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LARIBA (Islamic) Mortgage Financing in the United States

Providing an Alternative to Traditional Mortgages

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ABSTRACT

This paper describes LARIBA mortgage financing and proposes a model for its viability and success in the United States. It can only be successful if marketed at the local grassroots level to the estimated initial market of 7,500 households requiring about US$200 million of financing. Modeled as an alternative to traditional mortgages, LARIBA is a *halal* paradigm consisting of two parts. First, the equity stake is repurchased from the LARIBA financier by repaying the amount put forth to assist the buyer with the purchase. Second, payment is made to the LARIBA financier for leasing the portion of the home not yet owned by the buyer during the repayment period. LARIBA frees the buyer from debt much sooner than the traditional model. The LARIBA model not only complies with existing law in the United States, it will actually be more successful as a result of the strict regulation of the industry.

I. INTRODUCTION

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 both 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 owns a house makes the citizen proud of his citizenship, deepens the feeling of belonging to the country and enhances real estate values in general as owners strive to beautify their owned properties through continual maintenance and improvement. Finally, owning a home strengthens the feeling of responsibility toward the citizens' own families and the community at large.

Accordingly, major economic policies in developed nations have been designed to 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 catalysts in the promotion and facilitation of owning a home.[i] In fact one of the important parameters used by the Federal Reserve System, (the Fed) in its decisions regarding interest rate and monetary policy is the anticipated impact on the housing industry.

Finally, in an effort to encourage Americans to own homes through mortgage financing, the U.S. 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 describes how LARIBA financing is a viable option in the strengthening of civil society.

II. HOME MORTGAGES IN THE UNITED STATES

Approximately 66% of the residential properties in the United States are owner occupied. They represent about US$7 trillion in value. Mortgage payments are the biggest monthly liability of a typical American household. A typical homebuyer borrows up to 85 to 90% of the purchase price of a home for 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 long before the end of the 30-year term. California Home Financing Association statistics on the characteristics of homebuyers and sellers in California in 1996 indicate that the average number of years of ownership of a particular 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. As interest rates have continued to decline in the past two years many homeowners have refinanced their homes more than once.

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III. THE AMERICAN MUSLIM COMMUNITY AND LARIBA (ISLAMIC) FINANCING

The American Muslim Council (AMC) estimated that the population of Muslims in the United States ranges between 5 and 8 million.[ii] In the United States, California has the largest Muslim population with at least 1,200,000 Muslims, followed by New York (4.7% of total state population), Illinois (3.6%), New Jersey (2.5%) and Indiana (3.2%). There are also significant Muslim communities living in Michigan, Virginia, Texas, Ohio, and Maryland.

Most of the Muslims in the United States have been integrated in the *ribawi* conventional banking system prevailing in the United States, including interest-based FDIC insured deposits in banks, loans or mortgages, credit cards as a source of long-term *riba*-based credit or take home equity *riba*-based lines of credit. *Fatawa* (Islamic legal opinions) based on Muslims being a minority and/or that *riba* is usury and not interest have been used by many community leaders to justify *riba*. Most affluent and upper middle class members of the community have become accustomed to the *riba* system.

For an emerging alternative system to prevail and succeed is a very difficult battle. Unless an individual is motivated deeply by the strict adherence to the Qur'an, *Sunna*, and *Shari'ah*, it is almost impossible to capture people's interest and imagination.

In all fairness, based on first hand experience and an in-depth knowledge of the grassroots level of the community, a large portion of Muslim middle-class households has accepted *riba* mortgages against its will. Many of these households would convert to LARIBA if available in a competitive manner. 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 available to them are morally objectionable or economically unfeasible.

IV. LARIBA (ISLAMIC) MORTGAGES: THE MARKET

The first and foremost market segment is the small minority of American Muslims who refuse 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.[iii]

It is estimated that 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 *Shari'ah*, then the number of households drops to 150,000. If we further assume that 5 to 10% of this number are "LARIBA Puritans" dedicated to deal only in LARIBA, then the number of households which are in need of LARIBA financing is estimated to be between 7,500 to 15,000 households.

The profile of this market segment is unique. In particular, such households tend to have the following characteristics:

1. They are extremely pious;
2. They typically run a cash-only household;
3. They use the banks for safe deposits of fund and refuse to accept money market interest;
4. They carry no debt;
5. They fulfill their obligations;
6. They are extremely particular about the details of *halal* and *haram*;
7. They are devout members of the community.

These individuals can only be recognized if LARIBA (Islamic) bankers are true community workers at the grassroots level.

The median house price varies from state to state. It is estimated to be $250,000 in California and $120,000 in Texas. For purposes of this paper, we will use an average of $150,000. If we assume that 70% of the value of the home is to be financed using LARIBA (Islamic) mortgage, the mortgage would be $105,000. For a market of 7,500 households, it is estimated that the primary market size for LARIBA mortgages would then 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, we expect the concept of LARIBA mortgages to grow significantly to attract members of the middle class through refinancing, non-Muslims who are attracted to the concept and a new generation of youth that is more sophisticated in evaluating alternative mortgage concepts.

V. The LARIBA Lease Purchase Model

The LARIBA model consists of two parts:

A. Part I

The first part 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, with LARIBA becoming 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.

B. Part II

The second part of the LARIBA model is the leasing of the house. The client agrees to lease the house for a period of 60 months, to run concurrent with the term of the payback. The lease is estimated based upon 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.

VI. The Strategic Approach to LARIBA (Islamic) Mortgages

A. The Need for Grassroots Community Involvement

The primary market segment for LARIBA mortgages is large from the perspective of the American Muslim community, but $200 million is a "drop in the bucket" by American banking and financing standards. LARIBA (Islamic) banking and financing system does not yet have a proven track record in the United States. This requires that we rely upon localized grassroots community efforts at every community center.

B. The Law

When dealing with banking and financing matters in the United States, strict adherence to the letter of the law is required. Toying with financial, securities, and banking laws of America can be dangerous, with swift and irreversible punishment. Conversely, many components of the American system represent years of human experience that should not be thrown away. 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. Furthermore, the American financial, monetary and banking system is the most sophisticated and reliable in the world. Our efforts should concentrate on providing an alternative to that system, not a substitute. The reliability of the proposed alternative system is, in fact, enhanced by the tried and proven regulatory and legal system of America.

C. Matching the Competition

To be successful, LARIBA must provide a product that competes in the free market place equal to, if not better than, the traditional mortgage. Title and ownership should be given to the buyer without delay. 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 line with the monthly apartment or house rent they are already paying. The terms of the LARIBA mortgage (5 to 8 years), being much shorter than that of the traditional mortgage (15 to 30 years), require explanation, with the pros and cons discussed in great detail. The administration and processing fees incurred in a LARIBA contract should be contrasted with 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 a traditional mortgage. Most importantly, the LARIBA Puritan homebuyer should not be punished by not being able to deduct the implied interest as done in traditional mortgages. A letter from the IRS may be a good incentive but not sufficient in comparison to the announced policies of mortgage-interest deductions.

D. Marketing Approach

The marketing of LARIBA services, in general, and mortgages, in particular, cannot follow traditional marketing paradigms. At this stage of its product life it is a specialized product targeted toward meeting the needs of 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 do not believe in associating a time value with money. The LARIBA system focuses on serving local mosques (and later on churches and synagogues) in order to achieve adequate community penetration. This approach allows LARIBA officers to perform better due diligence and reduces costs as the percentage of non-performing loans approaches a negligible level. In its effort to promote its basic concepts, the LARIBA mortgage organization relies on personal contacts, recommendations of the leaders and active members of the community and, of course, all of the required due diligence tools of credit checking, salary confirmation, references, tax returns and financial statements. As a consequence, the major source of business eventually becomes referrals based on real experiences.

E. Education

Educating the public using simple and understandable language with facts about LARIBA versus traditional mortgages is a must. 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 equities of approximately 10%. 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 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 start a family needs to be explained to the community. These investments can be used to finance the mortgages of today and benefit future generations. All of these factors will bind the community together, increase mutual trust, and help in the economic development of the community.

VII. Conclusion

LARIBA financing offers many benefits for civil society and community in a world where many are excluded from credit and finance. Although there are initial concerns about the viability of LARIBA mortgage financing, if done strategically, even while satisfying the laws of the *Shari'ah* as well as those of the United States, LARIBA financing is a viable option. In order to reduce the risk of investment, LARIBA financing requires active involvement with local communities on the grassroots level. This will allow financing officers to gain insight into the reliability of individuals not found in traditional forms of due diligence.

Traditional mortgages lasting between 15 and 30 years may offer the buyer easier monthly payment, but they also serve to deepen the debt of clients. It is the responsibility of LARIBA bankers to counter this trend and rid their clients of debt in order that they may live freely. The LARIBA model helps pay off debt much faster, matching the lifestyle of contemporary America where families change residences every 5 to 8 years. Not only are LARIBA mortgages viable in the United States, they are actually *most likely* to be successful under the protection and scrutiny of the American banking, monetary, and financial laws.

[i] 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)

[ii] From a popular survey published in December, 1992.

[iii] 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.