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Key Concepts of Islamic Finance

Their Relevance to Consumer Finance Products

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ABSTRACT

The Islamic Cooperative Housing Corporation (ICHC) of Canada is one of the oldest non-banking financial institutions providing the Canadian (and to some degree the American) Muslim communities investment and finance avenues consistent with Islamic principles. Canadian Muslims established the institution 18 years ago with a farsighted vision, and the results to date have been commendable. One of the key products ICHC offers is house financing, which it bases on the *musharaka* concept. Some key concepts of Islamic finance are discussed, as is how ICHC has successfully implemented *musharaka* to provide home financing to Muslims. The track record of the corporation, its present performance, and other financial products offered to the Muslim community in Canada are also covered.

I. INTRODUCTION

Many financial institutions and organizations already operate on an interest-free basis. Some people are trying to find out how they can start such institutions and to learn the underlying principles of an interest-free Islamic finance product. From the Muslim perspective, humans are only trustees of God, the Owner of all that exists. Because humans are responsible for any breaches of the trust that Muslims believe God has placed in them and for any abuse, misuse, and injustice they cause while on earth, in the field of Islamic finance it is important that practitioners understand the fundamental concepts of Islamic finance. Only by starting on the right foot can Islamic financiers end up successful.

One way they can avoid causing wrong or injustice to other parties is to remain conscious of the realities and to have a sense of accountability. Furthermore, they should keep the basic principles of Islamic finance in mind every time they negotiate a transaction or design a product. The cardinal principle, of course, is the prohibition of *riba* (interest). There is no issue on which the Qur'an is more specific than this one: God has declared war upon those who do not shun dealing in interest. The Qur'an clearly condemns all dealings with *riba* as well as participation in and witnessing such transactions. The sayings of the Prophet Muhammad are full of similarly severe warnings.

II. ISLAM AND BUSINESS ETHICS

Despite the clarity of Islamic injunctions on interest, a misconception among Muslims as well as non-Muslims is that "interest-free banking" means using conventional banking while replacing the word "interest" with "profit." However, a conventional bank that makes the simple semantic change from interest to profit does not necessarily become Islamic. Moral and ethical responsibilities are involved as well. For example, a bank may finance a business and later find that its client has run into a genuine problem that makes it difficult for him or her to fulfill the original terms of the contract with the bank. In this case, a compassionate bank should be willing to renegotiate the contract.

While regular businessmen wish to maximize profits, there is a difference between the intentions and behavior of Muslims and non-Muslims in the business world. For instance, Muslims in business believe in acting truthfully and avoiding deception. Ideally, they are also honest and perform their jobs and duties with integrity. Because of the Islamic stress on the hereafter, Muslims may expect blessings and rewards from God in addition to monetary profit. Similarly, an awareness of the social and environmental effects of actions may weigh more heavily on Muslims than on others in business. Muslim businessmen, therefore, have an added responsibility: in addition to maximizing profit, they must be aware of the requirements of their religion.

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III. Islamic Finance

Islamic finance, consequently, consists of more than removal of the word "interest." It is based on Islamic norms such as morality, fairness, reasonableness, and justice. To an Islamic financial institution, social responsibility to the community should be more important than maximizing the return on investments. Islamic finance also involves a willingness to share the consequences: participants may reap gains as well as bear losses according to a pre-determined ratio. Therefore, an honest intention to take responsibility is the cornerstone of any Islamic business deal. A description of the four most common interest-free financing models, based on the above principles and on the *Shari'ah*, follows.

A. *Ijara*

Ijara, or leasing, is very common in the conventional financial system. The main difference between Islamic and conventional leasing involves the determination of the lease cost or rental. In conventional leases, the prevailing interest rate is used to determine the lease payments, while in Islamic finance they are determined by the profitability of the underlying product. For instance, the Islamic Cooperative Housing Corporation (ICHC) of Canada financed a chicken slaughterhouse in which the key issue was the determination of the profit shares of the financed party (lessee) and ICHC. Because the abattoir's profit depended on the number of chickens in the slaughterhouse and the volume of sales, it and ICHC agreed that the profit would be linked to the number of chickens slaughtered. The lessee would pay more to the lessor if it used more equipment (i.e., killed more chickens), and vice versa. This experience provides one example of how a business and an Islamic financial institution can comply with the concept of sharing, which is one of the key elements of Islamic commercial law.

B. *Murabaha*

Islamic financial institutions commonly use *murabaha*, or installment purchase. *Murabaha* is simple and easy to structure, but has limitations when long-term financing is considered because once the installment period is fixed, it cannot be changed. Neither can there be a discount for paying an installment early. For instance, a *murabaha* contract for a house purchase can not be modified or annulled once entered into. A house buyer cannot always be expected to complete the contract in 2-5 years; it may take 10-15 years to do so. If the client's job moves to another city or family outgrows the original house, he or she is stuck. Although limitations such as these make *murabaha* impractical for housing finance, Muslims have flexible alternatives such as *musharaka*.

C. *Musharaka*

Musharaka, or partnership financing, is a well-known concept, especially in Islamic finance. A *musharaka* contract, unlike a *murabaha* one, can have a fixed or flexible term: mutual agreement between the parties decides this and the profit- and loss-sharing ratio.

In Toronto, ICHC adopted the *musharaka* model to incorporate a housing cooperative 18 years ago. It started with US$17,000 from the local community, which promised to participate in a program through which it could purchase houses without interest. Although this group could more easily have banded together to help itself only, it chose to set up an institution that would serve others as well. ICHC initially consisted of 7 voluntary members. Today, it employs a professional staff of 5 people.

D. *Mudaraba*

Mudaraba (labor- and capital-partnership) is similar to *musharaka*. The difference between the two is that in *mudaraba* one party contributes labor, the other capital. The capital provider bears the loss in case it occurs, while the labor provider loses his or her opportunity cost only.

IV. ICHC's Housing Finance Model

The housing finance product of ICHC is formed on a decreasing partnership concept. A member of the cooperative initially contributes a fraction, such as 20%, of the value of the house he or she would like to purchase. The coop contributes the remaining portion of the required capital. After the prospective member has chosen the desired house, which may be anywhere in Canada, he or she and the coop determine the rental value of the house. The new member pays rent on the newly purchased home in proportion to the coop's equity ownership. Members are free to increase their equity at any time, and the rent decreases as a member's equity increases and the coop's ownership decreases.

A. Categories of Members

Coop members are motivated by several reasons and fall into several categories. Some members initially purchased houses through conventional (interest-based) mortgages and later approached the coop to convert their home financing to extricate themselves from interest. The coop also provides an opportunity to members to invest in interest-free institutions and earn Islamically acceptable income in the form of dividends from the rental income of the coop. Some parents have made their children members so the latter can save money they earn while off school, invest it, and in the future use it for educational or housing expenses. Several Islamic centers are also members of ICHC.

B. Commitments of Members

Members are required to pay US$75 to join and must buy, every year, at least 6 shares in the coop at $100 each. To qualify to buy a house, members must put up a minimum of 20% for the first $100,000 of the home price and 40% of the next $100,000. By the time the member owns 100% of the home, it is appraised and the gain or loss is shared between the buyer and coop. The coop is akin to a sleeping partner, as individual owners maintain the property they have stakes in. Therefore, if the property appreciates, the coop takes only 10% of the net gain; the remaining 90% remains with the owners. If the property depreciates compared to its original price, the coop takes 90% of the loss; the owner bears only 10%.

C. The Growth of ICHC

ICHC began with 16 members in 1980 and had 1700 members by 1998. Although they are spread across Canada, the vast majority is in Ontario. Foreign members are in the United States and elsewhere. Several North American communities have copied ICHC's housing finance model, including Montreal, New Jersey/New York, St. Louis, and San Francisco. As of 1998, the coop's assets were over $23 million and the total number of housing units purchased stood at 288. Rental income for 1996 passed the $1 million mark. The coop restricts itself to spending no more than 20% of rental income on operating expenses; the remaining income is a dividend to shareholders, investors, and members who are investors and are waiting to qualify to buy a house. Members received a $6 per share (6%) dividend in 1986. The dividend was as high as $10 per share at one time. In 1997, ICHC declared a dividend of $7 per share. The coop has expanded beyond its original domain of housing finance into car-purchase plans and interest-free retirement saving. ICHC has also financed a retail plaza and the purchase of business equipment, health care, a medical building, and a walk-in medical clinic. A deal involving a rehabilitation center is in progress.

V. CONCLUSION

Although Islamic law provides various mechanisms that can be used as financing vehicles, realistically there are only two modes of Islamic finance: *musharaka* and *mudaraba*. Both allow individuals to participate through labor, money, or both in *halal* business ventures to generate profit on their investments. Losses are also shared according to the contract signed between the parties. ICHC has successfully implemented the *musharaka* concept in providing a housing finance facility to Muslims in Canada and the United States. The company's track record to date is clear evidence that a process based on a simple Islamic finance concept can work efficiently in the current environment and regulatory framework of Canada. ICHC's concept has already been a model for similar organizations in the U.S. and Britain. This will assist not only today's Muslims, but those of future generations as well.