

ISLAMIC HOME FINANCING IN THE UNITED STATES

*A Market Analysis, Survey of Providers and Comparative Study of
the Methods Used to Offer Home Mortgages in the United States,
Proposals to Popularize Islamic Mortgages in America, Challenges
and Recommendations*

By

Dr. Yahia Abdul-Rahman
Founder, American Finance House - LARIBA
2091 East Altadena Drive, Altadena, CA 91001
YARAHMAN@MSN.COM

And

Mike Maguid Abdelaaty,
President, American Finance House - LARIBA
750 East Green Street, Suite 210, Pasadena, CA 91101, USA
WWW.AMERICANFINANCE.COM
WWW.LARIBA.COM
LARIBA@MSN.COM

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INTRODUCTION

The American Muslim Community has grown over the last 50 years. Its population is estimated to be 10 million and expected to expand to approximately 15 million by 2020 mainly through birth. The community has been endowed with a reservoir of highly qualified professionals, entrepreneurs, business executives, successful scholars and distinguished students. Most of the community members are compelled to violate one of the most basic requirements of their faith and that is dealing with interest; i.e. RIBA.

This paper is based on the practical experience gained by the authors in developing Islamic Banking and Financing services in the United States since 1986 through the founding of American Finance House -LARIBA, one of the older Islamic Financial institutions in the USA. Since inception of Islamic financing operations by American Finance House - LARIBA - in 1987, a wealth of in-depth knowledge of the market demand for ISLAMIC FINANCIAL products and services in the USA was accumulated. The authors have also been exposed to many challenges from the competition presented by the well developed, 600 year old and highly capitalized RIBA (conventional) financial and banking system. It is believed that the ISLAMIC FINANCIAL system, as it develops and becomes more publicized and popularized, will be in great demand, not only by members of the Muslim community, but by people of all faiths in the community at large.

BACKGROUND

THE PROMISED DREAM OF OWNERSHIP

The instinct of owning a place to live in and to produce livelihood has produced a natural dream for every individual and family. The motor of economic development throughout history has been through helping people own a home and a means of transportation. In today's language, it means owning a house and an automobile. That is why 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 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 owning by the citizen. Feeling that he/she own a house; "a piece of the rock", makes the citizen proud of his/her citizenship, deepens the feeling of belonging to the country, enhances the real estate in general as owners strive to beautify their owned properties by continually maintaining and improving it. Finally, owning a home strengthens the feeling of responsibility towards the citizens' own families and the community at large.

That is why major economic policies in developed nations have been designed to essentially 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 a catalyst in the promotion and facilitation of owning a home. Examples are:

Federal National Mortgage Association ("FNMA"): a government sponsored, publicly held corporation chartered in 1938 to provide ongoing assistance to the secondary market for residential mortgages by purchasing mortgages from lenders, packaging them and reselling them to investors thereby improving the distribution of investment capital available for such mortgage financing.

Federal Home Loan Bank System ("FHLB"): was chartered by the US Congress in 1970 to create a continuous flow of funds to savings associations, cooperative banks and mortgage lenders in support of Home Ownership and rental housing. The system consists of 12 regional banks and operates in a manner similar to the Federal Reserve Bank's role to Commercial banks.

Federal Home Loan Mortgage Corporation ("FHLMC"): a publicly chartered corporation which buys qualifying residential mortgages, packages them and sells them as securities backed by those pooled mortgages. The corporations

stock is owned by savings institutions across the USA and held in trust by the Federal Home Loan bank System.

Government National Mortgage Association ("GNMA"): a government entity that facilitates housing finance through two main programs; one, it guarantees payment of principal and interest to investors of mortgage-backed securities; and two, absorbs the write-down of low interest-rate loans that are used to finance housing catering to "low income" families.

In fact one of the important parameters used by the Federal Reserve System, (The Fed - America's Central Bank) in its decision regarding interest rate and monetary policy is the its impact on the housing industry.

Finally, in an effort to encourage Americans to own homes through mortgage financing, the US 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 indirectly poses the question: how, in a world of increasing economic and political uncertainty, are we to envision means of strengthening civil society and community? We believe that Islamic Financing is one of such means that is eminently doable and practical.

THE MARKET

THE AMERICAN MUSLIM COMMUNITY

The American Muslim Council (AMC), in a popular survey published in December 1992, estimated that the population of Muslims in the United States ranges between 5 million and 8 million. A most acceptable figure at that time was an average of 6 million. Most recent estimates indicate that the American Muslim population is closer to 10 million. The State of California has the largest Muslim population among all states. It is estimated that there are at least 1,000,000 Muslims living in California. Following California are the States of New York (4.7% of total population), Illinois (3.6%), New Jersey (2.5%), Michigan (3.2%), and Texas (2%.) There is a significant Muslim community living in other states like Indiana, Maryland, Ohio and Virginia.

Most of the Muslims in the United States have been integrated in the conventional (RIBA-based) banking system prevailing in the United States and the rest of the world. They take advantage of FDIC insured bank deposits, borrow money for buying homes (RIBA mortgages), use credit cards with delayed payment terms, and take home equity (RIBA-based) lines of credit. Most of the affluent members of the Muslim business community have used the RIBA-based banking system in the USA and have accumulated significant wealth through its use. In this environment, it was very difficult to convince many members of the Muslim community to change over, even in a small way, from this HARAM (forbidden) activity and into a HALAL (lawful) based system. A number of justifications

for continued participation in RIBA activities have been and continue to be raised, albeit at a lesser rate, by members of the community. Examples include:

- 1) The laws of Islamic Finance & Economics cannot be upheld by a minority group which lacks the credible institutions and the means to offer HALAL (lawful) financing and banking;
- 2) RIBA is “Usury” not interest. So, as long as the interest rate charged is not excessive and is done by the choice of the user and is not forced onto him/her then it is not considered RIBA,
- 3) RIBA, interest and Islamic-based profits are the same. All Islamic Finance institutions do is to replace the word *interest* with the word *profit*; and
- 4) Some Islamic financial institutions in Egypt and other parts of the World like in Dubai, Denmark, Belgium and Malaysia have failed due to inexperience, fraud, insufficient disclosure of risk, lack of transparency and regulatory supervision and mismanagement.

For a new alternative Islamic Finance system to prevail and succeed in the United States, which operates the most organized and sophisticated financial, monetary and banking system in the world, it was a very difficult uphill battle. In the beginning, we found it to be almost impossible to capture people’s interest and imagination unless they are motivated deeply by the strict adherence to the Shari’aa (Islamic Jurisprudence), the Quraan and the Sunna (tradition and system developed by Prophet Muhammad (s).) People thought that we are “silly” to try to bring an Islamic Financing concept in a World run by RIBA.

In all fairness, based on first hand experience and in-depth knowledge at the grassroots level of the community, we have discovered that a large portion of the Muslim middle class households have accepted RIBA mortgages and other conventional financial and banking services against their will. This was because it was the only alternative available. It is our feeling that many of these households would happily and readily convert to Islamic Mortgages and financing if such were available and competitive. There are many people, Muslims and non-Muslims, who feel disenfranchised by traditional methods of financing, or who feel – whether correctly or not - that they are denied access to adequate credit with terms that are morally acceptable and economically feasible and affordable. We are reminded of the successes of the Credit Union industry among blue-collar workers in America. History shows that the Credit Union system catered to those many people who simply could not afford traditional bank accounts because they live from paycheck to paycheck and cannot maintain a minimum balance and/or do not have the sophistication to prepare the financial disclosures required by banks.

THE MARKET

ISLAMIC HOME FINANCING IN AMERICA

The first and foremost market segment being addressed by Islamic finance companies in the United States, is that small segment 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 financial statements are clear of any debt of any sort. It is estimated that this segment represents approximately 2% to 5% of the professional segment of the community. It is the moral responsibility of the Islamic bankers and investment/mortgage bankers to cater to the needs of this “Puritan” segment of the community. It is also important to note that the term Puritan is used here on purpose. The term "Puritan" conveys the core principles of American democratic participatory freedom and virtue through industriousness and property ownership.

If we assume that the Muslim population in the USA consists of 1.5 million Muslim households (based on four persons per household) 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 Islamic laws; i.e., praying regularly, attending Friday prayers and Eid prayers, paying Zakat and performing Hajj, then the number of households would be 150,000. If we assume that 5% to 10% of this number can be considered “Puritans”, dedicated to deal only in accordance with Islamic laws, then the number of households which is in need of Islamic financing is estimated to be 7,500 to 15,000 households. We estimate that the market size is approximately 10,000 households in order to be on the safe side.

This very conservative figure of 10,000 households represents the real successful puritans who are businessmen/women, engineers, doctors, professors, and religious leaders. They demand an Islamic mortgage model and approach that can be validated by their most respected and trusted religious scholar (usually back in Pakistan or other Muslim countries). The profile of this market segment is unique. Such individuals are extremely pious. They run cash only households. They use the banks for safe depositing of funds and refuse to accept money market interest. They carry no debt. They fulfill their obligations on time. They are honorable and extremely successful and reputable. They do not show off their success and accumulated savings because of their training to be humble. They are extremely particular about details of HALAL and HARAM. They are careful in whom to place their trust; however, once earned; their trust will be given in full. They can be classified as the best credit worthy members of a community. They only can be recognized if those Islamic bankers are true community workers on a grassroots level.

The typical house price varies widely from one state to another. A median house price in California is \$250,000 compared to \$ 150,000 in Texas. For purposes of this analysis we use a price of \$150,000 for convenience and conservatism. Assuming that 70% of the value of the home is to be financed, then the average Islamic mortgage amount would be \$105,000. Therefore, a market of 10,000 households represents a demand of about \$1,050 million. As the Islamic mortgage concept gains credibility and proven track record, we expect it to grow significantly to attract members of the middle class through refinancing, non-Muslims

who will like the concept and the new generation of youths who are more sophisticated in evaluating alternative mortgage concepts.

It is also important to note that the population of American Muslims is expected to reach around 20 million by 2025 Mainly due to the growth in the number of children born to the first generation Muslims. This new generation will assume better and more affluent positions in the American infrastructure than their parents that will increase the percentage of prospects among them for this financing. We believe that the market potential for Islamic home mortgages could reach at least \$3,000 million. This does not include other community Islamic financing needs that include automobile financing, small business financing and construction financing.

ISLAMIC FINANCING AND RIBA (Conventional) FINANCING DEFINITIONS USING BANKERS' TERMINOLOGY

In today's banking terminology, one can conceptually define RIBA as unsecured and non-collateralized credit that are not asset or service based. In an Islamic Finance (or NO-RIBA) setting, the financing activity by a bank is looked upon as an investment by the bank in the individual (or company) in order to help that entity acquire tangible assets and/or services. In this capacity, the Islamic bank loans officer makes sure that the loan has merit and it is used for a specific use.

The other important aspect of an Islamic Banking transaction is that there is no predetermined value measurement for money as RIBA Banking transaction. In an Islamic Banking transaction, the return on investment is obtained as a result of the investment process or the leasing process of the asset in question. That return on investment is the real measure of the value of the investment activity with its unique characteristics. In doing so, the Islamic Banker marks everything to the market instead of using a unified interest rate throughout the country. For example, a house rent should reflect the value of that house and not a "cap" rate as it is done in most leases. The rent of two similar homes, one in Alabama and another in California should be different because of the difference in the economics characteristics of each state. That difference should be reflected in the financing process by the lease rate as dictated by the market forces of supply and demand.

In other words, Islamic Banking can be defined as a socially responsible and ethical conventional banking service for community economic development that uses asset-and/or service- based financing. One way of determining the economic utility of the item to be financed is the lease rate it can command on the market.

Conventional RIBA Banks' operating experience has shown that most non-performing loans come from the so-called unsecured lines of credit.

COMPARATIVE STUDY OF ISLAMIC FINANCING OPERATING COMPANIES IN THE USA

There are three companies offering Islamic Home Financing to the community in the United States. These are:

1. Al-Manzil Islamic Financial Services ("Al-Manzil"), a business unit of the United Bank of Kuwait PLC. - New York, New York.
2. American Finance House LARIBA - ("AFHL") - Pasadena, California
3. MSI Financial Services Corporation ("MSI") - Houston, Texas.

The following is a brief description of each company's program:

1. *Al-Manzil Islamic Financial Services*

FEATURE	DESCRIPTION
Company Structure	Company is a business unit of the United Bank of Kuwait PLC. It operates out of New York City.
Source of Funding	Seed capital is provided by United Bank of Kuwait, PLC. Parent company.
Model	Ijara wa Iqtinaa (rent to own).
Availability /Waiting Period	Company's products are available in California and Connecticut at date of this paper. There is no waiting period for qualifying.
Title Ownership	Property is registered in the name of Al-Manzil until the Home Buyer pays off has paid the original purchase price; at which time, the title is granted to the Buyer for a nominal fee.
Monthly payments	Payments include two components a rental portion and a portion representing a contribution towards the purchase price. The later amount is held in a separate account until it reaches the original purchase price of the property.
Payment Calculation	Payments are calculated using a regular amortization schedule as in conventional mortgages. Payments can be fixed for 1, 3, or 5 years and then readjusted based on an agreed upon spread over the London Interbank Offered Rate (LIBOR) which is used as a bench marks for rental value.
Financing Term	Financing can be made for up to 30 years
Down Payment	20%
Selling Property/ Prepayment	Home Buyers may sell the property and buyback the remaining share with mutual consent of Al-Manzil. In addition, Home Buyers may prepay a portion of the

	purchase price at any time with such proceeds to be held in a separate purchase account until it reaches full purchase price.
Upfront Fees	Initial expenses associated with the financing include application, credit report, processing and arrangement fees as well as other traditional real estate costs such as escrow, title, attorneys, etc. are for account of the Home Buyer.
Maintenance Costs	Ongoing ownership expenses such as insurance and taxes are for the account of the Home Buyer. Insurance is required to be obtained from an Islamic Insurance Company "First Takaful".
Tax Deduction	Company issues IRS Form 1098 to allow for tax deduction of the rental portion of the payments based on an opinion letter from the Internal Revenue Service (IRS.)
Share of Gain/Losses	In event of sale of property ahead of financing tenor, any gain realized is for the account of the Home Owner. Any losses are deducted from the Home Buyer's deposits against the purchase price.
Process	Home Buyers can apply through designated brokers or by contacting the company directly.

2. American Finance House LARIBA

FEATURE	DESCRIPTION
Company Structure	An independent company headquartered in Pasadena, California. Company was formed in 1987 and licensed as a finance lender in the State of California. Company provides financing for automobiles and small businesses in addition to its home financing activities.
Source of Funding	Individual shareholders and investors from the American Muslim Community who wish to participate in the profits generated by the company provide funding through share ownership or investment.
Model/ Availability	Lease to Purchase with Declining Equity, (Ijara -wa- Iqtinaa).
Availability/ Waiting Period	Company is registered in 12 states including Arizona, California, Colorado, Georgia, Illinois, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, Texas and Virginia (as of January 2000). No waiting period is required for qualifying.
Title Ownership	Property is registered in the name of Home Buyer with company holding a lien on the property as collateral.
Monthly payments	Payments include a rental component and an installment

	purchase (loan repayment) component. Home Owner pays taxes and insurance independently.
Payment Calculation	The rental component is a function of the fair rental value of the property as determined by both company and Home Buyer's research of rental values in the area of financed property. Rental value is agreed upon with the Home Buyer at the start of transaction on an ad/hoc basis. Home Buyer pays a percentage of the fair rental value based on the equity share of the company. This component is referred to as Return on Capital ("R-ON-C" pronounced ronsee). The installment purchase component represents the amount required each month to purchase back the amount advanced by the company over the life of the financing with NO ADDITIONAL INCREASE OR INTEREST. This component is referred to as Return of Capital ("R-OF-C" pronounced rofsee). Although monthly payments are fixed for the term of the financing, the rental component decreases each month as the company's equity share declines.
Tenor	Financing can be made for up to 15 years. Company recommends from 7 to a maximum of 10 years.
Down Payment	20-40% depending on availability of funds.
Selling Property/ Prepayment	Home Buyer may sell the property at any time and buyback the remaining shares of company (balance of financing amount). Partial prepayment (purchase) may also be made at any time. Partial payments will be applied against the purchase installments in inverse order of maturity, and rental component is reduced proportionately. A prepayment fee of approximately 2% of remaining balance and is calculated based on actual out of pocket expenses associated with the process.
Upfront Fees	Initial expenses associated with the loan including credit report, processing and arrangement fees as well as other traditional real estate costs such as escrow; title, attorneys, etc. are for account of the Home Buyer.
Maintenance Costs	The Home Owner pays ongoing ownership expenses such as insurance, maintenance, etc. Company requires that Property be insured for value of its equity with any reputable insurance company of Home Buyer's choosing.
Tax Deduction	Company issue IRS form 1098 to allow for deduction of rental portion of the payments which is calculated at the beginning of the transaction and <u>converted to an implied interest rate</u> on the promissory note.

Share of Gain/Losses	In event of sale of property ahead of financing tenor, any gain or loss realized is for the account of the Home Owner.
Process	Home Buyer can apply through the Internet, fax or by contacting the company directly.

3. MSI Financial Services Corporation:

FEATURE	DESCRIPTION
Company Structure	A financial services corporation founded in 1985. Company started its operation in Beverly Hills, California and later moved to Houston, Texas. Company provides financing for homes, automobiles and businesses.
Source of Funding	Company establishes and manages private limited partnership funds (Mudaraba basis) which are marketed to accredited investors (high net worth and annual income) from the American Muslim Community. The proceeds of the funds are used to finance the various activities.
Financing Model	Shared Home Appreciation in Rent and Equity (rent to own).
Availability/Waiting Period	Available in major US cities pending availability of partnership funds. Home Buyers must invest 20% of purchase price with company for at least 6 months in order to qualify for consideration.
Title Ownership	Property is registered in the names of both MSI's housing fund and the Home Buyer.
Monthly payments	Monthly payments consist of two components – rental amount and amount to buy back MSI's share. Payments also include taxes and insurance, which is shared by MSI based on its ownership share. Payments are adjusted annually based on the value of the house, which is determined by an independent appraisal.
Payment Calculation	MSI calculates the monthly payment every year to take into account the appraised value of property, amount of taxes and insurance and rental value in the area.
Financing Term	Financing can be made for 5-15 years
Down Payment	20% of the purchase amount must be invested with the fund for a period of 6 months prior to participation in the program. After qualifying, there is a waiting list for funding of several months.
Selling Property/ Prepayment	Home Owner may sell the property with mutual consent of the fund. Gains/losses are divided between the Home Owner and housing fund. Home Buyer may elect to prepay up to 20% of the property purchase amount annually.
Upfront Fees	Initial expenses associated with the financing include application, and credit report, processing and arrangement

	fees as well as other traditional real estate costs such as escrow, title, attorneys, etc. are for account of the Home Buyer estimated at 1-2% of financing amount.
Maintenance Costs	Ongoing ownership expenses such as insurance and taxes are shared with MSI and included in the monthly payment. Maintenance repairs are to the account of the Home Buyer. Large uninsured repairs are shared with MSI in accordance with each party's ownership percentage.
Tax Deduction	Monthly payments do not benefit from a tax deduction.
Share of Gain/Losses	In event of sale of property ahead of financing term, MSI and the Home Buyer in accordance with their ownership percentage share gains or losses at time of sale.
Process	Home Buyer can apply through company or its regional representatives. Home Buyer must become members of the fund by investing at least 20% of the property cost (minimum \$10,000) for a period of 6 months to become eligible for borrowing from the fund.

ANALYSIS OF THE ISLAMIC FINANCING MODELS USED BY THE MAJOR AMERICAN ISLAMIC FINANCE COMPANIES

It is evident from the above summary that all three entities although have different legal and operating characteristics, they share the basic concept of purchasing the property with the prospective Home Buyer and charging a return for their ownership share. Notwithstanding the agreement on charging a return for their equity share, each company has a different approach to calculating such amount. The approaches range from an interest-based index (London Interbank Offered Rate) that is adjusted periodically (Al- Manzil), to property value approach that is adjusted annually (MSI), to a fixed amount based on market value of rents in the particular area of financed property (AFHL). The basis for each company's calculation is its own proprietary information. AFHL endeavors to follow the "Mark to Market" when setting the rent as prescribed by our Prophet Mohammed (PBUH).

The security/collateral used by each company differs specially as relates to title (certificate of ownership) to the financed property. In the case of Al-Manzil, title is held in the name of the company until lease term is completed or total purchase price is prepaid. In case of MSI, the title reflects both MSI and the Home Buyer as owners. In the case of AFHL, title is solely in the name of the Home Buyer with AFHL taking a mortgage lien on the property. The different security structures allow certain flexibility and security to the Home Buyers. In our opinion, the AFHL model provides the most security and flexibility to the Home Owner while securing the interests of the company.

The term of financing offered also differs by company, which serves to benefit Home Buyer's cashflow circumstances. AlManzil offers the longest financing term of up to 30 years, which comes closest to terms offered by traditional mortgage providers. Both

MSI and AFHL limit their transactions to 15 years, however, in case of AFHL, we recommend a maximum of 7- 10 years. This recommendation is based on a 1996 study by the California Home Financing Association, which discovered that homeowners sell their residences every 8 years on average. We feel that by extending the amortization to 15-30 years, the rental (financing) charges add up to an unreasonably high amount. In addition, given the amortization nature of a 30-year financing, a homeowner who sells after 8 years will still have a very significant percentage outstanding of original amount financed. Therefore this individual will always be in debt and never enjoy the comfort of limited or “no bills”.

The legal structure of each company provides certain advantages to homebuyer and investors. For example, in the case of Al-Manzil, Home Buyers can enjoy a large source of funds to fund any size project. However, investors do not share in the returns of the company. On the other hand, both MSI and AFHL’s homebuyers are restricted by the availability of funds for large projects. MSI and AFHL’s customers also have to endure some waiting period for funding (up to several months in case of MSI); or have to pay a higher down payment due limited funds (in case of AFHL.)

A CONCEPTUAL COMPARISON BETWEEN THE APPROACHES USED IN RIBA (CONVENTIONAL) AND ISLAMIC FINANCING

In order to contrast the approach taken in a RIBA conventional financing with Islamic financing; let us consider a case study.

A family wants to buy a car for \$30,000. They only have \$6,000 of the purchase price. They approach a bank to help them finance the car. The following is a comparison between how the process will likely go in a RIBA Banking setting as compared to Islamic Banking setting:

RIBA Conventional Banker:

- 1. Evaluates the application form.**
- 2. Concludes that the family derives a good income and that they have a good balance sheet. Also, the banker finds that the family cash flow can help them pay for a larger car or even to take a bigger loan without putting the \$6,000 down,**
- 3. Decides to lend the family at a certain interest rate over a period of time.**
- 4. The repayment period defined by the banker can even be longer than necessary because the banker wants to help improve the family’s surplus cash flow. In fact, it also helps the bank derive more interest income from a good qualified family as the loan repayment is extended.**
- 5. In fact, the banker may convince the family to buy a bigger and more equipped car. This is because the higher amount will represent a small addition to the monthly payment and it will be taken care of by prolonging the financing period (term of the loan).**

Islamic Banker:

1. Evaluates the application form.
2. Concludes that the family derives a good income and that they have a good balance sheet and good tax returns. In addition, the banker finds that the family cash flow is enough to cover the monthly payment for the car purchase.
3. Calls around to ask with car agencies such as Hertz and Enterprise as well as manufacturers' leasing agencies such as Toyota, Ford and GM about the utility value of the car measured by the lease rate.
4. Draws an agreement with the family that complies with the Islamic Finance legal requirements. In this agreement:
 - 4.1. The family would own 6,000/30,000 or 20% of the car and the Bank would (temporarily) own 80% of the car. In the same agreement the family agrees to buy the bank's share of the car for the same value or $\$(30,000 - 6,000) = 24,000$. This way the bank does not own the asset that complies with banking rules and regulations. The family, based on their cash flow agrees to pay back the bank's share interest free over a period of 3 years or \$8,000 per year. This is called the Return OF Capital.
 - 4.2. The family and the Banker, independently, survey the market to find a fair leasing rate for the car. They negotiate a fair lease and agree on it. Here the lease is divided between the family (20% in the beginning and rising to 100% over 3 years) and the Bank (80% in the beginning and declining to 0% over 3 years term.) This is called the Return ON Capital for the Bank. The computer program developed by LARIBA is mechanically not much different from a regular amortization schedule. The difference is that the variable in the LARIBA program is the lease rate defined by the market while the amortization schedule uses interest rate as a parameter.
 - 4.3. The family and the Islamic banker, in order to satisfy the laws of the land, sign a promissory note, which documents the repayment of the debt (no time value of money) and the declining lease rate in a total monthly payment. In order to comply with the laws of the land, the Islamic banker plugs in the monthly payments representing the lease rate and the Return of Capital into a conventional amortization schedule to figure the "implied" interest rate. This rate is disclosed to the client in order to comply with the "truth-in-lending" laws.

Please note that the resulting “implied” interest rate is not uniformly the same. It differs from one car to another and it differs based on the leasing rate in the relevant market.

In the Islamic Banking environment, the Islamic banker encourages the family to pay their car off as fast as they possibly can in order to reduce the burden of debt on the family’s cash flow and free more money to save for the future.

PROBLEMS AND CHALLENGES ENCOUNTERED IN DELIVRY OF ISLAMIC FINANCIAL AND BANKING SERVICES

A number of problems and challenges face all those who have attempted to deliver financial and banking services in the west and primarily in the United States. The following is a summary of the problems and challenges:

1. PROBLEMS:

- 1.1. Use of the term “Islamic” with respect to business/operating philosophies in the Western Societies creates automatic defensiveness and potential conflict. This is due to the deep-rooted beliefs in the doctrine of “Separation of Church and State.” Many of the participants in the financial services industry believe that the system operates most efficiently when it has no influence from religious doctrines. Once a religious affiliation is introduced, problems of discrimination and biases surface.**
- 1.2. Cost of Islamic financing transactions is often higher (as a percentage of capital) than traditional financing. This is primarily due to the implicit American government subsidy of mortgages to enhance the economy, unified cost of funds applied for financing, the different and highly diversified source of funds, the ability to securitize the loans, and the economies of scale enjoyed by the traditional financing sources. The practice of applying unified interest rates as the cost of funds for all transaction conflicts with the Islamic Financing concepts that sets returns to the assets being financed or “Mark to Market”. Using a unified rate in effect subsidizes the cost of funds to the person financing the higher value asset from the cost of funds of the lower value item; which is totally unfair. Additionally, the US government’s ability to borrow money at the lowest rates through its agencies and chartered corporations such as FNMA, FHLB, FHLMC and GNMA (as described in the Background) artificially lowers the cost of funds for traditional mortgages compared to Islamic type financing. Lastly, the economies of scale enjoyed by the large traditional**

lending institutions also favor them in delivering a lower cost of funds.

- 1.3. **Suspicious and negative connotations against Islamic influences. Government regulatory and oversight agencies have developed sensitivities against Islamic banking activities due to association with foreign influences, money laundering, and terrorism. These sensitivities have been especially heightened after the BCCI experience. A point of misunderstanding and debate has been the role and relationship between bank regulators and the Shari'aa boards, with each claiming to have the "final" authority.**
- 1.4. **Poor image of Islamic Banking and Finance among some of the Muslims themselves. Unfortunate negative experiences of Islamic Finance Companies in Egypt, and Islamic banks in Denmark, Luxembourg, Dubai and Bahrain have caused concern by many Muslims about the lack of control which led to the mismanagement and fraud experienced in the above institutions.**
- 1.5. **Discrimination and fear by the non-Muslim members of the community against Islamic activities. In reaction to views perpetuated by the media and the actions of some of our Muslim brothers and sisters, there is a fear that Islamic activities are aimed at best to serve Muslims, and at worst, will conspire to destroy the financial system in which the West believes and trusts. Even some Muslims who have become accustomed to using the RIBA (Conventional) banking services share such views.**
- 1.6. **Lack of competitive Islamic financial products and services that can compete with the conventional RIBA services. The fragmented efforts and limited means of Islamic banking organizations in the West and limited emphasis on research and development have resulted in a paltry selection of products and services which are limited to very traditional transactions which are short term oriented. This lack of products affects both the investors who wish to participate in the system and the Home Owners who look at this system to meet their financing needs.**
- 1.7. **Confusion regarding proper classification of Islamic banking services. There is debate among the regulatory and oversight agencies regarding whether the Islamic products which rely on sharing the risks of the transaction with the Home Owner are truly commercial banking (as defined by such agencies), or are investment banking. The latter puts such products outside the control of traditional bank regulators and separate regulatory bodies. Additionally, certain laws exist in the USA because of historical financial imbalances that work to clearly define and**

separate the activities of commercial and investment banking entities.

- 1.8. Failure of Islamic banks to reach and serve the grass roots of the communities. Given the small and fragmented size of Islamic financial organizations, there has been little concerted efforts to reach out to the economically challenged members in the communities in which they operate to apply what bank regulators call "Community Reinvestment Act" (CRA). With resources and dedicated efforts, the Islamic financial institutions are best suited, and in fact ordered by the Quraan and Sunnah, to take on such activities.

2. CHALLENGES:

- 2.1. The ability to expand the delivery of Islamic banking and finance products is heavily dependent on our ability offer it as an alternative to the traditional banking within the traditional banks. New bank regulations have permitted banks to provide non-traditional banking products to their clients; we must utilize such environment to deliver Islamic products. This can be achieved through a specialized window that sources deposits and deploys funds in accordance with Islamic requirements while enjoying the same regulatory oversight and support as traditional banking.
- 2.2. In order to succeed in providing Islamic financing as an alternative, we must communicate the nature and benefits of our products to the regulators and traditional banks' ownership in western banking terminology that can be easily understood and accepted.
- 2.3. The key to gaining access to these traditional RIBA banking firms is to effectively highlight the benefits of the products to both the consumers and the communities in which these institutions operate. Many of these institutions are under pressure from regulators and management to cater to the underserved segments of their communities.
- 2.4. Marketing is a key aspect to the success of any product or idea. Acceptance can only be achieved after awareness. Popularizing Islamic finance, can best be achieved by having it available in direct competition with traditional products and under the same roof? Opening an Islamic financial service window in every conventional bank in the West would provide excellent means for delivery of the products. The challenge would then be to train and educate sufficient bankers that can administer and deliver these products. Several scholars have already agreed that opening such a window does not conflict with Islamic prohibitions relating to RIBA.

PROPOSED SOLUTIONS

1. It would behoove us to describe our transactions and contracts in terms that have a common equivalent in the western banking terminology. The sensitivities raised about the separation of Church and State in the USA and the feelings of discrimination and biases that result from use of the label "Islamic". This will not only facilitate communication, but also go a long way to diminish the bias against foreign influences. We can always conduct our selves and structure our contracts in a manner that meets the requirements of the Quraan and Sunna; which is our ultimate goal.
2. Emphasize the fairness of the Islamic financing system where the disadvantaged do not subsidize the cost of funds of the of the affluent. The higher financing costs can be viewed as a marketing tool to entice investors to place their deposits and share in the returns. As the products gain acceptance and larger institutions offer Islamic financing, market forces should minimize the cost of funds differential between the traditional and Islamic systems.
3. Conduct effective dialogue and extensive communication with the regulators and governmental oversight committees in academic and business forums. This will serve to diminish the biases and fears against Muslims. It should be made clear that such Islamic products will actually enhance the stability of the traditional banking system as more of the Muslim brothers and sisters will participate with their assets in the system which will benefit the traditional lending institutions' non-RIBA based services. Such cooperation between traditional and Islamic institutions will assist Islamic entities in developing new products that meet the demands of non-Muslims.
4. Design and implement training of American Muslim young men and women into areas of Islamic credit and banking will help in the development of this field and the realization of our goals. Many practitioners and academicians have already started down this path of education. However, their efforts are primarily based outside of the USA.
5. Lobby for including Islamic Banking and finance in approved forms of Community Reinvestment Activities, which will prompt traditional bankers to be more eager to participate. Regulatory agencies will be eager to embrace Islamic Financing products once their benefits are demonstrated.

CONCLUSIONS

1. There is enormous demand for Islamic banking and financial services. A most conservative estimate is that there are 10,000 households in the USA that would not participate in traditional financing services due to the RIBA prohibitions. There are at least twice as many that would seek out an Islamic alternative if one were available at competitive costs. This translates into a huge demand for financing services for homes, automobiles, businesses, etc. We also can not dismiss the unknown number non-Muslims who would choose to participate in an Islamic system based on the fairness of such system.
2. The three companies operating in this field, Al-Manzil, AFHL, and MSI have taken steps to meet this demand each in accordance with its own means. Although they compete for business, the developing state of the Islamic financing industry in The USA makes them complimentary to one another. In fact, we at AFHL, always make it a point to mention the other two companies to our Home Owners and encourage them to check with all companies before settling on one. As the market matures, the Home Owners will decide on which company offers the best model that meets its needs.
3. In order to succeed in reaching this huge demand for Islamic banking and finance, much work should be done to educate the regulatory and oversight agencies regarding both the need and the demand for such services. Key to reaching the desired level of understanding is the simplification of the terminology and concepts as well as use of existing widely used western banking terminology.
4. Significant investment in people and systems are also required to give confidence in the Islamic banking and finance model to both the participants and regulators. The history of fraudulent and mismanaged institutions must be explained and avoided. The role of the Shari'aa Boards and the regulatory bodies must be addressed and clearly delineated.
5. It is our belief that the best approach to begin delivery of such services in a way that reaches the largest number of clients, is through the establishment of separate windows to offer Islamic services within the traditional bankers. This will facilitate access to the Muslims as well as grant the regulators the desired access to assure that the system is sound. There are already precedents for delivery of non-banking products by banks, which can be used for allowing Islamic banking. It should be made clear that such products are alternatives to existing system and compliment it in reach a significant underserved segment of population. Through sincere interaction, the fears and misconceptions against Muslims as terrorists, and destabilizing groups can be minimized and ultimately eliminated.