

Islamic Banking in the 20th Century

The efforts to start Islamic banking and finance in the mid-1970s resulted in the development of a major model, which became very popular because it was very close to the conventional *riba*-based financing model. The model is called the cost-plus (*murabaha*) model, which, as described in Chapter 3, includes the following steps:

1. The finance institution buys the item at the order of the ultimate buyer (who wants to finance it) at a certain price.
2. Then the financial institution sells the item back to the ultimate buyer at the original price plus a profit element. The profit element usually reflects the accumulated *implied interest*—called profit—that would accrue over the period of financing.

The model focused on the fact that there is a buy/sell transaction and that interest is not charged, as required by the Law (Shari'aa). This model was very convenient to the new and emerging Islamic banking industry, because it was a straightforward application of the interest-based model used in conventional *riba*-based banks. It was also applied in many of the newly established financial institutions at that time, such as Kuwait Finance House (KFH), Dubai Islamic Bank, and Dallah Al Baraka Finance Company,¹ and later in Malaysia. (In Malaysia, the model is not called *murabaha* but it is called by what it does, which is to sell at a delayed payment price called in Arabic *al bai' bithaman aajil*, or *BBA*.) It was later adopted by many of the operating Islamic banks that emerged in many of the Muslim countries.

A number of challenges appeared to the Islamic bankers who began practicing the *murabaha* approach. These were:

1. How should one calculate the profit element that will be added to the original purchase price? As a solution to this problem, the finance companies were allowed by some scholars to use the prevailing interest rate as an index to be used to calculate the profit. Because the London money markets were accessed and used by most of the former British colonies in the Arab world (including the Gulf oil-producing countries) and Asia (including Malaysia), the scholars agreed on the use of the London Interbank Offering Rate (LIBOR) or local prevailing interest rates as the reference interest rate. This step was the source of frustration, confusion, disillusion, and disappointment for many young and dedicated RF bankers—Muslim and non-Muslim alike—whom I met all over the world, in Turkey, Malaysia, Egypt, Saudi Arabia, Kuwait, the Emirates, Pakistan, Europe, and the United States. “What is the difference?” they asked. “My boss asks us to survey the interest rates in the market and he ends up using it and we call it a ‘profit’ or ‘rental’ rate.”
2. What will the “Islamic” finance company or the bank do with the one-step capital gain that results from reselling the item at this huge added “profit” (cumulative interest), which is added to the original price the bank paid to buy that item? In the beginning, the profit was booked on the income statement as an income from transactions, resulting in great performances for the Islamic banks. Later, after the involvement of many international audit firms familiar with international accounting standards (like the Financial Accounting Services Board, or FASB, in the United States) and the establishment of AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), profit was spread over the life of the facility (amortized) in the same way a loan interest income is booked in a conventional banking operation or as in the case of an origination fee, which is handled by the FASB accounting standards (FASB-91).
3. What will the “Islamic” finance company do with delinquencies in payments? The original conditions (required by Shari’aa) of the cost-plus (murabaha) model were to not increase the profit element added to the original price in case of delinquency or inability to pay the periodic payments or the payoff in time, because increasing the profit would be considered a clear violation of RF values (*riba al nasee’ah*). This rule was abused by many of the customers of “Islamic” finance companies and banks. To resolve the situation, some scholars issued an edict (*fatwa*) that allowed the “Islamic” banks and the financial institutions to charge penalties to those who are chronically late in making their payments without an acceptable legitimate and reasonable excuse. A small loophole was left open by the fatwa, and that was to use the principle of

mercifulness (*tarahum*) in case the customer had a legitimate excuse. This small loophole created many lawsuits and many legal attempts to help borrowers who dealt with “Islamic” banks. In addition, the edicts ruled that the late payment fees cannot be added as an income. These fees—in the form of penalties—are booked in a separate account and are paid as donations to legitimate charities.

When Islamic banking proponents started considering the implementation of the murabaha approaches in the West, they met with many additional challenges. These were:

- The banks (depository institutions) in most Western countries are not allowed by the laws of the land to own properties unless the property was foreclosed on by the bank and was classified as *Other Real Estate Owned* (OREO). In this case, the bank is encouraged to sell OREO properties as soon as practical. This stipulation made it difficult for a bank to buy an item, change the title from the seller to the bank, then sell it to the ultimate buyer by changing title again from the bank to that ultimate buyer to satisfy the buy/sell rule called for by Shari’aa, as discussed earlier.
- If the Islamic financing institution was structured as a finance company, then it could—in some jurisdictions—buy properties and hold title to these properties. However, finance companies in the West discovered that when the company buys a property in its name at a price (X) and turns around and sells it at original price (X) plus a profit (P), then a tax event is created, because the tax authorities considered the profit (P) a capital gain that must be taxed. In addition, in some countries (particularly in Europe), a tax is charged every time title changes hands, creating unnecessary additional expenses.

The real challenge came when the Muslim communities in the West—mainly in the United Kingdom and the United States—wanted to obtain RF financial services. The effort to provide RF financial services was pioneered by Al Barak Bank in London in 1988, when it tried to come up with a home financing contract that would fit the requirements of the banking laws in the West in general and in the United Kingdom in particular and that would be compliant with Shari’aa. A number of meetings between scholars, attorneys, and bankers were held. This resulted in the birth of a new “Islamic” financing model based on the lease-to-purchase model (*Al Ijara Wal Tama-luk* or *Ijarah Wal Iqtina*—these Arabic terms both mean *lease to own*). This model is now becoming more popular because the “Islamic” banking attorneys—most of whom had Western training, experience, and credentials—

were able to adapt it in a way that makes the financing closer to the requirements of Shari'aa and to expand its use in the development of the "Islamic" asset-based bonds (*sukuk*.)

ISLAMIC BANKING MODELS

The following is analysis of the Islamic banking models designed to fit the existing conventional finance contracts to make them Shari'aa-compliant.

The Cost-Plus (Murabaha) Model

This mode of financing (in Malaysia it is called *Al Bai' Bithaman Ajil*, or *BBA*) was developed to finance trade transactions in a riba-free format. *The Institute of Islamic Banking and Insurance* magazine (London, the United Kingdom)² responds to reservations and criticisms made by many Shari'aa scholars, as well as users of murabaha "Islamic" finance models and contracts, by stating that we should not ". . . ignore that the basic Islamic finance structures adopted today were used primarily in trade in the early Islamic period." The article further states that

Murabaha [cost-plus], in its original Islamic connotation, is simply a particular type of sale, not a mode of financing. The only feature distinguishing it from other kinds of sale is that the seller in Murabaha [cost-plus] tells the buyer the cost incurred and the profit (mark-up) on the cost.

The magazine also quotes retired Justice Muhammad Taqi Usmani:

There are two essential points which must be fully understood in this respect: 1) it should never be overlooked that, originally, Murabaha [cost-plus] is not a mode of financing. Therefore, this instrument should be used as a transitory step . . . and its use should be restricted only to those cases where Musharaka [joint ownership with diminishing equity] is not practicable; 2) the Murabaha [cost-plus] transaction does not come into existence by merely replacing the word of "interest" by words of "profit" or "mark up."

The article further states that:

Murabaha [cost-plus], though not an ideal model in Shari'aa compliant finance, was adopted initially for home purchase in the UK in the late 1990s, as pure Musharaka [joint ownership with

diminishing equity] and other models were not well suited for mortgage transactions.

In response to concerns voiced regarding the added cost resulting from capital gains taxes levied by tax authorities in the United States for a sale and buy back at a higher price, the scholar Dr. Hamoud issued an opinion to the author when we, at LARIBA, started applying the cost-plus financing concept in the United States in 1987, allowing the company to appoint the customer as an agent (*wakeel*) to buy the property on the bank's behalf. The opinion of Dr. Hamoud was the basis for the fatwa issued by the First Conference of Islamic Banks (Dubai, 1997). *This fatwa—based on an opinion of the Maliki jurist Ibn Shubruma³—stated that an Islamic financial institution may require its customers to sign a binding promise that he or she will purchase the financed property on credit (with an agreed upon mark-up) once the bank buys it based on his order.* It is important to notice here the use of the term “binding promise” or *waad* in Arabic. The word *promise*, some scholars stress, is different from the word *contract*. The reason for this distinction to be made, with customers signing a promise to buy back rather than a contract to buy back, satisfies some of the scholars' demands. That is because of a clear ruling by the Prophet Muhammad (pp) that prohibits including two contracts (a contract to buy and another contract to sell back to back) in one contract to purchase the property. The resulting contract came to be known⁴ as *Murabaha Lil Aamiri bil Shira'aa* (meaning: *cost-plus sale to the one who ordered the original purchase*).

The mechanics of a murabaha financing transaction sometimes blur the boundaries between interest-bearing *riba*-based conventional loans and credit financing. In fact, cost-plus is sometimes called the bridge between *riba*-based conventional financing methods and the RF financing domain. Many of the puritans who were looking for RF financing criticized this mode of financing severely when it was first introduced in the United States because it was similar to *riba*-based financing. This perspective challenged us at LARIBA to research and try to come up with other methods of financing, which led us to innovate and develop the LARIBA RF financing model.

In murabaha transactions,⁵ the customer is appointed as the financier's buying agent (*wakeel*). Thus the customer may proceed as the financier's *wakeel* to purchase the property on the financier's behalf. Subsequently, the ultimate buyer also acts as the financier's selling agent to sell the property to himself. Technically, jurists argue,⁶ the financier in fact owns the property during the period of time between the two agency sales and bears the risk, for instance, of its destruction by lightning. Unfortunately, close scrutiny of the process used in this mode of transaction indicates that the bank or the finance company takes all precautions to ensure that the buyer will not go

back on that promise, so that the financing entity will not end up owning the property. In addition, Shari'aa defines the transaction based on the intention (*niyah*) of the transacting party. It is a fact that the financing entity never intends to buy and own that property.

In our efforts to evaluate the cost-plus model used in the United States for “Islamic” Shari'aa-compliant mortgage financing, we shall share with the reader important glimpses of the procedure used and the contract supplied by one of the banks in America that advertises its “Islamic” “no-interest” mortgage financing program, which uses the cost-plus (*murabaha*) model. We are deeply indebted to a friend in the community who financed his home using the services of this bank and was kind enough to share with us the details of the process he went through. Here are our observations:

- It is claimed that no interest is charged, despite the fact that the bank uses the prevailing interest rate of the day of the agreement as a base for calculating the added “profit” element in the cost-plus (*murabaha*) scheme used and uses the same mortgage amortization program. Would that be considered a violation of consumer compliance and advertising regulations mandated by the federal and state banking laws?
- It is claimed that the bank buys the property and that the customer promises to buy it back from the bank in a simultaneous back-to-back operation. Upon researching title of the property, we found out that the bank used very restrictive language to ensure that the customer would not change his/her mind and that he/she would proceed with the buy-back from the bank. The customer signs a contractual form, not just a promise. We found that the bank never changed title of the property to its own name, and the title was recorded in the name of the buyer. In fact, even the down payment was paid by the ultimate buyer and not by the bank, which was supposed—at least on paper—to have been the buyer of the property.
- Upon further investigation and research, we discovered that the bank in some cases has formed a special purpose vehicle (SPV) in the form of a limited liability company (LLC) that would “synthetically” purchase the property and sell it back to back to the ultimate buyer. In this case, the buyer is charged all the costs associated with this scheme.
- The buyer signs a promissory note for the original price and the accumulated interest together. This makes the buyer liable for the whole amount (the cost plus the profit (interest) charges).
- The bank required the buyer to sign a rider stating that the buyer will be responsible for any capital gains taxes that may be levied by the tax authorities should the buy/sell agreement produce—in the opinion of the tax authorities—an implied capital gain.

- The contract was mostly similar to a regular finance contract, and the note was also mostly similar to a standard note but without the word *interest*.
- The bank charged the customer for the additional expenses involved in this “circumvented” transaction.

Another attempt at Islamic banking was made by a major mortgage finance company which is now owned by the U.S. government, but was then (before the 2008 financial meltdown) classified as a GSE (government-sponsored entity) active in mortgage financing. The GSE was kind enough to seek the opinion of the author about its newly developed Islamic home mortgage financing model and structure. The proposed contract claimed that the customer would be charged zero interest and it had to post, in the contract, a table that translated the “Islamic” finance terms used in the contract to the regular *riba*-based finance language that is used in standard *riba*-based mortgage finance contracts. The GSE was informed that this contract should not carry the name of this respected GSE, because it is in fact a regular conventional contract dressed up to make it look compliant with Shari’aa. The GSE was also warned that this kind of contract can be challenged in the courts of the law, as happened in other instances in Malaysia, the United Kingdom, Saudi Arabia, and in the United States (with MSI Company of Houston, Texas). The GSE did not go further with such a contract.

It is surprising and troubling to experience these attempts at circumventing Shari’aa using such ruses. Bank regulations in the United States (as well as in the United Kingdom) have plenty of detailed consumer compliance laws that disclose the finite details of the transaction and the total charges levied by the bank in a finance transaction, as required by the “truth in lending” regulation (Regulation Z in the United States) and the regulation that gives the buyer the right of rescission of the deal. But most amazing of all is the fact that the cost-plus (*murabaha*) model is used by tens of banks that employ many of the “superstar” scholars on their Shari’aa Boards. Most important of all, it is noted that there is no mention of the method that is used to calculate the markup (profit) in the *murabaha* model. The fact of the matter is that they use the prevailing interest rate used by all banks in the conventional *riba*-based system, call it rent or profit, and claim that this interest (usually LIBOR-based) is looked upon as an index.

Financial Engineering and Shari’aa

One of the most controversial issues and sources of contention among scholars in Shari’aa has been the transfer of ownership or title of the property first from the seller to a special purpose vehicle (SPV), in the form of a

limited liability company (LLC) created by the bank in order to create a synthetic buy/sell transaction without violating the banking laws. While many scholars have allowed the appointment of the buyer as an agent (wakeel) in the back-to-back buy and sell, there are a few who refused to accept it. For example, in a cost-plus transaction, the bank or the financial institution would first buy the house and record title in its name; then it would immediately turn around and sell the house to the real buyer. However, U.S. government banking regulations prohibit banks from owning real estate properties (except those foreclosed on due to nonperformance, which are classified as OREOs on the balance sheet). Regulators press banks to sell such OREOs as soon as practical. To abide by these laws, and to circumvent Shari'aa in order to have a transaction that appears to be compliant, the bank would start by incorporating a new company (i.e., an SPV in the form of an LLC or a limited partnership) that does the buying and the selling in a back-to-back instant way. This would eventually make the process look—in form—as though it were legitimate with Shari'aa because the title of the property changed hands, making it a sale. However, this method forgets the real purposes and spirits of the Law (*shari'aa*) which are:

- Not to rent money at an interest rate
- To transact a true prudent investment in the property by marking the property to the market

Many Shari'aa scholars have condemned the use of deceptive financial engineering techniques used to circumvent the Law by focusing on the form of the transaction and the contract (on paper) rather than the substance! Dr. Elgamal⁷ states:

. . . Al Shatibi concluded that cynical adherence to classical contract conditions in order to achieve form and not substance using ruses and deceptive tricks (even if these tricks are classified as Hasan heelah—or a good trick) to circumvent [the Law] Shari'aa may violate it . . . “Legal ruses—al-heyal—in religion are rendered as generally illegal. In this regard, legal provisions—al-amaal al-shar'iy'ah—are not ends in themselves but means to legal ends, which are the benefits intended by the Law [Shari'aa]. Thus, one who keeps legal form while squandering its substance and intent does not follow the Law [Shari'aa].

It is troubling to see the bank or the financing entity form an SPV with the intention of abandoning it just to make the deal look compliant with Shari'aa. Conceptually, it is not much different from signing a marriage

contract as a matter of convenience with the intention of divorcing after the purpose of that contract has been achieved. It is believed that this renders the contract null and void. Such an approach stands in fact as a mockery of the real purpose, intent, and wisdom of the prohibition of *riba* or the culture of renting money. These SPVs cost money to conceive, design, and register—a cost that some call COBM (the cost of being a Muslim), to our surprise! We believe that wasting money, however small or insignificant, on such kinds of ruses does not fulfill the basic objective of Shari'aa, which is the pushing away of what is harmful and the bringing of benefits to the community. It is also important to note that such schemes have not yet been challenged in the courts of law or by the tax authorities. It is strongly believed that we should use wisdom to keep our community members out of harm's way by not following such unnecessary ruses.

The Lease-to-Own Models (Al Ijarah Wal Iqtina or Al Ijarah Wal Tamaluk)

In response to the many reservations and criticisms leveled against the model described above, another effort to develop new models was started, based on the lease-to-purchase transaction. The first model was developed by a group of scholars from the Arabic-speaking Middle Eastern countries for Al Baraka Bank in London in 1990.⁸ The second was a modification of the Al Baraka model developed later by (retired) Justice Taqi Usmani and detailed in his book⁹ for an “Islamic” mortgage finance company that has operated in the United States since 2001. The third model, which will be detailed in Chapter 10, is the LARIBA model, which improves on the Al Baraka model by applying the *mark-to-market* principle and the *commodity indexation rule*, explained in Chapters 3 and 5.

The Al Baraka Bank of London Shari'aa-Compliant Model¹⁰

This model was devised to fit the mortgage financing requirements in the United Kingdom in order to offer RF mortgage financing by the first Islamic bank to operate in London, Al Baraka Bank. It was the first serious attempt to offer solutions to the British Muslims' demand for mortgage financing according to Shari'aa. The author was closely involved with the growth of Al Baraka Bank's operations and experienced at close range the last few weeks before it was closed down by the Financial Services Authority (FSA). The closure was mainly because Al Baraka Bank owners did not have a chartered bank in Saudi Arabia, its country of domicile, but also due to regulatory violations in its operations. In general, the model calls for three steps:

1. The financing entity and the customer buy the property as a joint venture (*Musharaka*).
2. The share of the financing entity in the property is sold to the customer at the outset. This allows the ultimate and real buyer of the property to receive and record title immediately.
3. The financing entity would retain ownership of the “right to use the property” in terms of the lease rate it would produce if it were rented. In lieu of that, the financing entity would receive a lien (implied co-ownership) on the property and collect its share of the rent income as stipulated in the agreement/contract. (In many cases, Shari’aa scholars mistranslate the word *lien* as *rahn*, which means *pawn* in Arabic.) This issue will be discussed in further detail by researching the definition of lien (as an implied co-ownership) compared to pawn (complete arrest of the property to the pawn holder).

A series of edicts and opinions (*fatwa*)¹¹ were issued by a group of highly placed, recognized scholars. These edicts formed a milestone in the “Islamic” finance ways and means. Here are some of the important issues discussed and the edicts issued:

- *The use of the word interest*¹²: The word “interest” can be used in a contract to satisfy local legal requirements as long as *riba* is not practiced during the transaction. The fatwa states:

*Applying the principle for reviewing transactions, stipulating that what matters in contracts are the intentions and the substance—not words and forms—we have reached a consensus that there is no objection to using the term “interest” as an alternative to the term “profit” or “rate of return.” In this regard, it is imperative to ensure that the term “interest” in the sense described above is used only in the forms required by entities other than the bank, e.g. tax declaration forms for depositors, or special forms used in various financing cases. However, if the intent is to change the nature of the transaction to make it an interest-bearing loan, then such transaction will be fundamentally impermissible.*¹³

- *Developing the lease-to-own model to comply with the banking regulatory requirements of the United Kingdom’s FSA.*¹⁴
 - *Registering the house’s title in the partner’s name, based on trust, from the inception of the contract is permissible under Shari’aa. Registering the property’s title in this manner does not contradict*

the agreed-upon partnership, especially since the partner's ability to sell the home is restricted until his full ownership of the property is established. In this regard, we took into consideration the fact that this registration of title is a form of documentation insured by the officially established lien on the property, according to the conditions agreed upon with the partner.

- *Making the partner alone responsible for all [closing costs like] registration, survey, and other documentation costs* associated with the jointly owned property from the inception of the contract, and absolving the bank from responsibility for such costs, is permissible if the partners agreed accordingly. This is particularly appropriate, since the partner will ultimately become the sole owner of the property at the end of the financing contract.
- With regards to insurance, the default ruling would require that *both partners bear responsibility for insurance premiums* as a shared burden of the jointly owned property. However, the bank may take that into consideration when determining the rental of its share of the property, and include appropriate compensation for the appropriate share of insurance costs.
- The default ruling in joint ownership is *sharing profits and losses in proportion to ownership*, based on the principle that entitlement to profit must be commensurate with risk exposure. In this regard, since the regulatory framework requires that the bank should not be exposed to the possibility of losses when the partnership is dissolved, the model should be altered such that the order of the transaction proceeds as follows:
 - The bank and the customer share in purchasing the home according to the agreed-upon proportions.
 - The bank sells its share in the physical property ownership (milk al-raqabah) to its partner, while retaining its share of ownership of the right to use it (haq al-manfa'ah) until the time its partner pays the remaining portion of the price.
 - The bank collects an annual rent in accordance with the actually paid portion of the property's price.
 - If the partner is delinquent in paying the installments for which he is obligated, the bank has the right to keep the sale agreement intact and collect its right to the remaining portion of the price according to the obligatory performance clauses of the lien; or the bank may void the initial sale and take full ownership of the property, if the partner agrees. In the latter case, the bank should pay back to the partner whatever he had paid previously, as a revocation of the sale from its

inception. (This item was agreed upon by a majority of the participating scholars.)

The South Asian Diminishing Musharaka Shari'aa-Compliant Model¹⁵

This model was developed by retired Justice Muhammad Taqi Usmani, a world-renowned Shari'aa scholar who specializes in Islamic financing. In 1998, he authored a book on the subject.¹⁶ The step-wise approach and methodology recommended by Justice Taqi Usmani were essentially the same as the ones described above in the Al Baraka model (1990), but without splitting the rights to a property into the right of ownership (title ownership) and the right of using the property (usufruct). Following is a summary of the model based on the book authored by Justice Taqi Usmani, which is titled *House Financing on the Basis of Diminishing Musharaka (Joint Venture)*. The proposed arrangement is composed of the following transactions:

1. Create a joint ownership in the property between the buyer and the financing entity in the form of joint venture (*Shirkat-al-Milk* in Arabic)
2. Rent the share of the financier in the property to the client¹⁷
3. Get the promise (*notice the use of the word "promise" and not "contract"*) from the client to purchase shares owned by the finance company
4. Have the buyer gradually buy back the shares of the finance company
5. Adjust the rental paid by the buyer gradually, in proportion of the ownership by the finance company

The following is an analysis of each ingredient of the arrangement based on the model description as detailed in Justice Taqi Usmani's book. In general, the steps recommended in this model are not much different from the earlier model used at Al Baraka Bank in London, but with a number of changes. Contrasting the South Asian model with that of Al Baraka yields the following:

1. The finance entity leases its share in the house to its client and charges him/her a monthly rent. This is the same process that the Al Baraka model calls for. But the Al Baraka model is clearer and more defined, as it divides the rights of the owner in the property to two rights. These are the right to own title (*milk ul raqabah*) and the right to lease or rent the use of the property (*haq al manfa'aa*).
2. The South Asian model states that the client buys "units" of the "undivided" shares owned by the finance entity, compared to selling all the

finance company's shares outright at the beginning, as in the Al Baraka model. This step is a very serious step and has created a number of issues, because:

- a. In this model the buyer and the finance entity continue to own the property, which requires that the title be recorded in both names. However, in the Al Baraka model, the buyer buys back the shares in ownership from the finance entity, which allows the buyer, according to Shari'aa, to record title in his/her name only.
- b. If the finance entity sells back its shares over a period of time, the price of these shares cannot be fixed ahead of time in the beginning of the transaction, because that would be like a sale and buyback at a future date with a fixed predefined price. This type of sale is called in Shari'aa the sale of *eena*. This type of sale is clearly prohibited, because it represents a ruse or a deceptive trick to circumvent the Law. This model may imply that the model proposed accepts that the parties agree that the price of each share is fixed in the future. Sheikh Ali Al Salous,¹⁸ an established scholar in the field of Islamic finance, recommends that in cases in which the finance entity sells shares to the customer over a period of time in the future, these shares should be sold at the prevailing market price of the property and the price cannot be fixed ahead of time. After discussing with him the difficulty of establishing a share price every month, he suggested that when the customer is billed, he/she should be told clearly—through proper and clear disclosure on the billing statement—that the shares he/she is buying back from the financing entity are offered at a certain price, and that he/she has the right to accept it or refuse it. Of course, the client's refusal to buy the shares at the offered price will trigger other actions as stipulated in the particular contract. Justice Taqi Usmani agrees with this and states so clearly in the conditions listed in the book, but he provides a way out:

It will be preferable that the purchase of different units by the client is effected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client.

However, the signing by the client of a fixed price in the future—as done in many of the contracts we have seen—does not make the agreement compliant with Shari'aa, because it makes it a definite *eena* sale. That is why Justice Taqi Usmani states in his conditions that “. . . at the time of the

purchase of each unit, sale must be affected by the exchange of offer and acceptance at that particular date.”

- c. To get around the problem of having two sales contracts in one, the South Asian model uses the word “promise” to describe the action of the customer toward the financier without putting it in writing in the form of a contract. If this occurred, it would again be a sale and future buyback, with a predefined price or *eena* sale which is prohibited by Shari’aa. It is important that the steps recommended by the models are done independently, as Justice Taqi Usmani states in his book:

It is clear . . . that each one of the transactions . . . is allowed per se, but the question is whether this transaction may be combined in a single arrangement. The answer is that if all these transactions have been combined by making each one of them a condition on the other, then it is not allowed in Shari’aa, because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another . . . the proposed scheme suggests that instead of making two transactions conditional to each other, there should be a one-sided promise from the client, firstly to take share of the financier on lease and pay the agreed rent and secondly, to purchase different units of the share of the financier of the house at different stages. . . . It is generally believed that a promise to do something creates only a moral obligation on the promisor, which cannot be enforced through courts of law . . . [the] most the promise can do is to compel the promisor through court of law to fulfill his promise and if the promisor is unable to fulfill the promise, the promisee can claim actual damages he has suffered because of the default. This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it can be enforced.

It will be left to the reader to decide if this “promise” is in fact a contractual agreement or not. One fact needs to be made very clear. The contracts used by those banks and financial institutions do obtain clear and firm agreements from the customer to buy back the property—not just a promise. Based on our detailed research and in-depth evaluation of the documents used—at least those used in the United States—no bank or financial institution would act on a mere “promise.” The financier makes sure that the customer not only gives a binding contract, but also pays the down payment of the house he or she wants to buy. In addition, it is known that the financing entity does not intend in the first place to buy the property

and that it would have never embarked on the step of the “claimed” purchase of the property (as required by the model) without making sure that the client was fully committed and contractually obliged to buy the property back.

We have tried to understand the benefits to the client or to the financing entity of following all these “synthetic” steps, and we found that there are no benefits. It is important to note that this South Asian model requires that the finance entity devise new contracts, mortgage agreements, and promissory notes that may not be different in content, intent, and spirit from the standard *riba*-based ones, without adding any economic or real legal benefit to the customer. If these newly formulated—nonstandard—contracts are litigated in the courts of law, it exposes the customer to the risk of confusing the court and to liabilities that may be leveled against the financing entity or its parent bank or company. It is understood that this may be a remote possibility, but in the legal system, we learn from history that what may be considered remote today can be messy and greatly complicated and involved when a smarter attorney starts challenging it.

In contrast, the Al Baraka model solves the above problems in an elegant, straightforward, and more practical way, which is acceptable by Shari’aa. It does not need to resort to establishing the LLC or SPV, because of the direct sale back to back and the registration of the title in the customer’s name at the outset of the transaction. It simply states that the finance entity sells all its shares directly at the outset to the customer. The sale proceeds are paid by the customer—without any *Riba*/interest—over a period of time that is agreed upon between the finance entity and the customer. Against this trust, the client proceeds to record title in his/her name and proceeds to share in the rent that the two parties have agreed to in the proportion of ownership. The financing entity keeps a lien on the property. The lien is settled, title is *reconveyed*, and the implied joint ownership by that lien is released when the shares of the financier have been completely paid back.

Application of the South Asian Shari’aa-Compliant Model To examine the practical application of the South Asian model, the methods and procedures used by an American-based Islamic mortgage finance company that uses the model will be examined below. This “Islamic” mortgage finance company came to market in late 2001 and was heavily promoted as the real solution to the problem of providing “Islamic Shari’aa-compliant” financing to “Muslims and others” in the United States by the company that uses it.¹⁹ In general, the procedure used by the company is based on the South Asian model described in the previous section.

The company advertises and publishes on their Web site a copy of the fatwa signed by the Shari'aa Board of the company, which includes (retired) Justice Taqi Usmani. The company states that the purposes of the model are to:

- Assist Muslims and others to acquire homes in compliance with Shari'aa
- Help buyers to enjoy tax benefits
- Allow the company to securitize their ownership investment in homes

The company goes through the following steps:

1. The mortgage company forms a limited partnership as a special purpose vehicle (SPV) with the customer. They agree to purchase the property together and to record title in the name of the customer and the company jointly. The cost of forming the SPV is charged to the customer (approximately \$1,400 to \$1,500) and its monthly maintenance cost (usually \$18 to \$20) is also charged to the customer. The company makes the following disclosures about the use of a "Bankruptcy-Remote Limited Liability Company" (LLC—a special purpose vehicle) as co-owner: ". . . the LLC [has a] separate legal entity that prohibits co-owner from incurring debt other than the financing of the property." This may be an advantage, in that it limits the customer's ability to use his home as a credit card. Despite that fact, we have seen in practice customers who have still taken a home equity line of credit on homes financed by this model—but only from that company, because it has the customer captive through its joint title ownership. In fact, the company that uses this model has been advertising to encourage members of the American Muslim community to take a home equity line of credit to finance *Hajj* (pilgrimage.) It is known that Shari'aa requires that the Muslim pays off all debts before he/she goes on Hajj and not to borrow to go on Hajj. It is not clear whether the Shari'aa Board approved such an invitation to take a loan to go on Hajj, which first stands opposite to the condition required by Justice Taqi Usmani and second is in violation of Shari'aa. The LLC that serves as co-owner may also serve as co-owner with other consumers in up to 10 separate properties with 10 separate consumers.²⁰ The LLC mortgages the property to the financier ("the company"). The company also discloses that there will be an ongoing LLC fee of \$18.75 per month to be used to pay for unaffiliated third-party expenses. The company also states that it may adjust the ongoing monthly LLC fee in the future to reflect any increase to the current fee. The LLC fee is part of the financing costs, but is not reflected in the net monthly payment.

2. The SPV would proceed to rent the property back to the customer at a rate agreed between them using the prevailing (interest) rate as the rent of the property—making it, in fact, a process of renting money and not the property. This rent is exactly the *riba* interest rate charged in the market. It is well known that renting a property depends on the neighborhood, the specifications of the house, and any other special features the house may have. The actual rent of the property on the market can in fact be drastically different from what the company defines as rent using the interest rate at that time. The name of the SPV company stays on title until the buyback is completed. At that time, title is transferred to the customer. This feature limits the freedom of the customer to act without the approval of the joint holder of title. In other cases, it may represent a liability to the customer, in case the company faces challenging times.
3. The buyer would agree to buy back shares from the partnership, representing the payback of the principle. Since the units of property will be purchased by the consumer under this arrangement at cost and without increase, the company claims that there is no element of *eena* in this arrangement. As stated earlier, *eena* is defined as a sale with a promise to buy back at a later date at a pre-agreed-upon price. The buyer should be offered these shares at the prevailing market price, but that is not what happens.
4. The company states that the consumer will make monthly payments comprised of *profit payments* and *acquisition payments*. The acquisition payments, the company states, represent the consumer's payments for his/her acquiring the co-owner's interest in the property. It is noticed here that there is a lack of the full disclosure as required by Justice Taqi Usmani. The scholar makes the condition that for the model to be compliant, the company must offer its shares in the joint venture for sale at a true prevailing market price, and not just bill the customer to pay the acquisition payment (principal).

The company that uses this model discloses that this model or mortgage product conforms both to the practices of the U.S. mortgage regulation and the principles of *Shari'aa*. Therefore, the use of the terms *interest*, *principal*, *borrower*, and *lender* are mandated by law, and the model is subject to the same disclosures as a regular mortgage loan, such as a good faith estimate, the truth in lending disclosure, and so on.

It was also noticed that the company claims that both parties benefit and bear the risks of their respective shares in the property throughout the contractual arrangement (“term of the financing”). The customer benefits from the fact that he/she is participating in what is presented as a “*Shari'aa*-

compliant” contract. However, the customer has to go through a number of extra steps without reaping any economic or religious benefits—like joint venturing with an LLC, paying extra costs, and accepting a joint title ownership that may result in future undefined risks. One of these risks, for example, is a case in which the company—the joint owner of the title—experiences legal difficulties. The other concern that can be made about this model is the claim that this model allows both the customer and the company to bear the risks of their respective shares in the property. Upon further detailed analysis, it can be safely concluded that the risk carried by the company is even less than the risk assumed by a conventional bank or a financing entity doing a *riba*-based transaction. It is also concluded that this method exposes the consumer to many risks, especially the risk of getting involved in a nonstandard mortgage structure with nonstandard contracts and notes that has not been tested in the courts, as compared to the standardized mortgage finance contract offered in the United States. The other risk is the unfamiliarity of judges and participants in the legal system with such contracts, let alone the extra legal expenses that would eventually be incurred in case a lawsuit is brought to court as compared to a standard and simple administrative process in the case of a standard contract.

It is important to state that regardless of the objections voiced about the contract and the circumventive ruses and deceptive tricks used, it is believed that God will reward those who have made an attempt to develop it in good faith and those users who trusted these claims and were willing to pay more to avoid participating in *riba* because He knows their intention to not violate the Law.

COURT CHALLENGES TO THE SHARI’AA-COMPLIANT “CONTRACT FITTING” ISLAMIC FINANCE APPROACH²¹

It is important to note that the use of Islamic banking as a financing alternative was challenged in many courts in the United Kingdom, Malaysia, the oil-rich Gulf countries, and the United States. Many of the lawsuits were settled outside the court, and the details on all of these cases may not be readily available. Many of these lawsuits were brought to the Courts of the Law (*Shari’aa*) in Muslim countries in which such courts operate—in most cases—outside the realm of the civil laws that prevail in many countries of the world. Such courts exist, for example, in many of the Gulf oil-producing countries, such as Saudi Arabia. Details of the lawsuits and how such suits were settled are not available. However, in most cases, and based on reports from friends who live and work in these areas, a religious judge presiding

over a Shari'aa court may rule that the interest owed on a loan is forgiven because it is considered *riba*.

Malaysia and the United Kingdom courts have litigated many of these cases. Most of these cases involve financing deals that used the cost-plus model (*murabaha*, or BBA in Malaysia). Philip T.N. Ko, Esq.,²² a practicing attorney in Malaysia, has documented a number of cases that were brought to British and Malaysian courts.

These cases are quoted here to alert those who think that Shari'aa-compliant financing in the United States may not one day be brought to and challenged in court to please think again. All these LLCs and SPVs and sophisticated structures present a smarter attorney with wonderful opportunities to challenge all such schemes, ruses, and claims—most importantly, that the claim of “*Shari'aa* compliance” can be coupled with a discrimination claim. These claims can cause damages ranging from expensive settlements that may bankrupt the institution to negative publicity that may have far-reaching negative effects on the operation of the institution (s) involved.

The following are examples of such cases.

Cases Litigated in the U.K. Courts

In *Shamil (Islamic) Bank of Bahrain v. Beximco Pharmaceuticals*,²³ the defendant (Beximco) argued that obligations on them are enforceable only if valid under both Shari'aa and English law. They argued further that the cost-plus (*murabaha*) arrangements were merely a disguise for interest-bearing loans which are not unenforceable under Shari'aa.

The court held that reference to the Law (Shari'aa) was intended to mean that the bank held itself out as doing business in accordance with Islamic principles and was not intended to trump the application of English law.

There have been many other litigations and court cases in Malaysia regarding the same subject.²⁴ In a case that involved the application of the different schools of thoughts—*Sunni* and *Shi'aa*—the judge,²⁵ after conducting a survey of differing sects of branches of *Sunni and Shi'i*, described the issue as “a mind boggling minefield awaiting lawyers and judges alike.”

Resolutions Taken By “Islamic” Banks to Avoid Lengthy Trials

In response to these cases, and to reduce the confusion of the judges in different courts and in different countries (especially non-Muslim countries), many Islamic banks and finance companies have resorted to modifying their “Islamic” contract to include some of the following sample statements²⁶:

- “This Agreement shall be governed by and be construed in all respects in accordance with the laws of the State of Malaysia not being Islamic Law

(Shari'aa) and the parties submit to the jurisdiction of the Courts. . . (not being the Shari'aa Courts or any Courts implementing Islamic law or Shari'aa) in all matters connected with the obligations and liabilities of the parties under the security document.”

- “Nothing in this Agreement shall be invalidated and no rights powers remedies and security of the financier created under the Security Documents shall be affected in any way if any of the provisions herein . . . or the enforcement thereof contravenes or is prohibited by Islamic Law, Islamic tenets and/or ‘Shari’aa.’”

It is also interesting to note that in many of the “Shari’aa-compliant” contracts that are supposed to be “Islamic,” we find similar statements, most famous of which is: “. . . this is a finance contract and in case it is brought to court it will be handled as a regular interest-bearing financial transaction.”

CONCLUSION

It is amazing to have gone through all these statements, claims, models, and references, in addition to the hundreds of millions of dollars spent and the valuable energy invested to develop such models, to end up traveling a full circle. We read that in a court of law, the contract is to be handled as a regular (riba-based) contract. This is the same good old riba-based contract that many of the Shari’aa-compliant efforts made since the 1970s were trying to change. There is another amazing observation having to do with the complete and deafening silence about two very basic aspects of RF financing. These are the marking-to-market principle and the commodity indexation rule, which were discussed in Chapters 3 and 5.

NOTES

1. The Cost-Plus model was used by American Finance House LARIBA in the Southern California area in the United States when it started its operations in 1987; it was used until 1989. However, after severe criticism from many of the community members based on the fact that it was very similar to riba-based transactions, LARIBA started searching for another model. In late 1989, LARIBA started using the new model, which was based on a lease-to-own approach developed for home financing for Al Baraka Bank in London. However, it was further developed by the author to include in it the marking-to-market principle, as will be discussed in a later chapter.

2. *Institute of Islamic Banking and Insurance (IIBI)* magazine: New Horizon; www.NewHorizon-IslamicBanking.com, issue number 170, January–March 2009, p.38.
3. Cited in Mahmoud Elgamal: *Islamic Finance—Law, Economics and Practice*, Cambridge University Press, 2006.
4. Ibid.
5. Ibid.
6. Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Karachi: Idarutul Ma'arif, 1998, pp.152–153.
7. Mahmoud Elgamal, *Islamic Finance—Law, Economics and Practice*, Cambridge University Press, 2006, pp. 44 and 129.
8. Fatwa of Al Baraka available at www.lariba.com/fatwas/index.htm and in Arabic: www.lariba.com.eg/karadawy.htm.
9. Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Idaratul Ma'arif, Karachi, Pakistan, 1998, pp. 85–91. Also available online at www.lariba.com/fatwas/usmani.htm.
10. Fatwa of Al Baraka available at www.lariba.com/fatwas/index.htm.
11. Al-Baraka Annual Edict (Fatwa) Meeting of Islamic Finance Scholars—Meeting Number 6: (pp.77–78) Algeria 5–9 Sha'baan 1410 A.H./2–6 October 1990 C.E. Sha'abaan is the eighth month of the Islamic calendar, and A.H. (which stands for After Hijra) denotes the Islamic calendar system. (*Hijra* means immigration of the Prophet Muhammad (pp) from Makkah to a northern city in the peninsula called Madinah, where the early pioneering Muslims started the foundation of the Islamic civilization and where the Prophet Muhammad is buried.) The Islamic calendar has 12 months, but it is based on the lunar system, which is 11 to 13 days shorter than the Gregorian system. That is why, for example, the month of fasting—Ramadan—rotates through all seasons. The calendar does not have a “short” month concept, as in the Jewish and Asian lunar calendar, to adjust for the seasons. For more information, please visit: www.islamicity.com/science/islamic_calendar.shtml.
12. Ibid., pp. 81–82.
13. Ibid. The fatwa also states: “This opinion is based on the view that what is intended here is not to effect Riba, which is forbidden in the Law (Shari'aa). Thus, following our deliberations, we reached the following conclusion: ‘Despite the fact that interest, as conventionally used in banking transactions, coincides precisely with the Riba that is forbidden in the Law (Shari'aa) to pay or receive, and regardless of whether the underlying transaction is a consumption or production loan, we have found that there is no objection to the use of the term “interest” in the cases related to those dealing with Al-Baraka Bank, London, aiming to benefit from the financial advantages given to interest in various cases of deposits and financing.’”
14. Ibid., pp. 84–87.
15. Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Idaratul Ma'arif, Karachi, Pakistan, 1998, pp. 85–91. Also available online at www.lariba.com/fatwas/usmani.htm.

16. Ibid.
17. Ibid: Justice Taqi Usmani states of the Shari'aa foundation: “. . . there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party, its permissibility is a point of difference between the Muslim Jurists. Imam Abu-Hanifa and Imam Zubair are of the view that the undivided share cannot be leased out to a third party, while Imam Mali and Imam Shafi', Abu Yusuf, and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself, all of them are unanimous on the validity of 'Ijarah.’” It is interesting that he does not call the leasing its proper classification and name as the “right to use.” He also stays silent about his position on the subject of dividing ownership into the title and the right to use.
18. During a number of meetings with him at his home in Cairo and via telephone conversations.
19. Guidance Residential Finance.
20. It is interesting to note that company representatives claim that the LLC monthly fee is paid to the state, that it costs \$35 in the state of Florida, and that the customer pays half of it and the company pays the other half.
21. Philip T.N. Koh, *Islamic Financial Instruments: The Civil Law and the Sharia Confluence or Conflict?* Presented at the fifth Islamic Finance Conference, Monash University, Kuala Lumpur. Philip T.N. Koh, FCIS is an advocate and solicitor for the High Court Malaya; his degrees include: LLB (Hons) (University Malaya), LLM (London), MA (Theology) (Australian Catholic University).
22. Ibid.
23. Ibid. *Shamil Bank of Bahrain v. Beximco Pharmaceuticals* [2003]2AllE R (Comm) 849 (Ch); [2004] 2 Lloyd's Rep 1 (CA).
24. *Bank Kerjasama Rakyat Malaysia Berhad v. EMCEE Corporation Sdn Bhd* [2003] 2MLJ 408; *Affin Bank Bhd v. Zulkifli b Abdullah* [2006] 3MLJ 67; *Bank Islam Malaysia Bhd v. Adnan B Omar* (1994) 3CLJ 735; *Bank Islam Malaysia Bhd v. Shamsudin bin Hail Ahmad* [1991 1 LNS 275; *Arab-Malaysian Merchant Bank Bhd v. Silver Concept Sdn Bhd* [2005] 5 MLJ 210; *Tahan Steel Corp Sdn Bhd v. Bank Islam Malaysia* [2004] 6MLJ 1, 33,34.
25. J. Suriyadi, in *AMMB v. Silver Concept*.
26. Philip T.N. Koh, *Islamic Financial Instruments: The Civil Law and the Sharia Confluence or Conflict?* Presented at the fifth Islamic Finance Conference, Monash University, Kuala Lumpur.