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HOUSING FINANCE OF AUSTRALIAN ISLAMIC FINANCIAL SERVICE PROVIDERS (IFSPS): AN EMPIRICAL ANALYSIS FROM *SHARĪᶜAH* PERSPECTIVES

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ABSTRACT

The purpose of this study is to examine the extent of divergence in the practice of Islamic housing finance from the *Sharīᶜah* in the Australian context. It presents a discursive analysis of the extent to which the Australian Islamic Financial Service Providers (IFSPs) differ from the traditional *Sharīᶜah* in their current practices of Islamic finance by their use of different mortgage products. The study seeks to argue that the *Sharīᶜah* compliance of the IFSPs in housing finance should be strictly maintained, and a separate regulatory and legislative framework be established for Islamic housing finance to facilitate its growth since the underlying principles of Islamic finance differ from those of conventional finance. The approach for the study is restricted to critically examining the extent of divergence of Australian IFSPs from the strict *Sharīᶜah* compliance in their current use of different financial products and instruments for housing finance. Therefore, it does not attempt to examine any other Islamic products they use for Islamic finance. Besides, it does not evaluate the economic efficiency and profitability or otherwise, of Islamic finance in Australia. In addition to the direct policy recommendations and suggestions for further research it provides for authorities concerned, the study sheds new light on how the challenges of *Sharīᶜah* compliance for IFSPs in Australia are met since the *Sharīᶜah* contracts they use and advertise appear to be traditional mortgage contracts where the borrower takes the risk and the lender gets a fixed rate of return.

JEL Classification: G19, G21, Z12

Key words: Islamic housing finance, *Sharīᶜah*, Australia

1. INTRODUCTION

The Muslims with a population of 350,000 are the largest religious minority in the highly diversed multicultural Australia (Ahmad and Hassan, 2006a). Australia, with its liberal Westminster democracy, is a federation of six states and two territories. The constitution provides for equal rights to all citizens and the country has a reputation for religious tolerance. Religious freedom is guaranteed in the constitution. Naturally, the Muslims in Australia, like Muslims in other countries, wish to conduct their financial activities in accordance with the tenets of their Islamic belief. In other words, there is a necessity for the establishment of Islamic financial institutions (IFIs) that would cater for the needs of both the Muslims and non-Muslims. The establishment of these institutions, particularly the establishment of a full-fledged Islamic bank (IB) in line with the tenets of the *Sharī*ᶜ*ah*, would enhance competition in the financial market by offering a choice, i.e., an alternative to the traditional interest-based banking which ultimately would benefit the consumers. This would help the Australian economy through creating an opportunity to bring in a significant amount of foreign direct investments into Australia and also help expand its existing trade and economic ties with other Muslim countries.

Despite the remarkable growth and development of Islamic banks and IFIs over the last few decades in other comparable developed countries with minority Muslim populations, their expansion in Australia has been very slow, though steady. In December 1999, the Australian Prudential Regulatory Authority (APRA) under section 9(3) of the *Banking Act 1959* authorized the Muslim Community Credit Union Limited (MCCU) to carry on all kinds of banking business in Australia. However, in August 2002, its license was withdrawn when it was apparent that its funds were not enough to sustain its operations.[1] Currently there are only three Islamic financial institutions, out of which two, namely, the Muslim Community Cooperative Australia Limited (MCCA) and the Islamic Cooperative Finance Australia Ltd (ICFA), operate on the principles of cooperatives and are not banks in any sense. Another institution named Iskan Finance Pty Ltd. has also been working in the Islamic finance sector in the country. Several factors are responsible for such a slow growth, such as the history of Muslim migration in Australia, its population size, the financial strength of the Muslim community, the lack of understanding and standards on Islamic finance products, the absence of a standard rate of return in IFIs, the difficulty of classifying risk- sharing funds placed in these institutions, etc. This study seeks to explore the extent to which the Islamic *Sharīᶜah* has been followed by IFSPs in Australia in housing finance. With this in view, the project will examine the following.

(a) The extent of divergence of Islamic finance practice in Australia in housing finance from the *Sharīᶜah*,[2] and

(b) To what further extent must Islamic housing finance be adapted to be a viable alternative to conventional mortgage in Australia.

While the practice of Islamic financing is very broad, this study will focus on the most sought after forms of Islamic financing in Australia, namely, the housing finance. While this paper is not a comparative study of Islamic and non-Islamic Financial Institutions in Australia, comparisons will be made where necessary to clarify the current housing finance practice of IFSPs in Australia.

The authors believe that non-compliance to the *Sharīᶜah* by the IFSPs in Australia in their practice of housing finance will hamper their growth. Also, the Australian government should take the necessary steps to enable these growing opportunities to be pursued in the country. This study, therefore recommends that the IFSPs strictly maintain compliance to the *Sharīᶜah* in their practice of housing finance so that they can attract all devoted Muslim clients who are reluctant to deal with interest-based conventional banks to avail finance facilities for their homes. It also recommends that relevant regulations be developed by the Australian regulatory regime so as to make Islamic finance a viable alternative system of financing for Muslims in Australia. In addition, the study suggests that the IFSPs take an intensified program to familiarize the public and policy-makers with the Islamic finance and the mortgage products they can use in Australia.

This study is divided into a number of sections. The organization of these sections is as follows: Section 1 provides an introduction to the issues of Islamic finance practices in the Australian context. Section 2 introduces the leading IFSPs that have been providing housing finance in Australia. Section 3 undertakes a comparative analysis of mortgage products used by these IFSPs and critically evaluates the extent to which the Islamic *Sharīᶜah* has been complied to by IFSPs housing finance in Australia. Section 4 examines to what further extent Islamic finance must be adapted so as to make it a truly viable alternative system of financing for Muslims in Australia. Section 5 concludes with the summary and analytical findings of the study followed by some recommendations. It also argues for the necessity of further research in the field.

2. ISLAMIC FINANCIAL SERVICES PROVIDERS IN AUSTRALIA: AN OVERVIEW

The leading IFSPs that provide housing finance in Australia are as follows (Ahmad and Ahmad, 2007):

(a) Muslim Community Co-operative (Australia) Limited
(b) Islamic Co-operative Finance Australia Limited
(c) Iskan Finance Pty Limited

2.1 MUSLIM COMMUNITY CO-OPERATIVE (AUSTRALIA) LIMITED

The MCCA is a non-bank financier based on a unique system that recognizes and meets the community's religious needs. It also espouses a philosophy of providing finance on a fairer and more equitable basis, which, in the long-term should be better for society as a whole. Based in two major cities of Australia, Melbourne and Sydney, the MCCA serves the diverse needs of all consumers and was recently honored with the 2006 Australian Business Award for Small and Medium Enterprises (SMEs) in the categories of *Enterprise* and *Community Contribution* for community service and community reinvestment.[3] Its membership is open to all, whether Muslims or non-Muslims. Anyone who is interested in alternatives to interest-based finance is encouraged to become a member (MCCA, 2007).

The MCCA is considered "the largest provider of specialized financial services in Australia that comply with both conventional credit laws and Islamic requirements" (MCCA, 2007). Established in February 1989 with ten members and a starting capital of AUD 22,300, the MCCA's members now stand over 7,000 in Victoria and New South Wales (MCCA, 2007). According to updated information provided by MCCA in its official webpage:

"We have since become the largest and most widely recognized Australian provider of Islamic finance and investment services with 6,900+ member shareholders and more than $240 Million in financial accommodations currently managed," (MCCA, 2007).

Currently, the MCCA originates AUD 100 million a year in Islamic home finance and manages a finance book of Islamic home finance and equipment assets in excess of AUD 250 million. As a corporation with majority ownership by Australian Muslims, the "MCCA is now the most recognized and trusted brand within the Islamic finance market in Australia," (David, 2007). In addition to its consumer finance offerings, it co-developed Australia's first and only Islamic public offer ASX listed equities investment product–the Crescent Ethical managed discretionary account service.

The MCCA's principal managed funds for housing finance are of the following types: *al-Ijārah, al-Ijārah wa al-Iqtinā',,al-Ijārah al-Muntahiyah bī al-Tamlīk* (IMB), and *Tamlīk* (MCCA, 2007). Among these products, the MCC's fund under the *Ijārah* mode is provided for residential house financing only and for property construction ,while financing under *Murābaḥaḥ is managed for both residential and commercial* purposes. The MCCA's IMB, a relatively new product which was initially named as Sale to Lease (S2L), is now used for residential and commercial financing. On the other hand, the MCCA's *Tamlīk* is used for funding residential properties only, while the *Mushārakah* product is used for equity investment in the MCCA and the Crescent Ethical MDA Services (MCCA, 2007). The *Mushārakah* was initially used by the MCCA for home financing under the product named Shared Equity Rental (SER).[4] To the author's knowledge it is not in use anymore by the MCCA for home financing.

In fact the MCCA's Shared Equity Rental (SER) Scheme under *Mushārakah* looks akin to the model announced by the Australian Prime Ministerial Taskforce on home ownership in June 2003, in which the homeowner and a bank or another mortgage lender would co-own a home. Under the proposal, the financier would own about 30% of the home's value – reducing the amount of the homebuyer's mortgage and making it easier for people to buy a home.[5] In keeping with the Islamic principle that the financier and the buyer should share the risk and reward of the venture, the MCCA takes an equity stake in the property and the buyer pays monthly rent with a capital repayment component – eventually to assume full ownership.

As far as the activities and purposes of the MCCA are concerned, the following summary given by Peter Moody of the Australian Taxation Office is worthy of mention.

(a) A place for the advancement of the principles of the Muslim faith, and the evolution of a 'community' that overlooks its members and shareholders. MCCA funds can be, and are used to help those in need within the community. Donations are received and applied for this purpose. A separate fund has been created for this end, and is known as the *Qard Hasan* Fund.

(b) To operate as a housing co-operative that assists with the purchase of mainly residential properties for and on behalf of its shareholders. The purchase of other asset classes is undertaken in a similar fashion, mostly the purchase of motor vehicles, computers, and some limited business finance. The purpose of the provision of this facility is solely centered around the Muslim doctrine that forbids the payment of interest. MCCA charges an upfront 'administrative' charge for their involvement, but thereafter, the loan is interest free. This conforms to all the requirements of their religion, and such transactions are held to be Halal, which means that they are 'allowable' under Muslim doctrine. Repayments under these types of transactions are known as repayments of Murabaha.

(c) To accept funds and issue shares in the co-operative from time to time, and to distribute the trading surplus of the co-operative back to the members in the form of dividends" (Hamdi, 1999).

However, the MCCA itself underscores its core purpose in its official website as follows: "to provide goods and services to members in accordance with Islamic law and the principles of co-operation". It also stipulates that its vision is: "to be the leading provider of specialized financial and wealth management services catering to the needs of Australian Muslims" (MCCA, 2007).

2.2 ISLAMIC CO-OPERATIVE FINANCE AUSTRALIA LIMITED

Islamic Co-operative Finance Australia Limited (ICFAL) was officially endorsed and registered by the Registry of Co-operatives, Department of Fair Trading, the Government of the State of New South Wales, in May 1998 under the *Co-operatives Act 1992* (NSW), sections 8, 9 and 10 to function as a co-operative within the state of New South Wales (ICFAL, n.d.).

The primary objectives of ICFAL are:

"A. To provide methods of investment & finance opportunities for its members in line with Islamic principles (Halal): Equity Profit & Loss sharing concept, which is fair, simple and straightforward,

B. Facilitate earning Halal income,

C. Facilitate ownership of property (home, vehicle & other approved tangible assets),

D. Facilitate performing social & religious obligations for Muslim members i.e., Zakah & Hajj and,

E. Establish feasible joint venture or partnership deals with members & similar organisations" (ICFAL, n.d).

At present, ICFAL provides *Murābaḥaḥ*, *Mushārakah* and *al-Ijārah wa al-Iqtinā'* financing schemes. It follows almost all the terms and conditions and procedures followed by MCCA for its house financing scheme.

As regards the membership requirements, any person residing in the State of New South Wales may be eligible to become a general member of ICFAL by paying a one-off membership fee of AUD 100, and an active member of ICFAL by purchasing a minimum of 5 shares valued at AUD 100 each. An active member is entitled to receive finance from ICFAL's under the schemes mentioned above subject to the down payment of 20% of the total price of the house, commodity or other products under purchase (ICFAL, n.d).

2.3 ISKAN FINANCE PTY LIMITED

Iskan Finance, as stated on its official website, is an Australian business established in 2001 by a group of Australian and Non-Australian Muslims with the core objective to pioneer, create and promote the most competitive *Sharīᶜah*-compliant home facilitation program possible for the Islamic community in Australia (Iskan, n.d). In 2002, Iskan Finance commenced business with its *Murābaḥaḥ* Facilitation Program and building on the success of this core home financing product, has developed its *al-Ijārah wa al-Iqtinā'* ("Lease to Purchase") facility. Both the *Murābaḥaḥ* Facilitation Program and the facility of *al-Ijārah wa al-Iqtinā'* has been modeled on *fatwā*s[6] issued by various Islamic scholars and on opinions that Iskan has sought from scholars from Al-Azhar University in Egypt. At the same time, Iskan Finance has worked hard to ensure that the financing will have longevity and consistency of delivery by engineering both its funding products to comply with the Australian Uniform Consumer Credit Code (UCCC). In 2005 Iskan introduced a new product under the name "*Taysīr al-Ijārah*" for residential and commercial customers which replaced its previous product *al-Ijārah wa al-Iqtinā'*. In 2006, it introduced another product called ultiMATE Home Finance package offering a wider range of services for its customers. The reason given for this modification as it claimed was "to cater for the specific needs for our community" (Iskan, n.d.).

At a practical level, Iskan Finance has established links with a number of third party providers to service its customers. For instance, the custodian of Iskan's mortgages is Perpetual Trustee Australia Limited; mortgage insurance is provided by G. E. Mortgage Insurance Services; and the Program Manager is RESIMAC Limited. Iskan has contracted with Advance Investment Securities Australia Pty Ltd to manage distribution of its facilities, and strategic alliances have now been forged around Australia to service a growing customer base (Iskan, n.d.).

Iskan Finance believes its *Murābaḥah* Facilitation Program and its offer of *al-Ijārah wa al-Iqtinā'* a sound foundation for a growing suite of financing products that are planned to service the Australian Muslim Community. Iskan's *Murābaḥah* Facilitation Program is designed to offer a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. It is a contract of sale between Iskan and its customer that establishes a fixed *Murābaḥah* price including a profit mark-up, secured by a mortgage. Under Iskan's *Murābaḥah* Property Facility Program, following settlement, Iskan's customer is the sole owner of the property and enjoys the full benefit of any capital gain in the property (Iskan, n.d.).

Iskan's *al-Ijārah wa al-Iqtinā'* financing model as it mentions on its website is designed to be a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. The model is based on the concept of 'leasing to purchase' a home. Iskan's customer agrees to lease the property and pay rent, either fortnightly or monthly. Rent is reset at twelve monthly intervals and each rental payment made increases the customers' equity, ultimately retiring Iskan's equity. Iskan customers have the option to retire the facility in part or in full on yearly anniversary dates when the rental payments are reset (Iskan, n.d.).

The facility of *al-Ijārah* is secured by a mortgage on the property. Under this scheme, Iskan customers are required to pay a deposit of at least 5% toward the purchase price of the home and Iskan provides the balance. However, as Iskan customers do not need to open a savings account with Iskan, there is no lengthy waiting time to qualify. The facility of *al-Ijārah* does not require the customer to enter into any partnership with Iskan and the customer enjoys the full benefit of any capital gain in the property. Like Iskan's *Murābaḥah* Property Facility, applying for a facility of *al-Ijārah* is also simple. Most of the requirements of this program are stated on its website (Iskan, n.d.).

3. FINANCIAL INSTRUMENTS USED BY THE IFSPS IN AUSTRALIA FOR HOUSING FINANCE: A COMPARATIVE ANALYSIS AND DIVERGENCE FROM THE *SHARĪ^C^AH*

Islamic finance in Australia is an avenue enabling both Muslims and non-Muslims to benefit from financing provided by IFSPs. However, it is aimed to cater for the needs of those who wish to avoid conducting their financial dealings on *ribā*. Accordingly, IFSPs have introduced different *Sharīcah*-compliant modes for home ownership. While these modes of financing are operative, voices of discontent have begun to emerge from customers. Some products and instruments used by these finance houses have been widely criticized by different quarters branding them as non-*Sharīcah* compliant products. For instance, the *Sharīcah* legitimacy of MCCA's Sale to Lease (S2L) product for home financing was criticized by some quarters in the following words:

"…It is not important that we call the usury/interest (riba) gain but the important thing is that it should be in its nature and in its truth a real halal gain…there should be an honest debate about the validity of this contract that the customer is entering into them and how this company should be directed in Islamic legislation if they accept to deal within its boundaries…That is, what is the benefit of MCCA?" (IISCA, 2004)

Given the above and similar criticisms, an attempt has been made in this chapter to investigate whether or not they have diverged from the *Sharīcah*. In this connection, comparisons are made where deemed necessary to give a real picture of current practices in home financing using *Mushārakah Mutanāqiṣah*, *al-Ijārah al-Muntahiyah bī al-Tamlīk*, and *al-Ijārah wa al-Iqtinā'* structures.

3.1 IFSPS' *MUSHĀRAKAH MUTANĀQIṢAH* HOME FINANCING AND THE CONVENTIONAL MORTGAGE: A COMPARATIVE ANALYSIS

A comparison of IFSPs' current practice of home financing with that of their conventional counterparts and on analysis of the operational differences between IFSPs' *Mushārakah Mutanāqiṣah* mode of financing for housing and conventional housing finance are given in this section by use of a hypothetical example. For this purpose, the 'Shared Equity & Rental (S.E.R.)' model, i.e., 'Diminishing *Mushārakah*' or 'Diminishing Partnership' used by MCCA and ICFAL is chosen. The normal procedure for financing the purchase of a house today in conventional banking is to apply for a mortgage. If the price is AUD 400,000 for example, the bank may require a down payment equal to

10 percent of the apprised value. In case the apprised value and the purchase value are the same, the bank will require an AUD 40,000 down payment and lend the remaining AUD 360,000. The buyer will sign a mortgage contract that will require monthly payments over a period of years. Typically, home mortgages run for a period of 15, 20, or sometimes as long as 30 years. The bank, of course, charges interest based on the amount of the unpaid principal, whose rate depends on prevailing market conditions and the term, i.e., time period of the loan.

In the conventional system, if the bank agrees to give a 30-year mortgage for AUD 360,000 at an annual interest rate of 8 percent for example, the monthly payments will be AUD 2,641.56. Each payment will consist of the interest due and partly the repayment of principal. Since the interest is figured on the basis of the remaining unpaid principal balance, the interest portion will decline over time while the principal portion increases. Over the 30-year period, the buyer will make 360 such payments, which add up to a total of AUD 950,961.60 paid to the bank. This is more than two and a half times the AUD 360,000 borrowed, with AUD 590,961.60 interest accruing to the bank. *If the buyer misses payments as scheduled a circumstance arisen for, the bank is entitled to foreclose and sell the house to recover the amount of principle and interest the bank still owes.* The buyer may or may not recover any of his/her own investment. Since the bank's claim has priority over the buyer's, possibly it will not try very hard to get the best price. The bank is mainly concerned about recovering its own investment, not the buyer's. So, it may set the selling price low in order to liquidate the property quickly, leaving little or nothing for the buyer to recover.

Contrary to the conventional arrangement, the MCCA and ICFAL use as one of their modes of finance *Mushārakah Mutanāqiṣah* or 'Shared Equity & Rental' (Greco, 2002). Just as with conventional banks, MCCA and ICFAL require some down payment in equity sharing, which is the buyer's initial equity share. It can be the same amount as in the conventional system, i.e., 10 percent, or AUD 40,000 in AUD 400,000. The MCCA and ICFAL put up the remaining AUD 360,000. Now the buyer and the bank are co-owners. The buyer owns 10 percent of the house and the MCCA and ICFAL own 90 percent of the house. There is no interest to be paid on the MCCA and ICFAL's capital but if the buyer occupies the house, he will be required to pay rent to the owner. Of course, since the buyer is part owner, part of the rent comes back to him. At the outset, the bank will get 90 percent of the rental payments and the buyer will get 10 percent. But the buyer is also allowed to increase his ownership share at any time by making additional payments to the Islamic bank, in effect, buying out the bank's share in the house. As the buyer does so, his proportionate share increases while the Islamic bank's share decreases and the distribution of the rent payments will change accordingly.

Now, this arrangement can be compared with the conventional mortgage in the example given above. The big question, of course, is what is a fair amount for the monthly rent? It might be reasonable to assume that it is equal to the monthly payments the buyer would have made under the conventional mortgage arrangement, in this case, AUD 2,641.56. At the outset, the buyer will receive 10 percent of that rent as their ownership share and the MCCA and ICFAL will receive 90 percent. It might be assumed also that the buyer applies his share of the rental payments to increasing his ownership share. Table 2 is an abridged amortization table, which shows the respective returns to the buyer and the MCCA and ICFAL.

Under this arrangement, the buyer will own 100 percent of the house after making the 360th payment, or in 29.16 years. The buyer will have paid total rent of AUD 924,073.2. The bank's total share will have been AUD 564,073.20. This is a saving of more than AUD 24,000 over the amount of interest paid on the conventional mortgage. In percentage terms, this is saving of a little over four and a half percent. This may not seem like much, but we shall see when comparing this approach with conventional mortgages carrying higher interest rates, that the savings can be significant.

A more important advantage derives from the risk-sharing inherent in the MCCA and ICFAL's DP or shared equity approach. Under this arrangement, *if the buyer is unable to make the scheduled principal payments, there is no foreclosure. The buyer simply does not add to his ownership share.* If he is unable to pay the rent, however, he can be required to vacate the house, just as if he was renting from anybody else, but he would not lose his ownership equity. When the house is rented to someone else, the buyer will still receive his share of the rent, or if the house were to be sold, he would get his share of the proceeds based on the percentage of the equity which he owns. Of course, since the Islamic bank's claim does not take priority over the buyer's, it is in the best interests of both the parties – the buyer and the bank to try to get the highest price possible for the house.

In contrast to the conventional mortgage debt, the relationship in an Islamic mortgage between the buyer and the MCCA and ICFAL is amicable rather than antagonistic, since their interests are common rather than opposed. The conventional mortgage, being exploitative, creates conflict, stress, and insecurity, while contributing to greater disparities of income and wealth. Shared equity financing, however, reduces conflict, stress and insecurity, and makes for a more harmonious and equitable society.

To fully appreciate the advantages of the MCCA and ICFAL's Shared Equity and Rental approach, one must examine the numbers pertaining to higher conventional mortgage interest rates. Table 3 shows the figures for conventional mortgages at 8 percent, 10 percent, and 12 percent interest rates, along with figures for comparable shared equity. It can be seen how seemingly small changes in the interest rate cause enormous increases in the amount of money the buyer must pay back. At 12 percent interest, for example, the buyer will repay AUD 1,333,080.00 on his AUD 360,000 loan over 30 years, giving the bank an interest income of AUD 973,080.00. However, a shared equity scheme with the same monthly payment of AUD 3703.00 would give the buyers full ownership in 20.83 years. The total rent shares to the IB would be only AUD 565,292.56, saving the buyer over AUD 400,000.

The figures in this table assume that the fair rent in each case is equal to the mortgage payment. That assumption, however, may be too far fetched. It might be assumed that in every case, the fair rent is equal to the mortgage payment at 8 percent, or AUD 2,641.56. Under these circumstances, any amount paid over and above that figure would be directly applied to increasing the buyers' equity share rather than being split between them and the MCCA and ICFAL. The lower part of the Mortgage Summary Table (Table 3) shows the figures for monthly payments equivalent to those at the 10 and 12 percent mortgage rates. With payments of AUD 3159.24, buyers will achieve complete ownership in 17.75 years. The MCCA and ICFAL's share of total rents will be only AUD 310,248.64. With payments of AUD 3,703.00, buyers will achieve complete ownership in only 13.08 years, having paid the MCCA and ICFAL rent shares of only AUD 217,927.32, saving the buyers almost $756,000 or 77.6 percent over the conventional mortgage with the same monthly payment.

3.2 IFSPS' HOME FINANCING ON *AL-IJĀRAH AL-MUNTAHIYAH BĪ AL-TAMLĪK* AND CONVENTIONAL MORTGAGE: A COMPARATIVE ANALYSIS

Before delving into a comparison between IFSPs' home financing on *al-Ijārah al-Muntahiyah bī al-Tamlīk* and conventional mortgages, it is necessary to investigate thoroughly some significant differences between a conventional lease and an *al-Ijārah* lease. Four main differences are discussed below:

3.2.1 RENTAL PAYMENTS BASED ON INTEREST

Where an asset is financed by way of floating-rate funds, the owner will usually pass the risk of rate fluctuations down to the lessee through the rentals payable by the lessee. This creates a problem in the Islamic context where lease rentals cannot be expressed by reference to interest rates. This difficulty is, to a certain extent, surmountable. In leasing transactions the lessor is providing an asset, not funds, so the return is in the form of rent, rather than principal and interest. The lessor is, in effect, using its funds productively to invest in an asset and is accepting the associated risk. In an *Ijārah* lease the amount and timing of the lease payments should be agreed in advance, though the agreed schedule and amount of those payments need not be uniform. In some leases the problem has been overcome by referring to the rental payable under the lease at the date of signing, but subject to adjustments by reference to provisions in other documents. In another lease, the rent was adjusted by cross-reference to fluctuating rentals payable under a non-Islamic lease being signed at the same time and at the same rentals. Other transactions have included a rental adjustment letter linking rentals to LIBOR.

3.2.2 DEFAULT INTEREST

Conventional leases usually provide for default interest on late payment of amounts due, which is not possible in Islamic leases. In an *Ijārah* lease the same effect can be achieved in different ways, for example by providing for some form of discount formula, where an agreed rate of discount is applied for each day that payment is made prior to a backstop date. The backstop date is chosen to reflect a commercial period in which funds might be expected at the latest to be paid. However, if payment is made after the backstop date, then the lessor cannot recover any additional amount. In other leases we have seen late-payment fees replace the conventional default rate of interest.

3.2.3 INSURANCE AND MAINTENANCE

In contrast with most conventional leases, in an *Ijārah* lease the responsibility for maintaining and insuring the leased asset remains that of the lessor throughout. Therefore, the owner/lessor will agree in the lease to procure the maintenance and insurance of the asset. The conventional position of the lessor relieving itself of these burdens can be achieved within the *Ijārah* framework if the owner/lessor recovers the insurance costs by increasing the rental payments and if the lessor appoints the lessee or another third party as its agent to obtain the required insurance in return for a fee. Maintenance obligations can be dealt with in a similar way, where the lessor agrees in the lease to perform all maintenance and repair obligations but appoints the lessee or another third party to perform such obligations on behalf of the lessor in return for a fee. The extent to which maintenance responsibilities have been transferred is usually reflected in the lease payments due from the lessee.

3.2.4 THE *SHARĪᶜAH* BOARD CLEARANCE

One distinct feature of the modern Islamic finance movement is the role of the *Sharīᶜah* board, which forms an integral part of an Islamic financing institution. The role of the *Sharīᶜah* board is to monitor the workings of the Islamic financing institution from a *Sharīᶜah* standpoint and to review every new transaction to make sure that it is *Sharīᶜah* compliant. These boards include some of the most respected contemporary scholars of the *Sharīᶜah*. Yet the *Sharīᶜah* is open to interpretation and the *Sharīᶜah* boards often have divergent views on the key *Sharīᶜah* issues. In this regard, there is no practical guide as to what constitutes an acceptable Islamic financial instrument, and the suggestions mentioned above, which are designed to achieve the same effect as conventional leases within an *Ijārah* framework, need to be viewed in this light. A document or structure may be accepted by one *Sharīᶜah* board but rejected by another.

Given the above introductory analysis of Islamic and conventional leases, some of the key differences between home financing on *al-Ijārah al-Muntahiyah bī al-Tamlīk* and conventional mortgages are highlighted below:

(a) As owner of the property, the IFSP faces risks associated with property ownership. This is a situation that does not exist under an interest-bearing mortgage, where the conventional bank never actually owns the property.

(b) In a conventional mortgage, the customer is the borrower. However, in the structure of *al-Ijārah al-Muntahiyah bī al-Tamlīk*, the customer is the IFSP's tenant in the property. This different relationship between the IFSP and its customer presents the IFSP with different risks and requires different remedies to problems that might occur. It is crucial differences like these that allow Islamic legal scholars to approve a product and make IFSPs' *Sharīᶜah* compliant home finance an acceptable way for Muslims to finance the purchase of their homes.

3.3 THE EXTENT OF IFSPS' COMPLIANCE WITH THE *SHARĪᶜAH* IN THEIR CURRENT PRACTICE OF HOUSING FINANCE

The performance of IFSPs in Australia depends heavily on the extent to which the practice of these institutions adheres to Islamic legal principles and reflects well-established Islamic principles for financial transactions. Given this fundamental requirement, the underlying objective of this study as elucidated at the outset is to critically evaluate the extent to which the Islamic *Sharīᶜah* has been followed by IFSPs in Australia in their housing finance. So, in the following sections, attempts are made to determine the extent of the *Sharīᶜah* compliance in the practices of IFSPs using different mortgage products and instruments.

3.3.1 DIVERGENCE FROM THE *SHARĪᶜAH* IN IFSPS' PRACTICE OF DEBT-BASED FINANCIAL PRODUCTS FOR HOME FINANCING

The following divergences from the principles of the *Sharīᶜah* in IFSPs' use and practice of Debt-based mortgage products have so far been identified. As mentioned previously in this study, IFSPs of Australia under *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk* Islamic home finance contracts, purchase property selected by the customer, following a promise from the customer that he will live in that property and purchase it after an agreed period of time. In return, the customer pays monthly instalments to IFSPs, mainly composed of two payments. One portion of the instalment is considered to be a payment of the purchase price for the property, and another portion is counted as rent that the customer pays for living in the property in the meantime. The purchase price paid by the customer is equal to the purchase price initially paid by IFSPs for the property. Once the customer has paid all the purchase instalments plus the rental instalments, IFSPs will transfer the ownership of the property to the customer. IFSPs make their profits from the difference between the prices they pay for the property (including related transaction costs) and the amounts received in instalments from their customer.

This type of scheme, with some minor modifications, as discussed earlier, is practised in Australia by the MCCA, ICFAL and Iskan. In principle, an *Ijārah* scheme can be structured in such a way as to be acceptable under the *Sharīᶜah* so long as certain conditions are met. However, the implementation of the scheme by IFSPs is highly problematic for the reasons elucidated below:

Firstly, the contract of *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk* for Islamic housing finance is ambiguous in its nature. In fact it is not clear whether it is a lease contract, a purchase contract or a combination of the two. Based on an injunction in which the Prophet Muḥammad (PBUH) prohibited two transactions in one, some Islamic legal scholars forbid a transaction that combines both lease and purchase, although there are some who have allowed this type of transaction under certain strict conditions. However, there is a consensus among the scholars that the presence of a significant amount of ambiguity invalidates a contract. This consensus is based on a Prophetic Tradition which bans any sale that involves *al-Gharar* or ambiguity.

Some Islamic legal scholars, among them those who work in contemporary *Fiqh* Councils, hold the opinion that if rental and sale are mixed in such a way that one cannot distinguish at any point of time whether the customer is a tenant or a buyer, then such a contract is invalid according to Islamic jurisprudence.

When asked to clarify the nature of the *Ijārah* mortgages used by IFSPs in Australia, the relevant staff in these financial institutions frequently describe it as a 'lease ending in a purchase/ownership'. Yet if this really is the case, then the *Ijārah* mortgage should display the features of a lease throughout the entire time-span of the contract (often as much as 25 years) until it concludes with a purchase/ownership event. In other words, IFSPs will rent out the house for a period of time with the promise that it will sell to the customers/make them owners at the end of the tenancy. During the tenancy, IFSPs will remain the legal owners of the property. After the tenancy the customers will be the legal owners.

Although many scholars do not allow this type of combined contract, just for the sake of argument it may be assumed as valid according to the opinion of those scholars who accept it. Upon examining the available *Ijārah* schemes used by IFSPs more closely, it is found that the theoretical structure outlined above does not exist in practice. The *Ijārah* contract as it stands is neither a lease nor a purchase. Rather, it is closer to a conventional loan where banks lend money to customers for property purchases, and require that customers must repay with a mark-up under the guise of 'rent'.

The following questions which illustrate the ambiguity of the contract may be considered in this regard:

(a) Why does the tenant need to pay a large down payment? (Frequently an amount equal to 5-10 percent of the price is required. A genuine tenant does of course make some kind of down payment; relevant to the period of the tenancy, but no credible tenancy agreement can bind the tenant to place such a large down payment.)

(b) Who pays the insurance for the house? Are they IFSPs or the tenants? (Technically, the owner of an asset is the one who should pay for its insurance.)

(c) What will happen if there is loss or damage to the property and the insurance company refuses to cover the losses incurred? Who will pay for this? (Once again, if IFSPs are the actual owners, and such a loss or damage occurred through no fault of the customers, then IFSPs cannot hold the customers responsible for damages.)

(d) If the tenants decide to terminate the tenancy agreement, IFSPs will sell the property. If the price of the property has depreciated in the meantime (which means IFSPs as the owners of the property suffer a loss), why are the customers bound to compensate that entire loss while being only tenants?

The point of all these questions is to address the central issue, namely, who are considered the actual owners (and thus liable for any damages or depreciation in value) for the duration of the lease? Are they IFSPs (in which case all of the above scenarios do not make sense), or are they the customers (in which case this contract is not a lease contract in the first place, but rather something else)?

IFSPs may give an answer to all or some of these questions supported by quotations from jurists of the past or present. Some of these answers may indeed prove to be acceptable when looked at in isolation but, when they are taken as a whole, such practices may invalidate the contracts.

To illustrate the author's point, IFSPs might state that, according to a particular School of Islamic Jurisprudence, the down payment is not a part of the price of the property since it is not a purchase agreement. Rather, it is an assurance that the tenant is serious in renting the property for a given period of time (say up to 25 years). Such a condition is acceptable according to some jurists (Ahmad and Hassan, 2006b). Furthermore, IFSPs may state that the insurance is paid by the tenants based on a mutual agreement, and there is nothing wrong with such a condition, for in a *ḥadīth* the Prophet Muḥammad (PBUH) is related to have said: "Muslims shall be bound by the conditions/stipulations which they make except the condition which prohibits the lawful or permits the unlawful" (Muslim*, Abū Dawūd, Tirmīdhi* & Nasā'i).

Meanwhile, IFSPs might claim that they are bound by the law of the land (Australian/English Law) to hold the title of the property, and will only pass it to the customers upon the final payment. However, the contractual agreements that are signed between IFSPs and their customers put all of the risks of ownership upon the customers, and these factors defeat the purpose of *al-Ijārah*, even if technically speaking IFSPs claim to follow the letter of English law as 'owner' of the property.

From the above arguments it has been observed that each of these, on its own, is widely considered to be valid. However, this should not lead one into the grave error of assuming that three valid matters when combined produce a valid outcome. An example of a plain *ribā* transaction may be given within the following framework:

(a) An interest-free loan (which is something recommended)
(b) A gift (which is again, something recommended)
(c) A promise.

If the above three transactions are taken individually, they will be considered entirely valid. However, if they are combined in a single contract, the result is pure *ribā*. For instance, 'A' says to 'B': "Grant me a loan which I will repay you" (a valid matter), and 'A' says to 'B': "I promise you (a second valid matter) a gift (a third valid matter) in addition to the repayment when it becomes due”. If it is asked whether such a contract is valid or tantamount to *ribā*, the answer would be that it is clear *ribā* without any doubt, since ‘B’ who gave the money was promised that same amount back along with some profit.

Given the above, one should look at the end-to-end process here and evaluate it as one transaction. The critical question is “who is the real owner of the property during the whole process? Is it the customer while the IFSP is just financing the deal as it does in a normal conventional mortgage, or is it the IFSP?” Again, “if the owner is the IFSP, then can a real owner ignore his responsibility towards his own property? Why does the IFSP then avoid owning the property?”

Another example may be given to further illustrate the above argument. A financial transaction known as *Bayʿ al-ʿĪnah* or sale and buy back agreement is strictly prohibited in the *Sharīʿah* when taken as a whole, as it is seen as something similar to *ribā*-based financing. However, when broken down into individual parts and examined solely upon these parts, this transaction, appears to be valid. One of the means of practising *Bayʿ al-ʿĪnah* is that the first party sells a product to the second party on a deferred payment. The second party then sells it back to the seller at a lesser price, but in cash. If this transaction is broken into sub-transactions one can conclude that there are two acceptable sale transactions. It is allowed for a person to sell a product for a deferred payment, and it is also allowed to buy a product for cash. However, the ultimate aim of this transaction is to enact a pure *ribā* transaction in the guise of buying and selling. This is because the second party receives an amount of cash from the first party and is then required to pay back an amount of greater value at a later time. As for the product itself, since it changes hands twice, it returns to the initial ‘seller’. Therefore, the product is used merely as a loophole to avoid the prohibition on *ribā*.

Although Imām al-Shāfiʿī permits this concept, it is his personal opinion and not based on interpretation of any authentic Islamic authority. On the contrary, other Schools that prohibit such a sale base their opinion on the consensus of the jurists on the authority of Islamic legal sources. As Ibn Qayyim prohibited *Bayʿ al-ʿĪnah* quoting the following *ḥadīth* that the Prophet Muḥammad (PBUH) is reported to have said: “A time is certainly coming to mankind when they legalize *ribā* under the name of *bayʿ* (trade/sale)”. But again, Imām al-Shāfiʿī agrees with all other scholars that the aim of the transaction should not be to overcome a prohibited transaction. In other words, all scholars are in agreement that it is sinful for two parties to try to devise a scheme that appears to make permissible something that the *Sharīʿah* declares impermissible. Moreover, there is hardly any satisfactory evidence which enables one to say that Shāfiʿī has expressly declared *Bayʿ al-ʿĪnah* to be lawful. It should be pointed out that Shāfiʿī's method of determining the validity of any contract by formal evidence that they are legally concluded, and this cannot be cancelled on account of the intention of the parties. Although Shāfiʿī recognizes that such intentions may be lawful, he deems the contract to remain valid unless the unlawful intention is expressed in the contract. As not every valid contract is a lawful contract, Shāfiʿī thus permits contracts because their legal preconditions are fulfilled, but forbids the transacting act of the parties when it conflicts with *Sharīʿah* principle (Rosly & Sanusi, 1999).

In conclusion, there is no significant difference between the *Ijārah* scheme outlined above and the conventional mortgage which is a pure *ribā*-based loan. Under the *Ijārah* scheme, IFSPs perform what is essentially a money lending transaction, placing such conditions upon its customers that guarantee, for all practical purposes, that it will obtain the same amount of money in return plus a profit disguised as 'rent'. It might be true that many of the individual clauses and conditions of the contract are permissible (or, at best, subject to differences of opinion among the scholars), but when put together and examined as a whole, it is apparent that there is little that separates this contract from a simple mortgage. Of the many matters that clearly illustrate this is that the risks and rewards of ownership of the house are carried by the tenant, not IFSPs, regardless of who is the 'article-owner' under Australian/English law.

As per *Sharīʿah* rules for financial transactions, whenever an investment contract is structured in a way that one party is guaranteed a profit, something is simply not correct. Only in a *ribā*-based transaction will there be guaranteed profit. Any permissible transaction in the *Sharīʿah* must have an element of risk involved, no matter how small that element is.

Given this basic principle, when looking at the above particular transaction, it is essential that IFSPs do not take advantage of customers by exploiting the financial power of the former and the desperate need of the latter. If these IFSPs enact their transactions with this principle as an underlying moral framework, such contracts seem to disappear. Yet, the reality is far from this ideal. In light of this principle, a question will always arise: Do these IFSPs share with their customers the risk of loss, or are they stipulating all possible conditions to protect themselves against any loss? Additionally, do these IFSPs own the properties they are renting to people?

The simple answers to these questions in discussion would be that the current *Ijārah* schemes practised by IFSPs are almost identical to conventional mortgages. They appear to be a *Ḥīlah* or trick designed to promote conventional interest-based practices using Islamic terminologies and nomenclatures.

Based on the above, MCCA's *al-Ijārah* (including *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk*), ICFAL's hire purchase, and Iskan's *Taysīr al-Ijārah* schemes for home, automobile, and consumer durable financing as implemented here in Australia apparently are not based on the *Sharīᶜah* principles of financial transactions. In fact, this practice is a deception rooted in *ribā*. Until those in charge of these schemes prove that the above argument is invalid and give clear answers to the questions highlighted earlier, it is believed that such transactions are totally prohibited from the perspectives of the *Sharīᶜah.*

4. MORTGAGE PRODUCTS PRACTICED BY THE IFSPs: A CRITICAL ANALYSIS

4.1 CRITIQUE OF *MUSHĀRAKAH MUTANĀQIṢAH* CONTRACT

Various forms of partnership contract including *Mushārakah* are considered to be profit and loss sharing (PLS) modes of financing which may be contrasted with debt-based forms of financing (to be discussed later). It was viewed by some scholars that PLS modes of financing are more ideal from an Islamic point of view.[7] On this basis, it is viewed by some that most Islamic financing practices that are debt-based, such as credit sales and leases, are mere re-labelling of the interest forbidden in the *Sharīᶜah* (Khan, 1996).

However, some contemporary scholars do not agree with this view. They argue that if the IBs and IFIs carefully abide by the rules of the *Sharīᶜah*, there is no reason to think that debt-based financing such as credit sales and leases are any "less Islamic" than equity-based partnership modes of financing like *Muḍārabah* and *Mushārakah* (El-Gamal, 2000).

Although the *Mushārakah* mode of financing is believed to be the cardinal of Islamic finance, it has never been popular among the majority of IFSPs in Australia. The IFSPs have advanced various reasons for not employing this mode of financing, which can be summed up as follows:

(a) Secretiveness and lack of adequate transparency on the part of the managing partners with regard to the performance of projects.

(b) The high cost of following up and monitoring projects.

(c) Unfair treatment in taxation. While profit made from such contracts is taxed, interest, on the other hand, is treated as a cost item and is not taxed. Such discrimination can prove to be negative and can limit the growth of equity-based financing contracts (Dar and Presley, 2000).

While the above reasons may be justified to an extent, a close consideration of the circumstances involved reveals deliberate avoidance of these modes by the IFSPs in favor of relatively less risky modes of finance such as *Murābaḥaḥ* and *al-Ijārah* which offer predetermined rates of return.

A Diminishing *Mushārakah* (DM) in which a customer pays 'Rent plus Acquisition Payments' periodically does indeed resemble a conventional mortgage schedule. The Rental Payment corresponds to 'Interest Payment' in a conventional mortgage while the Acquisition Payment corresponds to the 'Principal Payment' in a conventional mortgage (Usmani, 2006). In reality, the DM differs from a mortgage loan by the nature of the transaction, in particular, the relationship between the parties involved. In a loan transaction, the lender advances funds to the borrower in exchange for a future repayment of the funds plus interest. This amounts to an exchange of cash for a greater amount of cash in the future and is prohibited in the *Sharīᶜah* (Naughton and Naughton, 2000). On the other hand, the relationship between the financier and the customer in the DM is that of co-owners in a property and not that of lender-borrower. The initial financing provided by the financier is applied to acquire a share in the property and not to provide a loan. The customer's monthly Acquisition and Rental Payments are applied, respectively, to acquire the financier's share in the property and for the customer's exclusive use of the whole property. These payments do not constitute a repayment of a loan with interest. This transaction does not involve an exchange of cash for a greater amount of future cash, which would give rise to interest (Ahmad and Hassan, 2007).

Notwithstanding the fact that a DM differs fundamentally from a loan, it is designed to provide benefits to customers that are equivalent to what is offered by a conventional mortgage, but in a manner that complies with the tenets of the *Sharīʿah*. The concept allows customers to acquire their homes at their own pace through pre-determined monthly payments and ensures the integrity of the transaction by respecting the rights and obligations of the two parties in the agreement. An essential difference between the *Sharīʿah* compliant modes of financing and loans that incorporate interest is that the financier is not permitted to profit from financial distress**.** No interest may be charged on late payments except that expenses incurred in the collection of such payments may be charged to the customer (Rafe, 2005).

Another important issue related to the DM form of contract is the purchase of shares by a home-buying customer. Here, the price and timing of share purchases is usually fixed at the outset of the contract. According to MCCA's DM contract, the price of share purchases is related to the market value of the underlying property at the time of the purchase, and such purchases are not forced upon the customer contractually. It is to be mentioned here that the *Sharīʿah* standards of the Bahrain-based AAOIFI prohibit the purchase of shares in a Diminishing Partnership (DP) at a price that is fixed in advance (AAOIFI, 2003). This is on the basis that partners in a contractual investment (in this case, a rental property) must share any losses on their investments in proportion to their capital contribution. If one partner forces another to buy his shares at a predetermined price, he may effectively be able to protect himself against loss, thus breaking the principle of loss sharing that must apply if an Islamic partnership is to be valid.[8]

The DP contract practised by some of the IFSPs, mainly MCCA, protects them from capital loss on their share of the partnership by various means and to varying degrees under Australian law. In the event of property market decline Muslims who default under such contracts may therefore find themselves required to guarantee IFSPs' original capital contribution to the property purchase. If property prices fall significantly, the position of negative equity could become widespread. This would no doubt be an unexpected surprise for many customers, given the language of "risk sharing" that typically accompanies Islamic home finance products. Given the above, it is believed that any *Sharīʿah* compliant financing scheme in which the financing organization stipulates conditions to protect itself from a negative return on capital is equivalent to an interest-bearing loan (Al Haddad and El Diwany, 2006).

4.2 CRITIQUE OF *MURĀBAḤAH* CONTRACT FOR HOUSING FINANCE

Although *Murābaḥaḥ* is a common instrument in Islamic Banking, its mark-up feature has frequently been criticized. Critics argue that the mark-up added to the original cost of the good is equal to or even higher than the amount of interest, which a borrower would pay in conventional banking practice. Therefore, it is often stated that "mark-up" is just another designation for interest and is consequently not in line with the *Sharīᶜah* principles (Henry, 1999).

Criticisms of *Murābaḥaḥ* or Mark-up Trade Finance stem from the role of the seller and the practical execution of the transactions. PLS, which is arguably a central tenet of Islamic finance theory, does not seem to feature in the *Murābaḥaḥ* mode of finance. Of course, the criticism that *Murābaḥaḥ* does not correspond to the original spirit of Islam is a criticism that can just as easily be directed toward the entire practice of contemporary Islamic finance (Moghul and Ahmed, n.d.). Besides this criticism, it is claimed that the mark-up element is *al-Gharar* on the basis that it is *ḥarām* for the bank to sell a good, which is not at hand. Also, in *Murābaḥaḥ* the customers accept the offer of the bank, in which they bind themselves to purchase the goods before the bank has approached the supplier. Moreover, the customers' deposits are not repaid in case of default of the customers, which may not be in accordance with the *Sharīᶜah* that prohibits contractual penalties. In addition, the mark-up represents a fixed profit for the bank that is obtained by the bank without further effort or risk taking, which should ideally not occur in Islamic banking.

From an operational point of view, the very essence of the *Murābaḥaḥ* contract states, among other things, that the seller be exposed to the risks normally associated with ownership such as the risk of loss, damage, and deterioration of the goods prior to delivery. The seller must also accept the buyer's right to return the goods and cancel the sale if the goods are damaged, do not meet the buyer's preferences, or involve a mistake in pricing (Burghardt and Fub, 2004).

In engaging in *Murābaḥaḥ* transactions as sellers, the IBs do not share in the profits and losses of their customers. Rather they assume the typical role of conventional banks. In some cases, the risks normally associated with ownership are transferred contractually to the buyer. In other instances, the seller does in fact bear such risks from the time of purchase until the time of delivery, leading some to argue that the bank takes a risk, until the customer fulfils his original promise to purchase the commodity, which justifies the profit.

The counterargument is that the seller does not *really* own the goods, never truly has physical or even constructive possession of the goods, and owns the items for only moments, as both sales are concluded at the same closing. Effectively, the bank as seller does not bear the risks of ownership. The rights of the customer as buyer, such as the right to inspect the goods and the right to rescind the sale, are typically nullified or shifted so they become beneficial to the seller rather than to the buyer. Some classical jurists held that such reallocations could take place if buyers were to affirmatively waive their rights. However, affirmative waivers do not occur as often as constructive waivers in modern Islamic finance. Moreover, according to many *Murābaḥaḥ* contracts, the buyer is responsible for compliance with all applicable laws and regulations, including those relating to the import of goods (Burghardt and Fub, 2004).

In short, the seller-bank has now effectively avoided many, if not all, of the risks and responsibilities that classical jurisprudence expects it to bear. The risk that the buyer may refuse to buy is avoided by means of an advance payment, “promissory note” security, third-party guaranty, and/or contract terms.

Some IBs use these measures well in advance of purchasing the item and deposit assets and collateral to be held until they have been fully paid. Typically, for example, the advance payment amount would be sufficient to cover any loss that may occur from a refusal by the buyer. Alternatively, the bank may contractually be afforded the right, if the customer refuses delivery, to sell the goods at the prevailing price in the market and if such sale price is insufficient, to demand from the customer the balance of what is due to the bank, including the profit margin. It is argued, thus, that like charging interest by a conventional bank an IB earns a predetermined return on capital by practicing the modern *Murābaḥaḥ* mode of financing.

As mentioned in this study earlier, penalties and fees for late payments were prohibited traditionally but are now allowed in a somewhat conspicuous fashion as part of modern *Murābaḥaḥ* transactions. Some contemporary jurists have observed that the penalty imposed is actually calculated by means of a bank doing nothing more than examining its normal rates of return. This is not dissimilar to conventional banks' seeking to recover the opportunity cost of their capital (Zubairi, 2006).

4.3 CRITIQUE OF THE *AL-IJĀRAH WA AL-IQTINĀ'* CONTRACT

The contract of *al-Ijārah wa al-Iqtinā'* used by the IFSPs in Australia has been criticized from both Islamic and Australian legal perspectives. From the *Sharīᶜah* point of view, it has been observed that rather than calculating the rent on the basis of average rent market, in such contracts rent is often pegged against measures such as the Reserve Bank of Australia (RBA) interest rate or the London Interbank Offered Rate (LIBOR).[9] The rate of this rent is subject to change any time in the future and, hence, unpredictable. Given that, it is not known what the RBA or LIBOR interest rate will be for any period in subsequent months or years; home buyers whose rental payments depend upon that interest rate are in a position of ignorance as to what their future rental payments will be. Some Islamic legal scholars have argued that setting rental levels in line with market interest rates is not in itself unlawful in Islam on the basis that it is permitted for a Muslim shopkeeper to make the same percentage profit selling lemonade as the non-Muslim shopkeeper makes selling alcohol. However, the problem is not the link to the RBA interest rate or LIBOR. Rather, it arises from *al-Gharar* (Elgari, 1999). The reason is that the customer does not know what rental amount he must pay to the bank until the beginning of each new period even though he is contractually bound to rent the property for the subsequent period. If interest rates increase dramatically, then the rental payments will likewise increase and the customer may find himself locked into the payment of rentals that he cannot afford. Similarly, it is not justified to increase rental payments due to the increase in interest rates because typically there is a fall in the value of land and property with the rise of interest rates.

If the home-buying customer later decides that he can no longer afford the rental, both the MCCA and Iskan contracts require that he must guarantee to repay the cash sum initially provided by these IFSPs to fund the purchase of the property. In those cases where the property has to be sold to achieve this, the possibility arises that, if property prices have fallen in the meantime, the sale proceeds may not be sufficient to repay the financed amount. In this case, by requiring the customer to make up any shortfall to IFSPs, the possibility of "negative equity" arises, a position in which the customer owes more to IFSPs than the property is worth.

From the *Sharīᶜah* perspective, a customer can only rent a property if he does not own it. Yet if the legal reality is one of rental, a question arises as to why the customer must bear the risk of a fall in the property's price. Those who rent cars from hire companies are not expected to compensate the hire company for a fall in the value of the car during the period of the hire. On the other hand, if the customer bears the risk of a fall in property value precisely because they own the property, then it must be asked why the customer is expected to pay rental to IFSP.

In answer to this question some Islamic legal scholars have argued that, in a modern agreement of *al-Ijārah wa al-Iqtinā'*, the bank or financial institution only buys the property and rents it to the customer because the customer has expressed a need for the property. It would be unfair, they argue, for the bank to suffer a loss if the customer does not proceed to purchase the property at the price agreed at the outset of the contract of *al-Ijārah wa al-Iqtinā'*. Such arguments would be seen as invalid under the principles of the *Sharīᶜah* as the essence of the contract of *al-Ijārah wa al-Iqtinā'* is to free the tenant from bearing responsibility for loss or damage to the property (unless it results from the tenant's misuse of the property). A compensation for loss of capital value is a condition that defeats the purpose of the contract of *'al-Ijārah wa al-Iqtinā'*, and this kind of condition is not permitted in the *Sharīᶜah* (Al Haddad and El Diwany, 2006). Furthermore, Islamic home financing with *al-Ijārah wa al-Iqtinā'* typically requires that the customer purchases the property from the IFSP at the end of the *'Ijara wa Iiqtina* term as a means of protecting the IFSP's original capital contribution. This transaction, involving a deferred delivery of both counter values (property and price), has been prohibited by the four main Schools of Islamic law. al-Qurṭubī mentions in this regard: "Delay from both sides is not permitted by consensus either in corporeal property or in liabilities as it amounts to a proscribed exchange of a debt for a debt" (Ibn Rushd, 1996).

So, far the problems with the contract of *al-Ijārah wa al-Iqtinā'* generally mean that in the case of home financing under the contract of *al-Ijārah wa al-Iqtinā'*, the property remains in the ownership of the lender. A person who would normally be a mortgagee is, in fact, a tenant - an assured tenant, but the person who is acquiring the house through *al-Ijārah wa al-Iqtinā'* finance is not the owner of the house.

The equivalent of the mortgage lender is the owner, which presents two serious technical and legal problems.

First, the occupant of the house is in a much weaker position in respect of disputes over arrears. Under *al-Ijārah wa al-Iqtinā'*, the lender or owner of the property can evict the borrower who has a few months of arrears, whereas under a conventional mortgage arrangements the mortgagee has security of tenure. In those circumstances eviction is a matter for a court and a court order has to be obtained. The borrower in *al-Ijārah wa al-Iqtinā'* is therefore in a much weaker position than the conventional mortgage borrower.

Second, another difficulty applies either when someone wants to pay off their obligations or to foreclose. Under a conventional mortgage, the mortgagee is protected in that the mortgage lender is obliged by law to secure the best possible price and to make available, if he sells the property, a full account of the transactions. Under the arrangement of *al-Ijārah wa al-Iqtinā'*, however, the provider has no such obligation. From legal perspectives, it is not fair to unwittingly place people who undertake *al-Ijārah wa al-Iqtinā'* transactions for perfectly good reasons in a very weak legal position with respect to the providers of those products.

4.4 CRITIQUE OF THE *AL-IJĀRAH AL-MUNTAHIYAH BĪ AL-TAMLĪK* CONTRACT

The product of *al-Ijārah al-Muntahiyah bī al-Tamlīk* for home financing has been criticized by its opponents in the following ways.

(a) The IFSPs are criticized more often than not, for basing the lease rent in *al-Ijārah al-Muntahiyah bī al-Tamlīk* on fluctuating conventional benchmarks such as the RBA interest rate or the LIBOR. Why is the lease rent not fixed at the outset for the entire lease term? The objection raised against this practice is that, by making the rental payments equal to a rate of interest, the transaction may be rendered akin to interest-based financing. By doing so, the IFSPs are guaranteed a return whatever happens to the actual value of the property.

(b) The future variation in the RBA/LIBOR rate being unknown renders the rent thus tied up to it uncertain (i.e., an element of *al-Gharar* is found in this product). This means that the customer is unaware of the rental rates in the future, and hence, the total cost of the property (total rent paid plus the sale price) is not known to the buyer at the time of the contract. This is not allowed under the *Sharīʿah* since all considerations in a contract must be clearly known and understood to the parties entering into it. The *Sharīᶜah* requires that the price of goods must be known at the time of a sale contract.

(c) It is claimed that *al-Ijārah al-Muntahiyah bī al-Tamlīk* boils down to a form of disguised security agreement since it transfers to the lessee all the risks associated with ownership. The long-term and non-cancellable nature of the financial lease adds to that problem. Even when the leased object is eventually rendered into a free gift or given at a nominal price, it does not address the issue that the residual value is predetermined and built into the lease payments which may prove to be unjust. The lessee loses the asset as well as the extra payments he may have made if he dies or is unable to continue the lease payments.

(d) In some cases the lease commences on the very day the lessee receives the price irrespective of whether he has taken delivery of the asset. The lessee's liability for rent thus begins prior to taking delivery of the leased asset. This contravenes one of the requirements of *al-Ijārah* as it amounts to charging rent on the money given to the customer, and it is tantamount to interest. If the supplier has delayed delivery after receiving the price, the lessee should not be liable for the rent of the period of delay.

(e) Furthermore, when the lessee himself has been entrusted with the purchase of the leased asset, two separate relations come into play between the institution and the customer, one after the other. In the first instance, the customer is an agent of the institution to purchase the asset on the latter's behalf. The lessor-lessee relationship has not yet come into operation at this stage. The second stage begins from the date when the customer takes delivery from the supplier. It is only then that the lessor-lessee relation begins within the context of *al-Ijārah*. During the first stage, the customer cannot be held liable for the obligations of a lessee as he only acts as a trustee and agent. It is only when he takes delivery of the assets that he acquires the role of the lessee (Kamali, 2005).

(f) It has been pointed out that the obligatory manner of committing the lessee to acquire ownership of the leased asset at the end of the contract period is inconsistent with the requirements of Islamic law. Stipulation of such terms in the original lease not only amounts to combining two contracts in one, but can also lead to injustice. There is no objection to drawing a basic memorandum of understanding, or exchange of promises, between the parties that would help secure the desired purposes of the parties, provided it does not bind the lessee to acquire ownership.

The lessor may also make a unilateral commitment to offer the lessee an option to buy the leased assets at the end (Kamali, 2005).

5. CONCLUDING REMARKS

While comparing the equity-based and non-equity (debt-based) financial instruments used by the IFSPs in Australia in their practice of housing finance, it has been observed that equity-based financial instruments have a strict risk, profit and loss sharing rule, whereas the non-equity based financial instruments, namely *Murābaḥaḥ*, *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk* can easily accommodate a hidden interest rate. Given this, among the non-equity financial instruments used by the IFSPs, the model of *al-Ijārah* of home financing is probably more *Sharīᶜah* compliant than that of the *Murābaḥaḥ* model despite the questions raised against *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk*. It is important that the act of buying the property by the IFSP and then selling or leasing it to the customer constitutes two separate transactions, but it is not permissible in the *Sharīᶜah* to combine two transactions into one.

In reality, the IFSPs in Australia commonly use an accounting interest rate for book keeping these transactions. Some IFSPs attempt early in their operations to conduct *Mushārakah Mutanāqiṣah* for housing finance but eventually submit to using *Murābaḥaḥ*, *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk* as the main modes of operation. Those practices are commonly favored due to the elimination of the risks of enterprise failure, moral hazard, and adverse selection.

Conceivably the common constructive criticism is that while the IFSPs rely on the non-equity (debt-based) modes for home financing, they do not seem to be fulfilling realistically the conditions laid down by the *Sharīᶜah* for the permissibility of these modes. This criticism may or may not be right. However, what provides credibility to it is the secretiveness and lack of adequate transparency on the part of these financial institutions about their operations.

Another criticism is that certificates bearing the Islamic credentials of the IFSPs are issued to them by their own internal *Sharīᶜah* boards. There may not be any doubt about the integrity of the members of these boards, who are highly qualified and well-respected Islamic legal scholars. Yet, they are also employees or paid advisers of these institutions and there is a possibility of conflict of interests.

It is not possible to ascertain the legitimacy of most of these criticisms until a comprehensive survey of the IFSPs has been undertaken. No such survey is feasible or meaningful unless there is assurance of transparency on the part of these IFSPs. However, those well-informed about the working of IFSPs feel that, while the IFSPs do deserve a significant part of the blame for their weaknesses, the total blame does not necessarily rest on their shoulders.

Expectations may be too high, and there seems to be little appreciation of the various problems that these IFSPs face while operating in a predominantly interest-based financial environment without experienced know-how, shared institutions, and whole-hearted official support. A major reason for their shortcomings may be systemic, and it may not be possible for them to solve systemic problems in their individual capacities. Moreover, these institutions are very small compared to the conventional mega-banks with which they have to compete, and do not have the resources to create a proper enabling environment.

6. SUMMARY, FINDINGS AND RECOMMENDATIONS

6.1 SUMMARY AND FINDINGS OF THE STUDY

This study investigated the practice and compliance requirements of Islamic finance in the Australian legal context. Following that, it attempted to critically examine the extent of divergence of Australian IFSPs from the strict *Sharīʿah* requirements in their current use of different financial products for housing finance. The study, however, did not attempt to evaluate the economic efficiency and profitability of IFSPs in Australia.

Given the above, the findings of the study can be summarized as follows:

- Islamic finance in Australia is still in its early stages as most of the Australian Muslim immigrants have naturally been more worried with how to support their families than with developing financial institutions. However, a number of small financial enterprises have been established with at least three in operation at present, namely, the Muslim Community Co-operative (Australia) Limited, known as the MCCA, the Islamic Co-operative Finance Australia Limited (ICFAL) and Iskan Finance. The MCCA and ICFAL are currently limited to providing facilities to their shareholders and are not allowed to accept normal bank deposits as in many other countries, Australian law normally does not permit taking deposits without an appropriate license. While Iskan works with a number of other providers and offers mortgage and leasing facilities.

- Products and instruments IFSPs in Australia use to provide facilities to their shareholders and customers to own their dream homes apparently look different because they use different Arabic nomenclatures, are limited to *Mushārakah*, *Murābaḥaḥ*, *al-Ijārah* and the combination of *Murābaḥaḥ* and *al-Ijārah*. However, IFSPs in Australia are supposed to promote *Mushārakah* transactions which are based on the concept of PLS since there is no better example of the *Sharīcah* compliant financing than PLS finance. Given that these financial institutions are Co-operatives, both MCCA and ICFAL are supposed to share their customers' risks as risk sharing is the essence and spirit of Islamic finance. Nevertheless, in practice these institutions invest only a tiny portion of their portfolio in PLS transactions and a very big margin of their assets consist of *Murābaḥaḥ* and *al-Ijārah* modes of finance, which in the view of some Islamic legal scholars carry interest veiled in Islamic costume.
- While comparing the different products practised by both IFSPs and conventional financial services providers in Australia it was found that inherently, the features of the Conventional HP loan and MCCA's *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk*, the ICFAL's HP, and Iskan's *Tayseer-'Ijara* schemes for home for example, are quite similar. However, the differences between the two are: Firstly, IFSPs' above mentioned HP financing under different names is supposed to follow the *Sharīcah* principles as well as the spirit of the Hire-Purchase Act, while conventional HP follows only the Hire-Purchase Act. Secondly, the financing for IFSPs is sourced from *halal* funds whilst the conventional HP has no limitation of its sources of funds. Thirdly, there are two agreements involved under IFSPs namely the Leasing Agreement; and the Purchasing Agreement. Fourthly, under IFSPs, customers have to sign the Letter of Acceptance to signify the offer and acceptance of transactions whereas conventional HP does not have such agreements.

It was also found in comparison analysis between conventional mortgage and the SER systems practised mainly by MCCA and ICFAL among IFSPs that the relationship between the buyers and MCCA and ICFAL is amicable rather than antagonistic, where interests are harmonious rather than conflicting. The conventional mortgage being exploitative creates conflict, stress, and insecurity, while contributing to greater disparities of income and wealth. The SER home financing, however, reduces conflict, stress and insecurity, and makes for a more harmonious and equitable society.

The following comparative analysis of IFSPs' *Murābaḥaḥ* mode of home financing with interest-based conventional mortgage being carried out in this study is worthy of mentioning as it led to investigate the extent of IFSPs' divergence from the traditional *Sharīᶜah* while practicing this mode:

(a) The *Murābaḥaḥ* contract needs a bank purchases commodity required by an end-user and then the bank sells the article to the end-user at a price that is calculated using an agreed profit margin over the costs incurred by the bank. In the event of default by the end-user, the financier only has recourse to the items financed and no further mark-up or penalty may be applied to the sum outstanding with passage of time as in the case of amounts borrowed from conventional banks on interest.

(b) As in the case with conventional bank, no money is loaned to the customer in the event of a *Murābaḥaḥ* transaction. Rather, the bank purchases the property itself, based on the requirement of the customer. This ensures that financing is always asset-based.

(c) In a *Murābaḥaḥ* transaction the bank assumes the risk by purchasing the commodity before it sells it at a mark-up. This mark up is considered as the reward of the risk it assumes. On the other hand, interest-bearing loans given by the conventional banks assume no risks whatsoever.

(d) In conventional financing the bank gives loans to its customers without ever being concerned how the money is being put to use, while in Islamic financing the bank cannot be unconcerned about the purposes for which the objects being sold is to be put to use.

Keeping in view of the above comparative analysis upon examining the *Murābaḥaḥ* contracts practised by IFSPs in Australia it was found that their financing (pricing, outcomes etc.) was mostly similar to conventional products and instruments for not fulfilling the following key conditions:

(a) As per *Murābaḥaḥ* sale, the bank or financial institution should add a known fixed amount of profit to its cost price which has to be known to the customer. The cost plus the known profit amount is the price for which the bank sells the object. All other additions to this profit such as penalties for late repayments, service charges etc. are deemed to be null and void and hence would not be permissible.

(b) To be in consonance with the principles of Islamic finance, *Murābaḥaḥ* transactions may be undertaken only where the customer of a financial institution, wants to purchase an object. This type of transaction cannot be effected in cases where the customer wants to get funds for a purpose other than purchasing an object.

(c) In a *Murābaḥaḥ* agreement it is appropriate for the sale of a property for a deferred price, but this implies a trading transaction that takes some time to effect. The critical condition is that to make *Murābaḥaḥ* a valid transaction it is necessary that the property is really purchased by the financial institution and it comes into the ownership and possession (physical or constructive) of the financial institution, who assumes ownership responsibilities until the property is resold. Hence, the risks associated with ownership are borne by the financial institution, justifying the mark-up. If the buying and reselling come into effect on the spot then there is no real risk for the financial institution and the transaction becomes a legal fiction, which is certainly in conflict with the spirit of the *Sharīᶜah*.

- It was also found from the investigations of the degree of the divergence of Australian IFSPs from the *Sharīᶜah* in their practice and services that from IFSPs' contracts of *al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk* for Islamic housing finance it was not clear whether it was a lease contract, a purchase contract or a combination of the two. Nevertheless, when all of the above three transactions (i.e. *al-Ijārah,al-Ijārah wa al-Iqtinā'* and *al-Ijārah al-Muntahiyah bī al-Tamlīk*) were taken individually, they were considered entirely valid. But the presence of a significant amount of ambiguity invalidated the contracts in accordance with the tenets of the *Sharīᶜah.* This is why the Islamic legal scholars hold the opinion that if rental and sale are mixed in such a way that one cannot distinguish at any point of time whether the customer is a tenant or a buyer, then such a contract is Islamically invalid.

6.2 RECOMMENDATIONS FOR THE STUDY

This study makes the following suggestions and recommendations for consideration by regulatory authorities for Islamic banking and finance in Australia:

(a) Recognising the problem that some home financing instruments practised by IFSPs closely resemble interest-bearing instruments, it is suggested that more PLS instruments should be developed and used by these financial institutions. This is because PLS financing being a basis for equal distribution of wealth in the society is unanimously considered by the scholars of the *Sharīᶜah* as one of the most authentic forms of the *Sharīᶜah* approved financing and thus a real alternative for the conventional interest-based financing schemes. There is another legitimate reason to justify the importance of this proposition. Taylor and Evans concluded when comparing the traditional Western banking system with the Islamic banking system that both systems prohibit usury and permit any return from partnership provided that the partner making the investment genuinely shares the risk. According to these writers:

"the closeness of the two systems (*conventional and Islamic financial systems*) is great and there is some evidence of common origins. Contemporary Western thought, however, has apparently removed itself far from its own tradition - hence the gap between Western and Islamic banking systems" (Taylor and Evans, 1987).

(b) Notwithstanding the fact that in practice using *Mushārakah* as a mode of financing by IFSPs for purchasing homes is difficult in the current conventional financial setup of Australia as IFSPs' investments under PLS are not regulated by the APRA. Under such adverse situations contemporary Muslim scholars have permitted the use of other non-Equity-based products such as *Murābaḥaḥ* and *al-Ijārah* as modes of financing to own homes. Islamic finance in Australia has currently introduced at least 5 basic *Sharīᶜah* compliant products for housing finance which can be extended to a wide, varied, and variegated menu of financial instruments. To this end, more creative techniques need to be undertaken to suit the financial needs of individuals and groups to facilitate their contribution in community development in particular and the economic development of Australia at large. Besides, this would facilitate IFSPs to provide greater security, liquidity, and diversity to meet the demand of investors mainly in purchasing homes in the Muslim community.

(c) Currently all of IFSPs in Australia are providing investment facilities rather than retail banking services that are insufficient to meet the growing demands of Muslim community. In order to attract more customers, the providing of both forms of banking to the communities' religious needs and economic development of the country, it is suggested that Islamic investment and retail banking facilities be integrated.

(d) The study recommends that the regulators in Australia introduce measures necessary to equalize the revenue duties liabilities of Islamic alternatives for interest-based mortgages with a view to creating a level playing field for financial institutions and customers. Given the differing treatment of similar financial products under the different State regulatory systems, it is suggested that the government consider making changes to facilitate the levying of a single charge on what in effect is a single purchase.

(e) The co-operative nature of financial institutions among IFSPs, namely MCCA and ICFAL may merge with each other for their future growth and development through attracting more capital and providing investment facilities for housing finance. This will help expand Islamic finance that Australia's vibrant Muslim community could use comfortably as it would meet their religious as well as financial and market requirements.

(f) It is not known to many people that one of the great successes and growth of Islamic banking lies in "its value-orientated ethos that enables it to draw finances from both Muslims and non-Muslims alike" (IB, n.d.). Also, since the *Sharīcah* contracts that are now used and advertised by IFSPs in Australia appear to be traditional mortgage contracts where the borrower takes the risk and the lender gets a fixed rate of return it is suggested that Muslim customers should be fully informed about the institutions with whom they enter into business relationships.

6.3 SUGGESTIONS FOR FURTHER RESEARCH

The volume of research on Islamic banking and financial systems has considerably amplified over the past two decades. However, there are still many significant issues remain to be critically examined. In relation to the practice of Islamic finance in Australia from *Sharīcah* perspectives, which is the topic of the author's research, there is scope of more work to be undertaken. The author's research was somehow limited to technical analysis. It should be followed by legal empirical studies and tests. Within a few years, sufficient volume of data on the Islamic banking and financial systems of Australia is expected t be available, to make such studies practicable.

Apart from the topic of this study, there are other issues for further studies into Islamic finance in Australia. An interesting area of future study relates to exploring the potential for launching *Sharīcah* compliant banking services by IFSPs' conventional counterparts like NAB, ANZ, Westpac, CBA, St George Bank etc. side by side with the conventional banking facilities they offer for the prospective customers since other leading global banking institutes such as HSBC Amanah, Citibank, Standard Chattered Bank, Deutsche Bank and UBS of Switzerland have already entered the markets to offer Islamic financing facilities in a significant manner through their trans-national banking subsidiaries.

ENDNOTES

1. Under section 9(4) (a) of the of the *Banking Act 1959*, the APRA imposed on the MCCU the condition of maintaining a minimum ratio of capital to risk-weighted assets of 15% at all times among other conditions.

2. The *Sharīʿah* is understood as Islamic law or the code of Muslim conduct outlined by the *Qur'ān* and the *Sunnah* of Prophet Muḥammad (pbuh). The *Enterprise* category acknowledges business that have shown the "initiative and willingness to undertake bold new ventures", while *Community Contribution* recognizes "those who demonstrate examples of policies or projects that positively impact on the community and generate outcomes that have a long time benefit".

3. The *Enterprise* category acknowledges business that have shown the "initiative and willingness to undertake bold new ventures", while *Community Contribution* recognizes "those who demonstrate examples of policies or projects that positively impact on the community and generate outcomes that have a long time benefit".

4. This product was applied as a Diminishing Partnership (DP). In home financing under DP the customer forms a partnership with the financial institution for the purchase of a property. The financial institution rents out their part of the property to the customer and receives compensation in the form of rent, which is based on a mutually agreed fair market value. Any amount paid above the rental value increases the share of the customer in the property and reduces the share of the financial institution.

5. The then Prime Minister of Australia Mr. John Howard said that he was particularly concerned about young home buyers struggling to afford properties in Melbourne and Sydney. However, some commentators have criticized the proposal, saying that a real danger is negative equity where the house is sold for less that the amount outstanding.

6. *Fatwas* are legal statements in Islam, issued by a scholar of Islamic laws, on a specific issue. They are asked for by judges or individuals, and are needed in cases where an issue of Islamic law and jurisprudence is undecided or uncertain. Lawsuits can be settled on the basis of a fatwa.

7. For instance Justice M. Taqi Usmani in his judgment gave in the Shariah Appellate Bench of the Supreme Court of Pakistan stated that *Mushārakah* is not only the principles of Islamic jurisprudence, but also the basic philosophy of an Islamic economy.

8. The AAOIFI clearly recognizes the risk that a *Sharīᶜah*-compliant partnership contract can be transformed into a *ribā* contract by means of pre-agreed share transactions. It says: "It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the institution) by the other partner, which is prohibited by Shari`a".

9. The LIBOR is the most widely used benchmark or reference rate for short term interest rates. It is the rate of interest at which banks borrow funds from other banks, in marketable size, in the London interbank market. Given the absence of reference rates based on Islamic financial instruments, most Islamic legal scholars allow the use of RBA or LIBOR as a reference rate. However, most Islamic legal scholars object to variable or floating rates in the body of an on-going *'ijara*.

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APPENDIX

TABLE 1
Amortisation schedule for a 30 year conventional mortgage at 8% interest; AUD 360,000 principal

Payment number	Monthly payment	Interest	Principal	Balance after payment
1	$2641.56	$2640.00	$1.56	$359758.44
2	$2641.56	$2398.40	$243.16	$359515.28
3	$2641.56	$2396.76	$244.80	$359270.48
12	$2641.56	$2381.68	$259.88	$356992.52
…				
120	$2641.56	$992.93	$1648.63	$315807.36
…				
240	$2641.56	$583.20	$2058.36	$217715.92
…				
359	$2641.56	$34.80	$2606.76	$2612.36
360	$2641.56	$29.20	$2612.36	$0.00
Totals	$950961.60	$590961.60	$360000.00	

TABLE 2

MCCA's Shared Equity with Rent Equal to Conventional 8%; 30 Year Monthly Payment; Owner's Share Applied to Repurchase; No Additional Principal Payments

Payment number	Monthly payment	Buyer's share	MCCA & ICFAL's share	Buyer's equity	Buyer's equity %	MCCA & ICFAL's equity	MCCA & ICFAL's equity %
				$40000.00	10%	$360000	90%
1	$2641.56	$240.16	$2377.40	$40264.16	10.07%	$359735.84	89.93%
2	$2641.56	$267.64	$2375.64	$40530.08	10.13%	$359469.92	89.87%
3	$2641.56	$267.64	$2373.92	$40797.72	10.20%	$359202.28	89.80%
…							
24	$2641.56	$307.32	$2334.24	$46845.36	11.71%	$353154.64	88.29%
…							
120	$2641.56	$578.16	$2063.40	$88123.76	22.03%	$311876.24	77.97%
…							
240	$2641.56	$1273.72	$1367.84	$194144.96	48.54%	$205855.04	51.46%
…							
359	$2641.56	$2610.08	$31.48	$397845.48	99.46%	$2154.52	0.54%
360	$2641.56	$2154.52	$14.24	$400000.00	100.00%	$0.00	0.00%
Total	$924073.20	$360000	$564073.20				

Table 3

Conventional Mortgage and MCCA and ICFAL's Shared Equity Mortgage Summary

Conventional mortgage

Comparative figures of different interest rates

30 year conventional mortgage: AUD 360,000 principal; AUD 40,000 down payment

Interest rate	Monthly payment	Total payback	Total interest	Total principal
6%	$2158.38	$777017.48	$417017.48	$360000.00
8%	$2641.56	$950958.89	$590958.89	$360000.00
10%	$3159.24	$1137332.75	$777332.75	$360000.00
12%	$3703.00	$1333081.93	$973081.93	$360000.00

MCCA and ICFAL's shared equity AUD 360,000 initial MCCA and ICFAL's equity (90%); AUD 40,000 initial buyer's equity (10%) buyer's share of monthly rent applied to repurchase of MCCA and ICFAL's share

Total payment	Monthly rent	Total payout	MCCA & ICFAL's share of rent	Principal	Payment required to complete buyout	Years required to complete buyout
	$2158.40	$923517.40	$563517.4	$360000.00	428	35.67
	$2641.56	$924073.20	$564073.20	$360000.00	350	29.17
	$3159.24	$924669.19	$564669.16	$360000.00	293	24.42
	$3703.00	$925292.56	$565292.56	$360000.00	250	20.83
$3159.24	$2641.56	$670248.64	$310248.64	$360000.00	213	17.75
$3703.00	$2641.56	$577927.32	$217927.32	$360000.00	157	13.083