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# America's sub-prime mortgage crisis: Could it happen in a Shariah-compliant system?

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markets led to an escalating number of foreclosures, resulting in major declines in house prices. This structure left the lenders unable to recover their losses in the market. However, the losses were not curtailed to only the mortgage and commercial lending of banks. The bigger impact was felt by the global structured finance markets in addition to lower prices of bank shares due to the linkage of exchanges. The impact of higher borrower default rates across the US affected structured products such as mortgage-backed securities. Investment houses that heavily backed hedge funds involved in real estate or subprime mortgages suffered massive losses.

As Islamic finance becomes more popular and investments in the Middle East increase, the question that must be asked is: would the sub-prime mortgage crisis have happened in an Islamic finance system? This can be answered by discussing Islamic mortgages. There are three main principles that underlie Islamic finance, namely: prohibition of *gharar* (excessive uncertainty), *riba* (interest) and investing in *haram* (not permissible) products.

The purpose of any mortgage is to provide finance to an individual or an institution intent on purchasing a property. The property will then be used as collateral. Shariah-compliant mortgages are granted as an alternative to conventional interest-bearing mortgages. Islamic mortgages can be granted with two structures: a diminishing *musharaka* (partnership) or an *ijarah* (lease). There is no loan in Islamic mortgages; rather, an equity-sharing with each party bearing the risk of equity ownership pro rata.

In a diminishing *musharaka*, as the mortgagee makes monthly payments to the mortgagor, the equity stake of the mortgagee in the property increases while the beneficial interest of the mortgagor diminishes. By using a diminishing *musharaka*, there is a partnership between the bank and the home owner with respect to the property. The bank's beneficial interest is on a diminishing basis, with the payments made by the home owner to the bank representing (a) rent and (b) a contribution to a drawdown of the bank's partnership interest in the property.

Each time the home owner makes a payment, his percentage of ownership in the property increases while the bank's percentage of equity decreases. This results in the home owner being entitled to his share of equity in the property regardless of any price fluctuations. In a conventional structure, a decline in property prices could result in the home owner losing all rights to the property if the mortgage is higher than the property's market price at the time of the foreclosure.

In an *ijarah*—a lease-to-own agreement—the lessee will make payments to the financier until the expiry of the term of the lease, at which point the financier will transfer the ownership of the house over to the lessee. As part of the lease-to-own agreement, payments represent both rent and an equity contribution towards the purchase price of the property. As an alternative to conventional finance, it is mandatory in an *ijarah* for the financier to transfer ownership at the end of the term.

***As Islamic finance moves from niche to mainstream, finance companies can mitigate the risks facing their conventional counterparts***
***Oliver Agha***

In both financial structures, because the financier has an equity stake in the property, it will be more discerning with whom it forms a partnership. All risks are borne pro rata between the mortgagor and the mortgagee and the two parties share all risks as opposed to one party shifting the associated risks to the other.

In an ideal Islamic finance structure, it is unlikely that risky borrowers would be granted a mortgage to such an extent as seen in the conventional model, thus minimising the use of leverage, the catalyst for the sub-prime mortgage crisis.

In an Islamic system, the financiers will ensure that those with whom they enter into Islamic contracts are highly suitable candidates, as this will reduce the chances of default and, in turn, will diminish the possibility of the financier ending up foreclosing on a property in a declining market. Therefore, when granting a mortgage, the Islamic bank or institution offers an amount based on the individual's ability to meet its obligations. In addition, Islamic finance prohibits unjust enrichment and would ensure against loss of the property as part of a foreclosure proceedings.

As Islamic finance moves away from its niche status to mainstream financing, especially in the Middle East, finance companies can successfully mitigate the risks facing their conventional counterparts. This is due to the nature of Islamic mortgages, especially in an *ijarah* in which the bank owns the asset and the title is vested with the bank until the last payment is made by the borrower, and title then transfers to the borrower.

In this sense, unlike its conventional counterpart, an Islamic mortgage is not an instalment sales scheme; rather, it is a lease–to–own structure. Title vests with the bank until the last payment is made by the lessee at which point there is a transfer of ownership. Therefore, there is less chance of default, as the lessee's rights are more limited under this scheme. Since title does not vest with the lessee, the lessee cannot create other charges or liens on the property; whereas, under a conventional mortgage this is highly possible, with an exponential rise in second and third mortgages and home equity loans prior to the crisis.

In Islamic finance, any risks or rights associated with assets cannot be traded independently from the assets as trading in debt is not permissible because it strips the investor from a right of recourse in case of a default. The recent sub-prime mortgage crisis led to after–shocks worldwide, especially in conventional credit markets. However, as Islamic finance gains momentum—especially in the Middle East—investors and financiers are more likely to consider it as a viable alternative, especially for real estate. ■

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# Crisis? What crisis?

**With the sub-prime mortgage crisis causing conventional markets to take a tumble, Oliver Agha explores whether a similar problem could ever be faced in Islamic finance**

In the latter part of the year, the financial press has heavily concentrated on the "sub-prime" mortgage crisis and the consequent credit crunch grappling the global financial markets. The domino effect of this crisis has parlayed into the structured finance markets, especially the mortgage-backed securities industry. What are the major elements responsible for the crisis, and would an Islamic finance model have prevented this?

A sub-prime mortgage essentially refers to a mortgage granted to a risky borrower, with lenders facing a higher risk of default due to the borrower's short or poor credit history. This may include a borrower having difficulty in proving the capability to repay the debt due to a less-than-average credit rating or an income that could arguably be unstable.

Globally the real estate market enjoyed a boom period for the last five years, especially in middle America. The exuberance was attributable to low interest rates, especially in the USA. At the height of the boom in the US housing sector, banks and other financial institutions were providing interest-only mortgages with variable interest rates. The need to increase liquidity based on the upward trend in housing prices blinded the lenders to ignore the realities of the market in terms of risk of default by certain borrowers.

However, activity came to a halt as the Federal Reserve, in an effort to combat inflation, slowly increased the prime rate—the benchmark interest rate used for mortgage loans. Many borrowers with sub-prime mortgages were first-time buyers, confident about rising home prices but inexperienced with variable interest loans. As the prime rate climbed, they struggled to make the payments.

The mounting default rate across US