marital property laws, which requires companies who want to implement a similar product to change the structure of the Co-Ownership Agreement. In Texas, the homestead of a family or a single, adult person, is protected from a forced sale except for certain limited encumbrances.\footnote{Texas Constitution, Art. 16, § 50.} The exceptions are liens that are created for the purposes of purchasing or refinancing a homestead, making improvements to or paying taxes on a homestead, owelty of partition, home equity and reverse mortgage loans, and conversion of personal property security interests in manufactured homes to property liens.\footnote{Texas Constitution, Art. 16, § 50(a)(1) – (8).}

Through the author’s contact with local Texas counsel, the author discovered that the Security Instrument executed by the consumer for the benefit of the co-owner, in a similar situation as the product mentioned above, will only create a valid and legally enforceable lien in a portion of the financed property to the extent of the consumer’s economic interest in the financed property (i.e., initially the down payment and then thereafter to the extent of monies advanced for the benefit of the consumer, or monies paid by the consumer at any time to the co-owner). The Assignment of Agreements and Amendment of Security Agreement is viewed by local counsel, who advised the author, as being ineffective under Texas law with respect to

\footnote{Id.}
\footnote{Id.}
\footnote{Texas Constitution, Art. 16, § 50.}
\footnote{Texas Constitution, Art. 16, § 50(a)(1) – (8).}
creating a valid and enforceable lien on the “entire” financed property, because the consumer’s homestead rights will have already attached to both the consumer’s and the co-owner’s undivided interests in the financed property under the terms of the Co-Ownership Agreement and, therefore, the homestead may only be encumbered for constitutionally authorized purposes, mentioned above.

The author and local counsel conferred and ultimately concluded that a vendor’s lien would probably be the most viable option to pursue. In this situation, the seller would retain a vendor’s lien in the warranty deed conveying title to the financed property to the consumer and the co-owner for the full “funding amount” advanced to the seller by the financier at the request of the co-owner, which is then assigned by the seller to the financier in the same warranty deed. A vendor’s lien is a prime lien that secures the indebtedness and is considered to affix to property before the homestead character of the property is created upon delivery of the deed. Creation of the vendor’s lien and its assignment to the lender are recited in the deed instrument itself.

The drawback to this approach is that a debtor-creditor relationship must exist between the co-owner and the financier, whereby the co-owner is obligated to repay the amount of funding advanced by the financier at the co-owner’s request and for its benefit. Although not required, the author and local counsel concluded that the Security Instrument be retained in the transaction. This would provide further evidence of indebtedness and would also allow for non-judicial foreclosure consistent with Texas practice. The consumer, of course, would not be a party to the credit transaction between the co-owner and the financier, and accordingly would be immunized from the debtor-creditor relationship between the co-owner and the financier.

**Conclusion: A Unique Combination of Religion, Contract Law, and Property Law in one Mortgage Lending Product**

Legal scholars have taught common law real property to law students for generations using the analogy of a “bundle of rights.”\(^\text{211}\) Think of it as a bundle of sticks that can be

distributed among individuals in ways to create complex legal relationships, and each stick constitutes a legal right that a person possesses.\textsuperscript{212}

Common law real property rules set the framework with which companies like Guidance Residential may deal within, because there are limitations to what a person can do with property.\textsuperscript{213} The law’s restrictions on the forms of property rights establishes an “optimal standardization” of property rights into a limited number of discrete forms.\textsuperscript{214} Back to the analogy of the bundle of sticks, the law only allows buyers and sellers a limited amount of sticks and within those boundaries contract law allows the parties to divvy the sticks as they see fit.\textsuperscript{215}

A final layer of religious law creates an obstacle that is unique to Sharia compliant finance. It creates a new way that Islamic banks and financial institutions must label and maneuver the “sticks” that they contract for with the client. As discussed in length, riba (interest) is forbidden in Sharia law.\textsuperscript{216} However, in traditional mortgage lending it is not. Therefore, Muslims cannot use the traditional financier-debtor apportioning of the bundle of sticks that has become commonplace in U.S. property law. Instead the Sharia compliant financier starts with a structure that may be seen as analogous to tenants in common.\textsuperscript{217} Tenants in common is a type of shared ownership of property where each owner owns a portion of the property.\textsuperscript{218} This relationship lacks clear separation among the property “sticks” or ownership rights. Instead, it is meant more for two or more people to occupy the whole property as one.\textsuperscript{219} Thus, using the tenants in common relationship structure creates legal complexities, because the financier is not looking to own a home with the purchaser.

This is where contract and real property law play a substantial role in the Sharia compliant mortgage. Contract law can be used to manipulate the bundle of sticks and apportion

\textsuperscript{212} Id.
\textsuperscript{213} Id.
\textsuperscript{215} Jane B. Baron, \textit{supra} note 212.
\textsuperscript{216} M. Umer Chapra, \textit{supra} note 42.
\textsuperscript{217} The Declining Balance Co-Ownership Program: An Overview, \textit{supra} note 150.
\textsuperscript{219} Id.
them among the parties who want to “share” the property.\textsuperscript{220} The tenants in common bundle of sticks provides the opportunity for Muslims to enjoy property ownership without violating their religious law, but this bundle does not lend itself naturally to a lender-purchaser relationship.

Moreover, if one reviews a U.S. residential mortgage, the rights granted to a secured lender include certain rights that derive from or can be seen to be analogous to some of the “bundle of sticks” – the right of entry for inspection, the right to protect the property by making advance for taxes, insurance and to remove other liens, the right to inspect, protect and preserve the property, and the right to collect rents, among others things. In this regard, these rights, otherwise viewed as traditional lender rights under a U.S. residential mortgage, can been seen as an “Indicia of Ownership” under a financing structure designed to be Sharia compliant.

In some jurisdictions, a long term lease is considered to be or held more or less on par with a conveyance in land, while a short term lease is not considered to have the dignity of a conveyance of a fee simple interest.\textsuperscript{221} Nonetheless, both a lease and a deed conveying the full fee are contracts between parties with respect to rights in real property.

The contracts used by companies like Guidance Residential are essential to develop rights and obligations as well as legal positon between the financier, the co-owner, and the consumer.\textsuperscript{222} These contracts specifically portion out the sticks or rights in property in order to create a relationship within a bundle of property rights that are segregated and apportioned for U.S. law, on the one hand, but can be seen and construed as shared cooperatively for purposes of Islamic law. In the end, the relationship between the Sharia compliant financier and the consumer can resemble and mimic a traditional lender-debtor relationship without the traditional labels of debt and interest that come with a lender-debtor relationship as typically defined under U.S. law. Thus, the U.S. law structures that allow and recognize the sale of property at a price, the occupancy of property, and the lease of property, among other things, are similar to precepts under Islamic finance law, and can be utilized to create Sharia compliant home acquisition and financing structures.

\textsuperscript{221} See Md. Code, Real Property § 8-704.
\textsuperscript{222} The Declining Balance Co-Ownership Program: An Overview, supra note 150.
Overview

- Religious History of Usury
- Islamic Finance
- Case Study of Guidance Residential’s Declining Balance Co-Ownership Agreement
- Texas Perspective
- Unique Combination of Property, Contract, and Religious Law
Definition of Usury

Merriam-Webster defines usury as, “interest in excess of a legal rate charged to a borrower for the use of money.”

Religious History of Usury
“You shall not demand interest from your countrymen on a loan of money or of food or of anything else on which interest is usually demanded. You may demand interest from a foreigner, but not from your countryman, so that the Lord, your God, may bless you in all your undertakings on the land you are to enter and occupy.”

Deuteronomy 23:20-21

Catholic Church has flip-flopped on its biblical definition of usury.

- **Pre-Medieval Times**: the Church defined it as uncharitable, but not a sin.
- **Medieval Times**: the Church council defined it as a crime, sin, and something that could deny a Christian a proper burial.
- **16th Century**: Theologians gradually started to accept the idea of charging interest, because of the amount of risk the banker took on when lending money and risk deserved compensation.
- **1745**: Pope Benedict XIV wrote, “entirely just and legitimate reasons arise to demand something over and above the amount due on the contract.”
- **2009**: Pope Benedict XVI wrote, “above all, the intention to do good must not be considered incompatible with the effective capacity to produce goods.”
Judaism

- Jews specialized in money-lending.
- Jewish law allows Jews to lend to Christians, but Judaism made it very clear that Jews should not lend to other Jews unless it was a “free” loan, a loan with no interest.
- Hebrew word for usury: *neshek*
  - Means “bite”
  - No distinction between a small bite or a low rate of interest or a big bite or a high rate of interest.
    - Can’t even say thank you if not usual practice
- Bans usury for the lender AND the borrower AND the witnesses.
- Classified as one of the worst sins.
  - Some rabbis even say selling one’s daughter into slavery was less self-defeating than a usurious deal.

Judaism (cont’d)

- Over time, the *hetter iskah* developed.
  - Permission to form a partnership
  - This allowed a lender to provide a certain amount of money and in exchange the borrower would manage the business, guarantee the lender’s investments against all loss and provide a fixed minimum profit to the lender.
  - The lender and borrower agree to share losses.
    - But this portion of the agreement is made null and void by requiring unobtainable evidence to prove a loss.
- Practice became well established.
  - All interest transactions are freely carried out in Jewish communities just by simply adding to the contract the words *al-pi hetter iskah.*
Islam

- Usury in Arabic is “riba” which translates to “excess or addition.”
- The Quran mentions *riba* in 4 Revelations.
  - First Revelation stresses *riba* benefits an individual instead of benefitting society as a whole, but does not outright forbid *riba*.
  - Second Revelation uses harsher language, and speaks of a grievous punishment for those taking *riba*.
  - Third Revelation forbids *riba-al-Jahiliya*.
    - If a borrower could not pay back his original loan, the lender would extend the loan a year, but double the amount that the borrower owed. If at the end of the second year, the borrower had yet to pay, the lender would double the amount the lender owed from the combination of the first and second year easily quadrupling the amount the borrower owed.

Islam (cont’d)

- Fourth Revelation:
  - “Those who benefit from *riba* shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say ‘Trade is like *riba*’ while God has permitted trade and forbidden *riba*. Hence those who have received the admonition from their Lord and desist may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of fire and abide therein forever.”

- Many Muslims believe and still do that this Revelation of the Quran prohibits *riba-al-nasia* or interest on a loan.
  - No distinction between excessive and simple interest.

- However, it does permit trade, but one must not commit *riba-al-fadl*.
  - *Riba-al-fadl* means “all excess over what is justified by the counter-value” in trade.
Islamic Finance

Contracts of Partnership

- **Mudaraba**
  - Translates loosely to profit and loss contract
  - BUT there is no loss sharing
  - An investor invests wealth in a fund manager.
  - Parties share the profit.
  - Investor bears the entire loss, while the fund manager loses his time and effort he put into the fund.
  - “Sleeping Partnership,” because the financier does not have discretion on how the fund manager manages the capital.
  - Used by Islamic banks
    - Bank can act as the financier for a person managing a business, or as the fund manager for someone who provides the bank capital.

- **Musharaka**
  - Means “sharing”
  - Contract between two individuals who agree to share the profits and losses in a specified ratio.
  - Can be a broad general partnership or a more limited liability partnership
  - Used in Sharia compliant mortgage lending
    - The homeowner puts a certain amount down on the home which reflects his percentage of ownership, and the bank owns the rest.
    - The consumer pays the bank rent for its portion, and pays extra to gain more ownership in the home.
Contracts of Exchange

- **Murabaha**
  - Similar to a rent to own arrangement
  - The bank buys an item from an individual for a predetermined amount over the cost of the item, and then sells it back to the individual in installments.
  - Not considered riba, because the amount over the cost of the item is predetermined.
  - Used in mortgage lending

- **Salam**
  - The seller obliges to supply a specific good to the buyer at a future date, and the buyer pays for the good on the spot in full.
  - Developed as parallel contracts
  - The bank pays for a commodity with a future delivery date. The bank then sells that commodity on the same date to another person.

- **Istisna**
  - Bank purchases a project under construction, and delivers the finished product on a future date.
  - Developed as parallel contracts
  - Bank acts as manufacturer for a consumer, and then goes and finds a manufacturer to produce the product for the consumer.
  - Contracts must be independent.

- **Ijara**
  - Also similar to a lease to own arrangement
  - A party that owns property leases it to another party, but the lessee has the rights to use (and/or occupy) the property
  - Assets can be returned to the lessor at the end of the lease
  - In this case, the lease appears to have features similar to an operating lease and only a part asset leased amortizes over the lease term.
  - Lessor and lessee can agree at the consummation of the transaction for the purchase and sale of the asset at the end of the lease term, in which case the lease takes on the nature of a hire purchase known as *ijara wa iqtina* (literally, lease and ownership).
  - Some Islamic scholars do not approve of this latter arrangement because it may appear to represent or resemble a guaranteed financial return to the lessor at the outset of the transaction, similar to a modern interest-based finance lease.
  - Some Islamic home finance companies in the U.S. have described a *ijara wa iqtina* as a lease with an option to purchase where a person desiring home ownership select a property and an independent trust acquires the property and rents it to the home occupant.
Contracts of Safety

- **Wadia**
  - Much like savings and checking accounts
  - The consumer contracts with the bank to provide safekeeping.
  - Bank charges service charges for the benefits it offers the consumer, and the bank may use the funds while in its charge.

- **Kafala**
  - Guarantor relationship

- **Al-Rahn**
  - Resembles a traditional pawn shop arrangement
    - A consumer gives a piece of property to another to hold as collateral in exchange for money.
  - Used in home mortgage lending
    - The financed house serves as the collateral to secure the payment obligations to the bank.

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U.S. Government Agencies’ Recognition or Opinions on Sharia

- **The OCC**
  - Bank of Kuwait
  - OCC Interpretive Letter #806 (Dec. 1997)

- **New York Department of Taxation**
  - HSBC
  - TSB-A-02(4)R, Real Estate Transfer Tax (July 26, 2002)
Case Study: Guidance Residential’s Declining Balance Co-Ownership Program

- Sharia compliant product that shields the financier from liability while also allowing the financier to sell the securities on the secondary market.
- Extensively reviewed by a Sharia Supervisory Board.
- Creates a tenants in common relationship between a consumer and a co-owner, each with an undivided interest in the entire property.
  - The co-owner is an LLC owned by the financier.
- Consumer makes monthly payments to the co-owner.
  - Split into two parts:
    - Acquisition Payment
      - Goes towards the consumer’s ownership interest
    - Profit Payment
      - Made to the co-owner for the benefit of using its portion of the property, much like a rent payment.
- Islamic institutions cannot charge interest on late payments.
  - Sharia board has approved a fee that covers the expenses of collecting a late payment.
The Contracts

- Co-Ownership Agreement
  - Sets out the respective rights of the co-owner and the consumer in the property
  - Gives the consumer the sole right to occupy the property
  - Lays out the monthly payment split between acquisition and profit payments

- Obligation to Pay
  - Specifies the consumer's responsibilities to make payments, and the terms for making payments
  - Explains the penalties for failing to pay on time, if any, and that the consumer may pre-pay the loan.
  - Addresses the co-owner's rights if the consumer defaults
  - "Non-recourse" clause
  - Reflects that this obligation is secured by a Security Instrument.

- Security Instrument
  - Further describes the payment obligations of the consumer, consumer’s obligation to the property, and the protection of the co-owner.
  - Overlaps with the other contracts
    - Helps protect the co-owner and its later assignee together in a legally enforceable document.

- Assignment Amendment and Amendment of Security Instrument
  - The co-owner assigns and transfers to its assignee (i.e. the financier) all of its rights, title, and interests that it holds as beneficiary under the Security Instrument, and further irrevocably grants and conveys a power of sale in the co-owner's interest in the property.
  - The LLC still retains legal title and the indemnity rights as to third party claims.
Texas Perspective

- Texas Constitution protects the homestead of a family or a single, adult person, from a forced sale except for certain limited encumbrances.
  - Exceptions are liens that are created for the purposes of:
    - Purchasing or refinancing a homestead
    - Making improvements to or paying taxes on a homestead
    - Owelty of partition
    - Home equity and reverse mortgage loans
    - Conversion of personal property security interests in manufactured homes to property liens

- Security Instrument only creates a valid and legally enforceable lien in a portion of the financed property to the extent of the consumer’s economic interest in the financed property.

- Assignment of Agreements and Amendment of Security Agreement is ineffective under Texas law because the consumer’s homestead rights attached under the terms of the Co-Ownership Agreement.
Texas Perspective (cont’d)

- **Solution: Vendor’s Lien**
  - Obtain a vendor’s lien in the warranty deed conveying title to the financed property to the consumer and the co-owner for the full “funding amount.”
  - Vendor’s lien is a prime lien that secures the indebtedness and is considered to affix to the property before the homestead character of the property is created.

- **Problem: creates a debtor-creditor relationship between the co-owner and the financier**
  - Security Instrument should be retained in the transaction.
    - Provides further evidence of indebtedness and provides non-judicial foreclosure consistent with Texas practice.
  - Consumer not a party to the credit transaction, and would be immunized from the debtor-creditor relationship.

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Unique Combination of Property, Contract, and Religious Law.
Unique Combination of Property, Contract, and Religious Law

- Must work within the “bundle of rights” provided by property law.
  - Start with the tenants in common “bundle,” which does not lend itself easily to mortgage lending.
- Use contract law to parcel out the tenants in common bundle within the parameters of Sharia law.
- In the end, the relationship between the Sharia compliant financier and the consumer resembles a traditional lender-debtor relationship without the traditional labels of debt and interest.