INSURING TITLE
UNDER
ISLAMIC RESTRICTED FINANCING

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I. Introduction.

Throughout history, religious teachings have limited the ability of the faithful to borrow and lend money.

a. Judaic law prohibits a Jew from charging or collecting interest ("*ribit*") from another Jew.[1]
    1. The *Heter 'Iska* was developed in order to structure business transactions so as to avoid violating the prohibitions against *ribit*. [2]
    2. However, the Bible does allow a Jew to collect interest from a Gentile. [3]

b. Generally speaking, however, Western civilization has not observed the Judeo-Christian prohibitions on interest.

c. Under the law of Islam, *Shari'ah* principles likewise forbid Muslims from the payment or receipt of interest ("*riba*") for the use of money.

II. Islamic religious laws govern the charging of interest.

a. "Islam is a comprehensive way of life, religious and secular; it is a set of beliefs and a way of worship; it is a vast and integrated system of laws; it is a culture and a civilization; it is an economic system and commercial norm; it is a polity and a method of governance; it is a society and a family conduct; it prescribes for inheritance and divorce, dress and etiquette, food and personal hygiene. It is spiritual and human totality; thus worldly and other-worldly."[4]

b. As part of this complete lifestyle, Muslims are forbidden from engaging in those activities which Islamic law determines to be abhorrent, such as gambling, alcohol, drugs, pornography, and usury (or *riba*).[5]

c. The traditional Islamic view of the prohibition of *riba* is that it includes interest. The prohibition of *riba* does not mean that money may not be lent under Islamic law; the prohibition simply forbids unearned profit (or stated otherwise, profit without expected, normal business risk).[6]

III. Shari'ah

Shari'ah is the body of legal principles derived from the Koran, the teachings of the prophet Mohammed and interpretations of those teachings by Islamic jurisprudential scholars.

a. The *Shari'ah* establishes rules that govern and define the economic, social, political and cultural life of Islamic societies, including their financial institutions.
b. An Islamic banking institution has two parts, (1) the business side and (2) the supervisory board of religious advisors to review proposed financial transactions.
c. Based on the guidance of these religious supervisory boards, Islamic financial institutions have developed several types of banking transactions which comply with *Shari'ah* principles.
d. When dealing with real estate, the most common forms of structure are *Murabaha*, *Musharaka*, and *Ijara*.

IV. Murabaha – Third party purchase and sale.

Although *Murabaha* is considered a financing, it is structured as a sale to a middleman, who then sells the product or real estate to the consumer at an agreed price equal to the cost of acquisition plus a profit.

a. The financial institution or lender actually takes title to the property before conveying it to the consumer. This can be done through wholly-owned special purpose LLC's created for each transaction.
b. The consumer agrees to pay for the property over a period of time in stated installments. This obligation can be secured by a mortgage or deed of trust to the LLC, which is assigned to lender.
c. In the event of a default, the customer is liable only for the contract sale price, not any fees or interest calculations usually charged. Also, the lender is left holding the property, and must find an alternate buyer.
d. The conveyance from the middleman can be made either up front, or after full payment of the contract price. Up front conveyances look more like conventional financing structures.

V. Musharaka – Partnership or Joint Venture

Musharaka literally means "partnership", and compares to our partnership or joint venture structure.

a. The lender contributes a percentage of the capital needed with the agreement that the lender will participate in the profits generated by the consumer partner in accordance with a pre-agreed formula.

b. The consumer participates by managing and putting in sweat equity.
c. One American Islamic lender uses this format as a starting point for residential lending, with the difference being that during the contract, the consumer makes periodic payments to acquire the lender's percentage interest in the property. This is termed a "Declining Balance Co-Ownership", with the consumer ending up with full ownership of the property at the end of the term.[7]

VI. Ijara – Sale/Lease financing

Ijara is a financing arrangement where the lender purchases the target real estate on behalf of the consumer, and leases it to the consumer. At the end of the lease agreement, the lender sells the property to the consumer for the same amount of the original acquisition. Since leases are payment for the right of occupancy, not payment for the use of money, they are one of the most popular forms of financing vehicles.

a. An Ijara lease begins the day the asset is delivered to the consumer, not the day of the agreement.
b. The lessee cannot be forced to purchase the property at the end of the term, but can also purchase the property earlier than agreed in the lease.
c. To be *Shari'ah* compliant, the lease may not be a true triple net lease. The lender/owner must retain some risk of ownership, such as paying the property insurance and taxes, and maintenance of the structure, with the expenses for these items rolled into the lease payments.

VII. Islamic Lenders are becoming involved in Shari'ah based residential financing in the United States.

There are a growing number of financial institutions involved in lending in accordance with Shari'ah based principles.

a. One of the oldest is American Finance House LARIBA, founded in 1997, and based in Pasadena, California. It offers home, auto and small-business loans in 32 states.
    1. LARIBA uses the Ijara style of financing, where the payments are based on the fair market rental.
    2. Fannie Mae has committed to invest $10 Million in home financings originated by AFH LARIBA. [8]
b. Al-Manzil Islamic Financial Services, a New York-based division of United Bank of Kuwait, is also active in the residential market.
    1. The company's program operates in New York, Connecticut and California.
    2. The program is based on the Murabaha structure. [9]

c. Guidance Financial Group, in the Washington, D.C. area, is using a *Musharaka* based structure to provide $200 million in Fannie Mae approved financing.[10]

VIII. Title Insurance of Shari'ah based lending structures.
Title can be insured in most cases, depending on how the parties have structured the transaction.

a. *Murabaha*:
1. Owner's Policy: issued to middleman/lender, with exception to installment purchase agreement.
2. Loan Policy: will insure the investor/lender under the terms of the Mortgage or Deed of Trust securing the payments under installment purchase agreement.

b. *Musharaka*:
1. Owner's Policy: issued directly to consumer, with exception to rights of cotenant under agreement.
2. Loan Policy: will insure the investor/lender secured by the Mortgage or Deed of Trust, which secures payments under the Co-Ownership Agreement. Exception to the rights of Consumer under the Co-Ownership Agreement.

c. *Ijara*:
1. Owner's Policy: insures the lender/investor with exception to leasehold interest of consumer, exception to rights of Consumer under Lease/purchase Agreement.
2. Loan Policy: none, unless Lease/purchase Agreement is secured by Deed of Trust or Mortgage, then to lender/investor with exception to leasehold interest of Consumer under Lease/purchase Agreement.

IX. Additional information available at the following websites

a. http://www.lariba.com
b. http://www.guidancefinancialgroup.com
c. http://www.amanahfinance.hsbc.com
d. http://www.iibu.com

[1] Exodus 22:24; Leviticus 25:35-38. See also: Barclay's Discount Bank Ltd. v. Levy 743 F.2d 722, note 2 at 724 (9th Cir. 1984).

[2] "The *Heter 'Iska* principle is based upon the borrower and lender agreeing to be partners in a business venture, whereby one partner invests money and the other uses his entrepreneurial skills to manage the venture. The investor-partner can thereby earn "profit" attributable to his portion of the joint business venture, and the sharing of such profit by the manager-partner would not constitute payment of interest upon a loan. The arrangement thus has characteristics of both a loan and a trust" Kenneth Ryesky, Secular Law Enforcement of the Heter 'Iska, *found at* http://www.jlaw.com/Articles/heter1.html.

[3] Deuteronomy 23:20-21.

[4] Imitiaz Pervez, Islamic Banking and Finance, reprinted in Information Sources on Islamic Banking and Economics 1980-1990 at 8,9 (S. Nazim Ali & Anaseem N. Ali eds. 1994), quoted in Taylor, Islamic Banking—The Feasibility of Establishing an Islamic Bank in the United States, 40 Am. Bus. L. J. 385, Winter, 2003.

[5] Muazzam Ali, Publisher's Note to 1 A Compendium of Legal Opinions on the Operations of Islamic Banks iv (Yusef Talal DeLorenzo ed., 1997), quoted in Taylor, Islamic Banking—The Feasibility of Establishing an Islamic Bank in the United States, 40 Am. Bus. L. J. 385, Winter, 2003.

[6] Taylor, Islamic Banking—The Feasibility of Establishing an Islamic Bank in the United States, 40 Am. Bus. L. J. 385, 391. Winter, 2003.

[7] See website of Guidance Financial Group, specifically "Declining Balance Co-Ownership and How does it Work", *available at* http://www.guidancefinancialgroup.com/products/OurProgram.aspx

[8] Fannie Mae News Releases, December 6, 2002, available at http://www.fanniemae.com/newsreleases/2002/2291.jhtml.

[9] Craig Worker, Community Banking, A Michigan Start-Up Plans "Mortgages" for Muslims, American Banker, Vol. 165, No. 113, 6/13/00, found at 2000 WL 3362246.

[10] See webpage at http://www.guidancefinancialgroup.com.