



ISLAMIC FINANCE PROJECT, ISLAMIC LEGAL STUDIES PROGRAM
HARVARD LAW SCHOOL

SHAR‘IAH-COMPLAINT HOME FINANCING IN NORTH AMERICA

A panel discussion featuring

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SUNDAY, OCTOBER 28, 2012

2:00-5:00 P.M.

AUSTIN HALL, HARVARD LAW SCHOOL

CONTEXT AND OVERVIEW

SHAR‘IA-COMPLIANT HOME FINANCING IN NORTH AMERICA

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Beginning with the premise that home finance represents the single most important factor in the growth of a vital retail Islamic financial services industry in North America, this seminar is organized to study what may be done to further the progress of Shari‘ah-compliant home finance and to address some of the concerns that are limiting the adoption of these services among potential clients.

The North American Muslim community is a relatively affluent and well-educated group. Shari‘ah-compliant home finance has managed to make a reasonable start for itself here. Not in every community, but in many. The question now is how to build on what has been accomplished to date. Moreover, home finance is not the only Shari‘ah-compliant financial products and services business to compete for market share in North America (including the US, Canada and the Caribbean). Indeed, it is hoped that a wide range of financial services and products that comply with the Shari‘ah will be made available to the public here in North America. Many believe that the success of Islamic finance services lies in the success of the home finance business, as that is the business that figuratively opens the door to other opportunities.

Home finance in general aims at the higher end of the middle class market, and is therefore particularly well positioned to offer related financial services to the consumer. In the North American Muslim community, estimated at between seven and ten million people in the US alone, this important demographic has the potential to spur the development of a wide range of Shari‘ah-compliant financial services, either as replacements for conventional services already in use or as first time services. There are, however, several keys to the successful introduction of these services.

From a Muslim retail consumer’s perspective, financial services must (1) come with competitive pricing, (2) offer competitive services, (3) and comply with recognized Shari‘ah norms. The order of importance for these factors may differ from client to client. From the perspective of businesses offering Shari‘ah-compliant financial services in North America this means that, in the absence of large scale operations, they must find ways to be cost efficient. At the same time, their services and products must be recognizably different from conventional financing products to strengthen their credibility among potential clients.

In many ways, the home finance industry may be considered a test balloon for the rest of the Islamic financial services industry. Success in this industry, under the particular circumstances of the North American Muslim community, will only come through hard work, innovation and keen attention to the market. It is the latter that this seminar will seek to understand.

The financial industry, regardless of the product or service sought or offered, is built first and foremost on trust. Conventional financial institutions, the competition, have a distinct advantage in this regard. Many of them have branded themselves to become household names, many have a historical presence that may extend as far back as a century or more, and many have a physical presence in neighborhoods and suburbs having a high concentration of Muslims. All of these may be considered obstacles in the development of Shari'ah-compliant businesses. They may also be considered healthy competition and motivation.

Other challenges to the industry come from within the North American Muslim community itself. In addition to the keys alluded to earlier, competitive pricing, competitive services, and Shari'ah authenticity, we may add the need to overcome (4) inertia, (5) skepticism, (6) doubt and (7) fear.

1. Competitive Pricing: Middle Class Muslim families in North America are very much attuned to the day to day dynamics of family finance. Through networks of colleagues, friends and neighbors, not to mention the media, Muslims are keenly aware of market prices and market. Thus successful home finance operations are those that offer competitive rates. Businesses must assume that the days of the COB (Cost of Being Muslim) or the Shari'ah Premium, if there ever were any, are over. Or are they? And what does this mean to businesses? And to Muslim consumers?

2. Competitive Services: For the reasons cited above, Muslims are also well aware of what good service means. Accustomed to smiling and efficient service from local banks and insurance brokers, Muslims are accustomed to, and have grown to expect, good service and assistance. Sales representatives at Shari'ah-compliant home finance companies must be well trained, educated and skilled in dealing with all manner of people and situations. As the first line of contact with the Muslim public, the sales team, including the people on the phones (and this can be a factor in outsourcing as I will allude to later in this talk), must be a priority for a successful home finance operation.

3. Shari'ah Authenticity: While the threshold for satisfaction in the matter of compliance with Shari'ah norms may not be high for many Muslim consumers, if not most, it is nonetheless of utmost importance. For many consumers in North America it is the single most important factor in the decision to buy or not to buy. Obviously, it is what differentiates the Islamic product from its conventional competitors. More importantly, it is why the product exists in the first place. If there hadn't been a need and a demand for Shari'ah-compliance, there wouldn't be a supply. In surveying the list of businesses presently operating in North America it is interesting to compare the degrees of attention given to this matter. Time and again, voices have raised the question of the authenticity and the true 'value-add' of products marketed with the claim of being Shari'ah-compliant but apparently no different than conventional products. There are many criteria to be considered, and varying reasons for the perceived disparities, but in general it is clear that some businesses give the matter more attention than others. I will not delve into the matter here, but it is worthy of attention and perhaps even academic study.

4. Inertia: The inertia factor is undoubtedly strong as most Muslims in the home owning demographic are already banked, insured, invested and financed by conventional means.

Overcoming such inertia is never an easy task. Appeals to the religiosity or to the nationalistic sympathies of Muslim consumers aside cannot be relied upon for success in the home finance market when people have established themselves as customers and, in many cases, have gained some sort of status (gold card, platinum account, good driver, etc.) within the system.

5. Skepticism: The element of skepticism, too, is strong in our North American community where many educated Muslims and professionals in particular question the credentials of Shari‘ah-compliant businesses, if not the very premises on which they are founded. For many in the immigrant communities, there may be negative experiences or attitudes from their home countries. Ways must be found to meet each of these challenges. Moreover, the solutions developed by the Islamic home finance industry may be applicable by other Islamic financial product and service providers.

6. Doubt: Doubt is, by definition, insidious. In business, doubt can be fatal. There are many forms of doubt. Doubt can be related to the reputation of the industry itself. If Shari‘ah businesses have failed in the past or, even worse, if they have been involved in scandals or frauds, the doubts will be even more difficult to deal with. Particularly in the context of contemporary North American society, where revelations of financial scandal are becoming commonplace, this is an issue that must be addressed. Doubt may be aimed at the company and its reputation, or at members of its sales or management teams. Another form taken by doubt is doubt in the authenticity or Shari‘ah credentials of a Shari‘ah-compliant financial service or product. This form of doubt can have a devastating effect on a business. Whatever the form in which doubt appears, it must be dealt with. Clearly it is best to anticipate and dispel doubt before it occurs and actually becomes a factor.

7. Fear: Finally, there is the matter of consumer trepidation, from outright fear to simple timidity. Fears about new businesses and their sustainability are always a factor at the retail level. This is something that all start-ups have to deal with. The logic goes something like this: If the consumer cannot see that others have bought the product or service, the consumer will not feel comfortable being the first to do so. So, unless there is a track record, the business will not attract customers. But without customers there cannot be a track record. Islamic financial products and services face the same challenge. Moreover, what’s to say to the consumer that a business that was started six months or two years ago will be around for the term of the financing it offers... often ten, fifteen or even thirty years hence?

Obviously, there are a host of remedies for these challenges and many of them are more properly addressed in business schools. However, seminars such as this one may be the right sort of forum for identification and discussion. There may be much that Islamic home finance providers can learn from the conventional industry and its collective wisdom. In fact, of the challenges mentioned above, the last four can be countered to an extent by having Islamic financing windows in conventional banks. Such a market entry seems to have obvious advantages under the current circumstances. Given the specifics of the target market, it should be obvious that gatherings such as this one will prove of benefit to everyone involved. People in the industry might even want to begin thinking about a trade organization of their own.

From my own perspective, however, it seems that one obvious approach to the challenges listed above will be consumer education. Indeed, if the Shari‘ah-compliant home

finance industry can find a successful formula for educating potential consumers, the same may be adapted for use by other Islamic financial product and services providers. So here, too, is a way that this industry can contribute to the growth of other Islamic financial services. And again one thinks of a greater Islamic board of trade for North America. Whatever the solution, or solutions, it is clear that consumer education must become a priority for businesses in the Islamic financial products and services industry here.

In addition to the subjects already mentioned, the importance of Fanny Mae and Freddy Mac to the survival of the industry must also be considered. Obviously, these institutions play a key role in the supply of capital. And just as obviously, these institutions have been shaken to their very foundations in recent years, beginning with internal auditing irregularities and continuing through the global financial crisis and the erosion of political support. How dependent are our Islamic home finance businesses on these two? What sorts of relationships exist?

Finally, in the absence of such institutions, we must ask what options may become available for Islamic home finance? Indeed, what options are there for the so-called “non-conforming” market not covered by Fanny and Freddie? Indeed, many of our most lucrative markets, at least potentially, demand more than Freddy and Fanny can provide. What, then, about the Jumbo Islamic home finance product? Who are the investors, or potential investors?

A topic related to Fanny and Freddie is *Sukuk* and the possibility of securitizing Shari‘ah-compliant home finance contracts through their networks and under their labels. What obstacles stand in the way of a program to regularly issue a series of such investment instruments? Is volume an issue? Does politics play a role in this?

And how are all of these matters to be explained to the public? Muslim consumers in North America are often very particular about their associations, personal or professional. Some Islamic home finance providers have developed materials, however basic, to explain their relationships to Freddy and Fanny, particularly in terms of cash flow and the possibility of tainted funds entering into the transactions they conduct for their clients. Even so, this remains a little understood subject and one that needs clarification. In short, sales reps and their support teams need the tools to be able to explain these matters as succinctly as possible.

In addition to originating home finance contracts, and refinancing through replacing existing contracts (often in the form of conventional loans), Shari‘ah-compliant home finance businesses deal with consumers through servicing. In some instances, the servicing is outsourced to specialized servicers. Are there issues that need to be considered before handing this business over to others? Consumers in general are not clear on the role of servicers. Muslim consumers are no different. Again, special care will have to be taken to explain these things to consumers, many of whom will be first time home buyers or immigrants who are unfamiliar with such practices.

All of these are issues that can be discussed by representatives of the industry at seminars such as this.

For my own part, I am convinced that if Islamic finance is to be meaningful, and by that I mean if it is to become a true partner and contributor to the global financial system on the one hand, and if it is to become a real factor in the financial lives of Muslims in every walk of life, and in every part of the globe, then it will have to demonstrate its virtues, and it will have to be successful, in North America and Europe among the middle classes where the competition is

tough and where its survival will rely on its ability to adapt, innovate and be seen as an authentic and credible alternative to existing products.

Islamic finance has to be about more than millions of dollars swirling about in a sea of rolling *murabaha* transactions. Meaningful finance begins at the level of the retail consumer. This is where the real volumes are, at least potentially, and this is where finance has the greatest and most immediate impact on people and society. Sure, we need those swirling pools of liquidity to keep our treasuries healthy. But that is of no consequence to Mr and Mrs Abdullah, when they plan to live in the suburbs, raise a family, buy a car, start a business, insure their assets, and plan for their children's educations and marriages, and then their own retirement. That's meaningful. Likewise, what about the development of our Muslim communities here and abroad? How are they to be financed? A dam in Pakistan, an airport in the Sudan, seeds and equipment for small farms in a central Asian republic, cottage industry in Bangladesh, a mosque in Springfield... all of these may be financed in compliance with Shari'ah norms and many will be financed using the same basic contracts used in Islamic home finance.

The place to hone our skills, to develop our strategies, and to carry out our well-designed and cutting edge business plans for Islamic finance is the place where all of these will be tested to the extreme, going head to head against well-established mega businesses in North America.

I have often described the development of modern Islamic finance as a trickle down process. As a participant from the early stages, I have remained optimistic that one day, the contracts, instruments and processes that we developed for use by high end institutional investors would be of value at the retail level and at the levels of development and micro finance.

The industry has endured a great deal of criticism for its seeming preoccupation with investment banking, private equity, stock markets, and the like. In recent years, however, the picture that is beginning to emerge is that the same law firms and bankers who helped to develop the high end of the industry are more than willing to lend a hand to the retail sector. Moreover, without that body of work, that accumulated knowledge and experience, the tools that were developed (including the benchmarks), the relationships that were established, and the difficult ground that was broken with businesses and regulators, progress on the retail front would be limited, if not impossible.

Clearly, we have a long way to go. But that is what is called life's adventure. For many of us, the road ahead has become our life's mission. I hope and pray that this seminar can help us prepare together for the challenges ahead.

Questions to Guide the Panel Discussion

1. How can we dispel the confusions, misgivings and misunderstanding facing the Islamic finance industry generally and the Shari‘ah home finance option in North America?
2. What can Shari‘ah compliant home financing learn from the conventional framework and vice versa?
3. Is it possible to establish common ground between these two seemingly opposed sectors of the home financing industry?
4. Is Shari‘ah home finance disadvantaged in North America by regulators and the regulatory system? If there are problems, might these be dealt with through the application of basic regulatory principles?
5. How do we ensure or enhance consumer protection in the Shari‘ah home finance sector in North America?
6. Has the time for the establishment of a board of trade for the Shari‘ah-compliant financial products and services industry?
7. What sources of funding exist for Islamic home finance other than Freddy Mac and Fannie Mae?
8. Will the US market ever generate investment grade *Sukuk*? What is needed for this to happen?
9. Can Islamic home finance in North America lead to the development of a *takaful* industry here? While such development seems to be a natural by-product of Shari‘ah home finance, it has yet to establish itself. What are the issues?

Yusuf Talal DeLorenzo's Short Bio

Sheikh Yusuf Talal DeLorenzo is an independent Shari'ah Consultant. A scholar of Islamic Transactional Law, Sheikh Yusuf works with international financial entities, including institutional investors, home finance providers, international investment banks, asset managers and governments. He serves as Chairman of the Shari'ah Board for the Dow Jones Islamic Market Indexes, the Islamic Interbank Benchmark Rate (IIBR), and several others. Sheikh Yusuf helped design the first *Sukuk* using assets based in the United States, and was Chairman of the Shari'ah board that approved the first corporate Sukuk in Saudi Arabia. His career was noted in a front page story of the Wall Street Journal (Aug 9, 2007), and he has been featured in stories on Islamic Finance in The Financial Times, The New York Times, Fortune, Forbes, The US News and World Report, Newsweek, CNBC, Conde Nast Portfolio, and others including TV and radio media.

Sheikh Yusuf is the author of the three volumes *Compendium of Legal Opinions on the Operations of Islamic Banks*, the first English/Arabic reference on the *fatawa* issued by Shari'ah boards. In addition, Sheikh Yusuf wrote the introduction to Islamic Bonds, the 2003 book that introduced *Sukuk* and transformed the world's Islamic capital markets. His work has appeared in academic and industry journals and as chapters in books, including Euromoney's Islamic Asset Management (2004), Islamic Retail Finance (2005), and Islamic Finance: Innovation & Growth (2002). His entries on the terminology of Islamic finance appear in The Oxford Dictionary of Islam.