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Opening Doors for Muslim Families in America

Saber Salam*

ABSTRACT

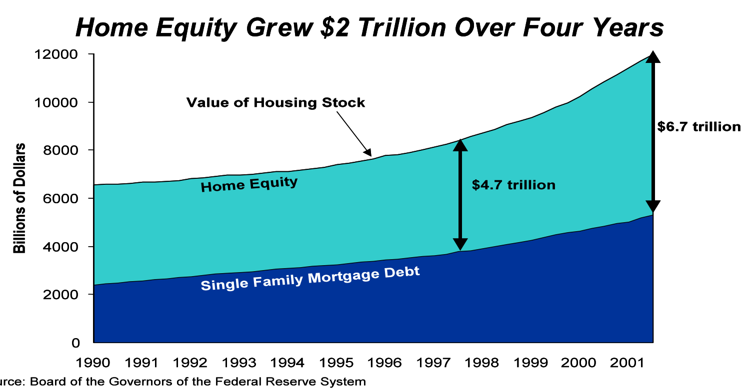
Although home ownership is central to the American way of life, as it facilitates wealth accumulation and builds strong and vibrant communities, opportunities for American Muslim families have been very limited. Most observant Muslims purchase homes through family savings, financing from individual investors, cooperatives organized by communities, or the handful of financial institutions providing financing through portfolio lending. The lack of steady capital flows combined with the expense of alternative financing modes make it prohibitively expensive for *riba*-avoiding Muslim families in America to realize the dream of homeownership. Although the home-financing system in the United States is among the most progressive in the world, structuring contracts that are both compliant with Islamic standards and compatible with U.S. home financing regulations is a difficult task. In addition, the secondary markets central to providing a steady flow of low-cost financing are not being fully employed. In March 2001, Freddie Mac entered the market to facilitate the flow of low-cost financing available through secondary markets. Key areas of focus for Freddie Mac include product development, providing a steady flow of capital by purchasing home financing contracts from Muslim homebuyers, and approving new Freddie Mac Sellers/Servicers that specialize in providing financing to Muslim consumers in the U.S.

I. INTRODUCTION

While the dream of homeownership remains one of the core values of American society, there is a growing segment of our society that will require innovative thinking to realize this dream. For devoted Muslims, financing a home presents a unique challenge as they strive to avoid interest-based mortgages.

Homeownership is one of the primary methods by which American families accumulate wealth. Over 68% of American families own their own homes. The pride of owning a home and the opportunity to build wealth through appreciation and federal tax incentives explains why housing drove an estimated 40% of annual economic growth in 2001. As figure 1 illustrates, America's homeowners have seen over $2 trillion dollars in-house price appreciation since 1998.

FIGURE 1

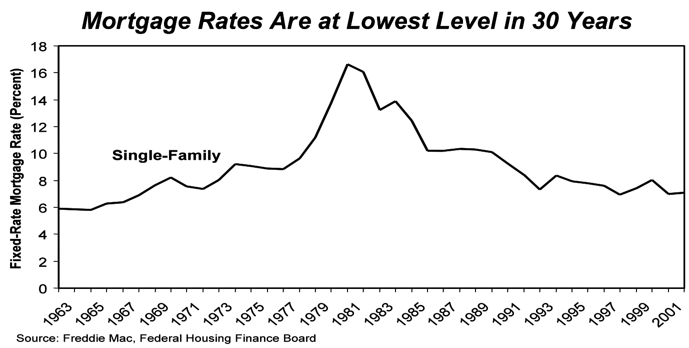


* Vice President, Freddie Mac, McLean, Va.

II. HOME FINANCING OUTLOOK

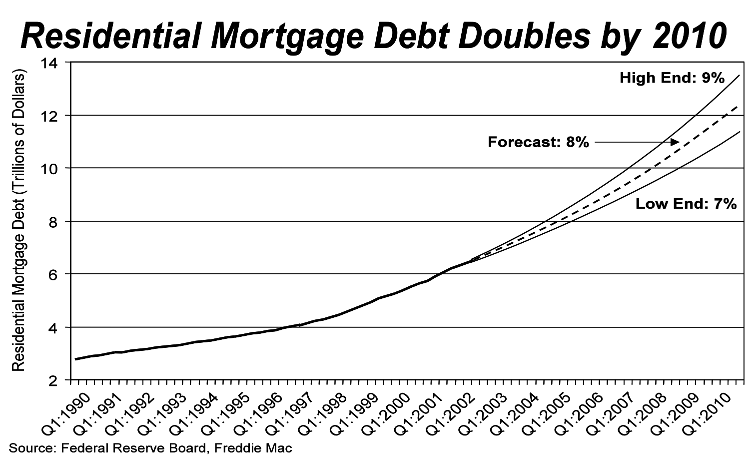
Not surprisingly, the mortgage finance industry has seen record originations over the past 24 months; 2001 set a record with $2.1 trillion in originations, of which 57% were refinances. In addition to lowering the cost of housing related expenses, these refinances enabled consumers to tap into their home equity to finance home improvement, automobiles, and college education and to consolidate consumer debt. Single-family mortgage rates are now at a 30-year low (figure 2).

FIGURE 2



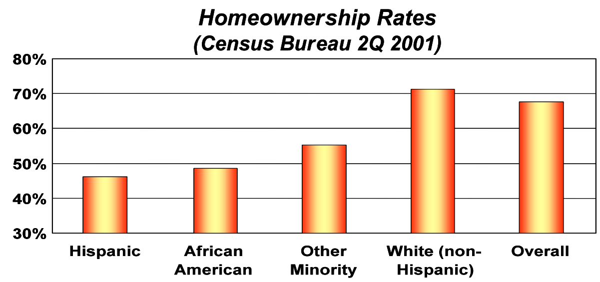
The outlook for mortgage origination continues to be very strong in the coming decade. The Federal Reserve Board and Freddie Mac expect the mortgage finance market to double from about $5.5 trillion to $11 trillion by 2010. The factors driving this growth include: 1) growth in the number of households, 2) house price appreciation, 3) growth in the overall homeownership rate in the United States, and 4) better leveraging of housing debt by consumers. Taken together, the Residential Mortgage Debt Market is likely to grow by an annual rate of 8% in the coming decade as seen in figure 3.

FIGURE 3



A significant portion of the growth in homeownership is expected to come from minority communities. Although the national homeownership rate is 68%, homeownership rates among minority and immigrant families lag by about 20% compared to non-minorities in the United States. The homeownership rate is even lower among Hispanics and African-Americans, as seen in figure 4.

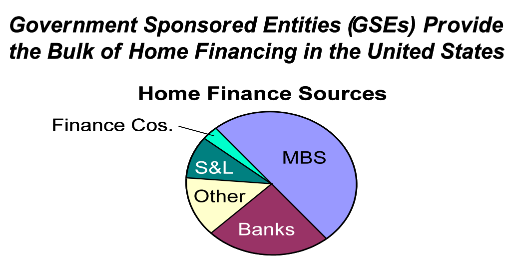
FIGURE 4



A. Home Financing Structure

The United States home financing process is among the most progressive in the world. As shown in figure 5, secondary markets finance more than 50% of homes in the United States, more than any other country. Banks and mortgage lenders play the traditional role of sourcing borrowers, processing, underwriting, closing, and servicing loans in collaboration with the capital markets. The capital markets in turn auction mortgage-backed securities to individual and institutional investors to attract capital for the home financing industry in the United States. Three Government Sponsored Entities (GSE's), Freddie Mac, Fannie Mae and Ginnie Mae, facilitate the securitization of mortgages. This process, known as MBS mortgage-backed securitization (MBS), has created significant liquidity for the home financing industry. In addition, the process enables banks to recover their capital from home financing while maintaining their relationships with consumers. From a consumer's prospective, the availability of abundant low cost financing has enabled them to finance their homes using 30-year repayment terms.

FIGURE 5



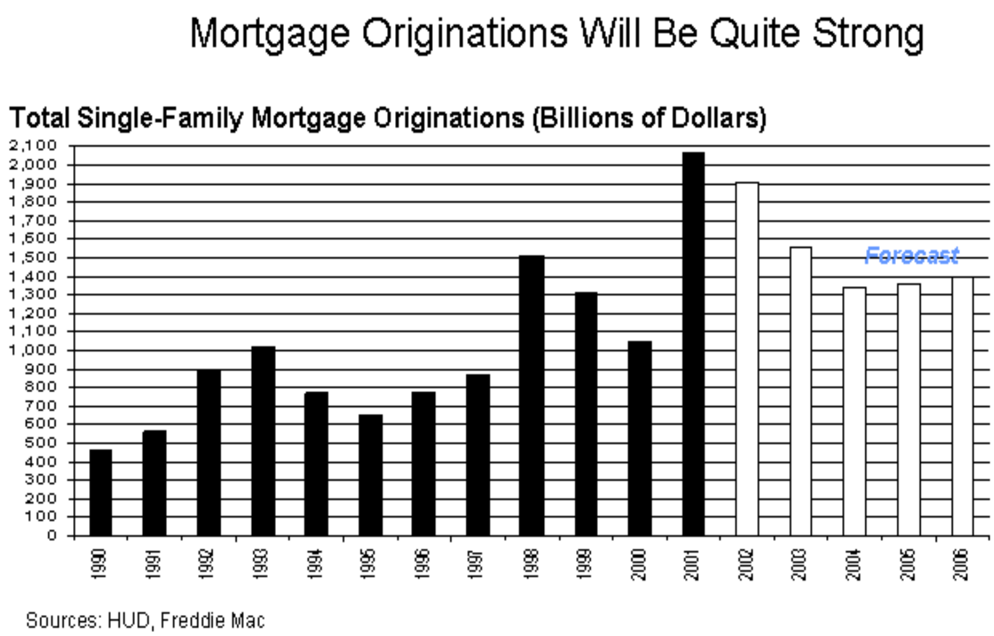
B. Industry Structure and Outlook

The mortgage industry has continued to be one of the very few bright spots in the economy over the past 18 months. In addition to lower rates which have enabled consumers to refinance their mortgage debt and reduce their monthly housing expenses, American families have also been able to leverage the appreciation of their homes to consolidate higher cost debt and other expenses. Furthermore, house price appreciation and lower financing costs have created a strong demand for new homes and sales of existing homes.

The mortgage industry has responded to this increased demand by adding both origination and servicing capacity. On the origination side, which is typically more labor-intensive, a record number of loans are originated, underwritten, processed and closed by mortgage brokers, mortgage bankers, credit unions, community lenders, and national banks. The cost of entry in the origination business is relatively low thereby allowing many originators to enter the business with fairly modest investments. On the servicing side of the business, we see continued consolidation. Servicing, which requires substantial investments in systems, people, and infrastructure, has created an opportunity for large, national, primarily bank-owned mortgage companies to thrive because of their scale operations and risk management expertise.

During 2001, the mortgage origination market totaled a record $2.1 trillion. Of this, approximately 57% of the mortgages originated were refinances. The current mortgage finance rates in 2002 are at a 32-year low thereby creating an opportunity for a bigger mortgage origination market than in 2001. Both Housing and Urban Development and Freddie Mac continue to project a strong home financing market in the coming years as illustrated in figure 6.

FIGURE 6

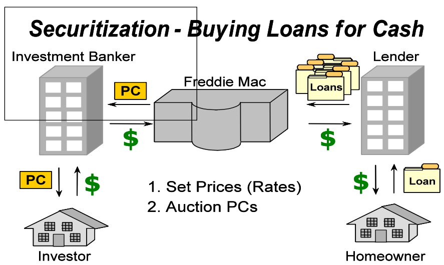


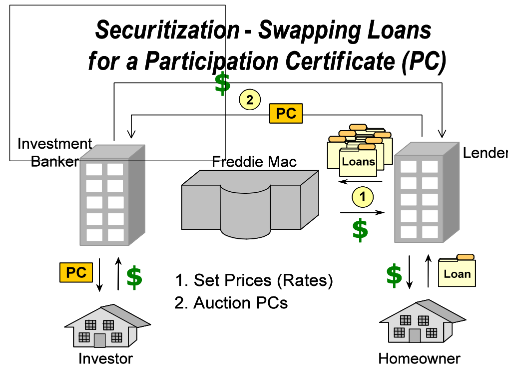
C. The Role of Freddie Mac

Congress chartered Freddie Mac in 1970 to facilitate the steady flow of mortgage financing capital to the mortgage market. Freddie Mac enables banks and mortgage companies to originate mortgage assets for sale in the secondary market. In 1989 Freddie Mac became a publicly owned company whose stock is listed in the New York Stock Exchange (FRE).

Freddie Mac does not lend money directly to consumers but rather guarantees the performance of Mortgage-Backed Securities (MBS) against credit risk. Freddie Mac is also an investor in mortgages and MBS's. It finances its investment in mortgage instruments by raising capital both domestically and internationally. Freddie Mac's major business areas include the financing of home loans through its Single Family Unit, financing of multifamily complexes through its Multifamily Unit, and investment in mortgage assets through its Funding & Investment Unit. The Single Family unit at Freddie Mac offers two main models for mortgage securitization as illustrated in figure 7. The first one involves lender's closing the mortgages in their own name and then selling their assets to Freddie Mac through Freddie Mac's Cash Window. Freddie Mac then determines whether to keep all or a portion of these mortgages in its investment portfolio and to sell portions of these mortgages in the secondary market by issuing MBS. Approximately 15% of sales to Freddie Mac come through cash transactions. Alternatively, a bank or mortgage company that is an approved Seller/Servicer of Freddie Mac can sell MBS directly to the secondary market on behalf of Freddie Mac, based on terms approved by Freddie Mac. Approximately 85% of Freddie Mac's business is done using this approach.

FIGURE 7





III. ISLAMIC MORTGAGE INITIATIVE

So what does this mean for observant Muslims who are forbidden to pay or receive interest by religious law? Until recently, America's housing finance system really did not work for them. As a result, the demand for home financing alternatives for Muslim families far exceeds the capital available to the Muslim community. Many of the home-financing options for devout Muslims are available through limited access to capital from portfolio lenders and/or community-related investor groups. This lack of access to capital is limiting the potential for Muslim families to own homes and accumulate wealth through house price appreciation.

Recognizing the need to expand homeownership opportunities in this underserved market, Freddie Mac began seeking out organizations that were in a position to help meet the home financing needs of Muslim families. Freddie Mac's role in the process is to collaborate with companies that are financing homes in the Muslim community and to develop products that are eligible for sale in the secondary market. Once this is done, these organizations have the ability to make home-financing available to Muslim families and then sell the financing contracts to Freddie Mac and recoup their capital. The result is a constant flow of capital for financing more homes for Muslim families.

Freddie Mac is pursuing a two-pronged approach. First, it is helping to identify products that can be sold in the secondary market. Second, it is approving new Seller/Servicers that have the experience with Muslim homebuyers to better connect the financing needs of Muslim families with the financing structures needed to do business with Freddie Mac.

This process started in March of 2001 when Freddie Mac financed a $1 million pool of Muslim home financing contracts for a single company. As of March 2002, Freddie Mac has approved two additional mortgage finance companies, three more financing structures, and more than $45 million worth of home financing contracts for Muslim families in the United States. We are forecasting over $100 million in financing contracts for Muslim families in the calendar year 2002.

Some of the opportunities that we see in the Muslim market include: 1) standardization of home financing contracts that simultaneously conform to Muslim religious requirements and United States home financing laws and regulations, 2) helping more mortgage professionals and firms to reach out to the Muslim community with financing products that can facilitate the growth of homeownership, and 3) investing in marketing, infrastructure, and operational capabilities needed to tap the potential of this underserved market.

IV. CONCLUSION

Homeownership is an important aspect of building communities and wealth in the United States. There is a gap between the home financing needs of the Muslim community and the available capital. This creates an opportunity for the community to standardize product structures, for mortgage professionals to help create home financing solutions, and for investors to develop an infrastructure to help reach this market. In addition, these efforts will allow observant Muslims to utilize more broadly the home financing system in the United States which leverages the secondary market, thus making homeownership a reality for many more Muslim families.