

ISLAMIC HOME PURCHASE FINANCING: A CONCEPTUAL INTRODUCTION

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INTRODUCTION

This paper has been prepared in response to requests from different law and business students in my Islamic Finance class at the Law School and the Wharton School of the University of Pennsylvania. They requested a simple, generic introduction to, and survey of, the transactional structures and rudimentary principles applicable to *Shariah*-compliant home purchase financing. That introduction took form as a serialized discussion, in client alerts and blog postings, for the Oman Law Blog of Curtis, Mallet-Prevost, Colt & Mosle LLP.¹ Those alerts and postings were presented in the context of (a) the 2012 introduction of an Islamic banking framework into the Sultanate of Oman and (b) the adoption, also in 2012, of a new mortgage law, aimed largely at home purchase financing, in the Kingdom of Saudi Arabia.² This paper retains the generic, summary blog format. The hope is that an overview of this type will find a broader audience that will delve further into a more rigorous study of these topics.

The paper summarizes six of the most frequently used home purchase financing structures provided by banks and financial institutions that provide *Shari`ah*-compliant alternatives. They are: (a) the lease (*ijara*); (b) the diminishing partnership or diminishing *musharaka* (*musharaka mutanaqisa*); (c) the cost-plus sale (*murabaha* and *tawarruq*); (d) the deferred payment sale (*bay' bithaman ajil*), which is used in Malaysia and Indonesia but only infrequently elsewhere; and (e) the two-tier construction contract financing (*istisna'a* – parallel *istisna'a*).

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¹ The Oman Law Blog and the four articles addressing home purchase financing can be located at <http://omanlawblog.curt.com>. Capitalized terms used in the text of this paper are defined by reference to the Figure associated with that text, unless otherwise indicated.

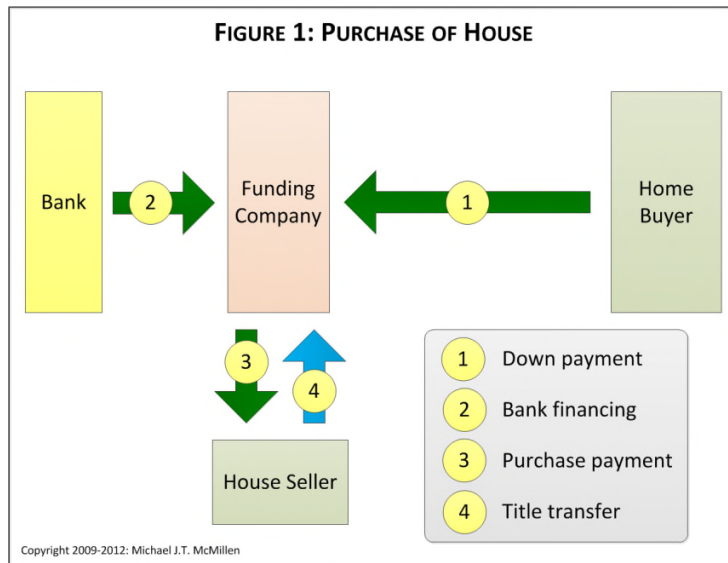
² The long-awaited Saudi mortgage law was approved by the Council of Ministers of the Kingdom of Saudi Arabia on July 2, 2012. The draft of that law that was approved by the Shura Council is considered in Michael J.T. McMillen, *Rahn Concepts in Saudi Arabia, Formalization and a Registration and Prioritization System*, available at <http://ssrn.com/abstract=1670104>. It is currently unknown if the final version varies from that draft. A structure used to obtain an obtain and enforce *rahn* (mortgage and pledge under the *Shari`ah*) in Saudi Arabia, without regard to the new law, is discussed in Michael J.T. McMillen, *Islamic Shari`ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INTERNATIONAL LAW JOURNAL 1184 (2001).

The Saudi Arabian mortgage law is anticipated to result in significant market growth, and even constitute an entirely new industry. That development is expected to enfranchise a significant portion of the Saudi population as home financing becomes available and the Saudi population moves to home ownership and enhanced participation in the Saudi economic system. That mortgage law implements *Shari`ah*-compliant *rahn* concepts and will stimulate the growth of *Shari`ah*-compliant home financing, and thus the growth of Islamic banking. Spill-over stimuli in surrounding countries is inevitable. It is also likely that the newly created Islamic banks and Islamic windows in the Oman will also offer home purchase financing.

LEASE FINANCING ALTERNATIVES

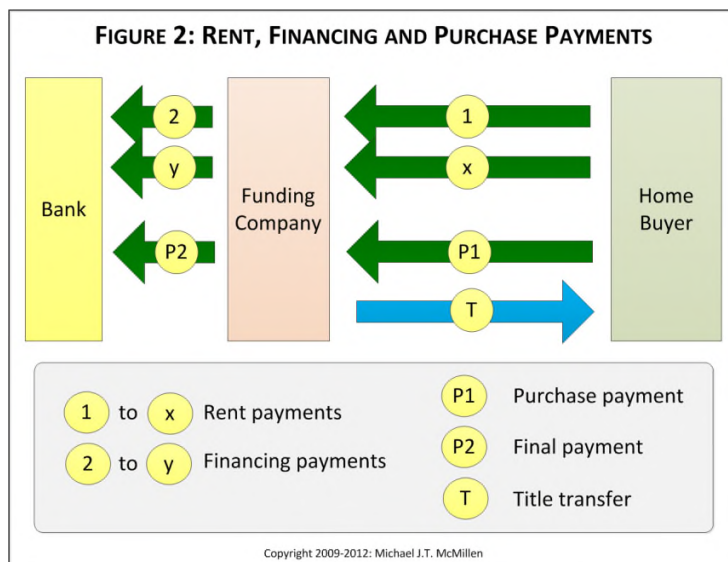
Lease Financing: In Principle

The lease (*ijara*) financing structure is the most widely used *Shari`ah*-compliant structure in the world for sophisticated financings (the *murabaha* being the most widely used as a more general matter). It is



simple in concept. An Islamic Bank (usually through a surrogate) purchases a house using the Bank's funds (in the leverage amount, say, 75% of the house purchase price) and funds from the Home Buyer (in the down payment amount of, say, 25% of the purchase price). The acquisition of the house is illustrated in FIGURE 1: PURCHASE OF HOUSE (a surrogate purchase, through a "Funding Company", is illustrated).

In the Figure 1 example, the house is owned by the Bank surrogate, the Funding Company. The house is then leased to the prospective Home Buyer for a period of time (say, 15, 20 or 30 years). The Bank's return is the profit on the lease. The lease rent schedule will be quite similar to the home purchase financing amortization schedule that would be used if a conventional interest-based loan had been made to finance the home purchase. If the Home Buyer makes all its rental payments over the term, the Home Buyer may purchase and take title to the home for a further final payment, which is usually nominal. The making of multiple rent payments, the use of those rent

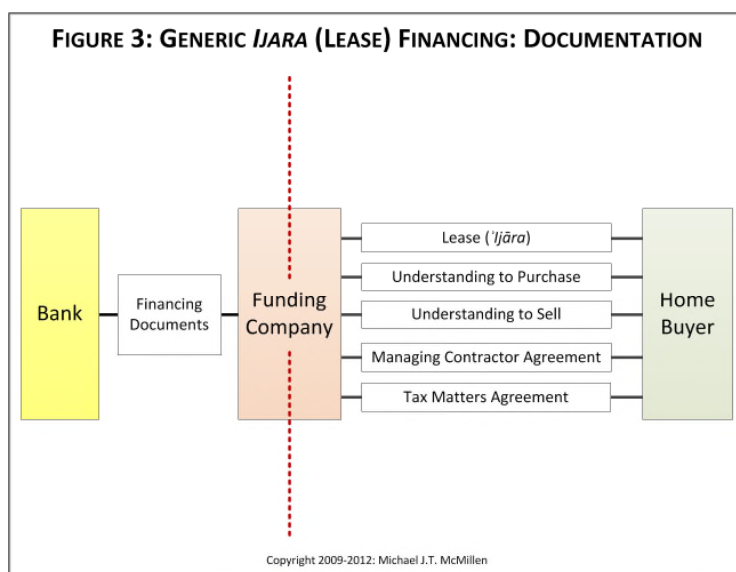


payments to make payments on the Bank financing, the making of the final purchase payment, and the transfer of title to the Home Buyer are illustrated in FIGURE 2: RENT, FINANCING AND PURCHASE PAYMENTS.³

An *ijara* is a lease of an object or services involving the transfer of the usufruct or *manfa'a* (the use of an object or the services of a person) for a rent consideration. The nature of the usufruct must be precisely defined, the rental consideration must be for a fixed value,⁴ whether payable in a lump sum or installments, and the term of the lease must be precisely determined. Both the rent and the term must be clearly ascertained and designated in the lease. The rent may escalate or diminish during the term so long as the amounts of such escalation and/or decrease are known to the parties and specified and contractually fixed.⁵ The lessor is responsible for structural maintenance of the assets and correlative obligations (*e.g.*, casualty insurance) and these obligations may not be passed to the lessee pursuant to the lease. The lessor is entitled to receive its rent as long as the lessee has the enjoyment of the leased assets as specified in the lease, but not after termination of the lease.

Lease Documentation

FIGURE 3: GENERIC IJARA (LEASE) FINANCING: DOCUMENTATION summarizes the documentary structure of a lease financing arrangement (without security documentation).



The financing structure depicted in Figure 3 is of a generic home purchase financing transaction. However, this structure (in various iterations) is used in a wide range of transactions, including financings of real estate, petrochemical, electricity, mining, industrial and infrastructure projects, among others. It is also the base structure for private equity transactions. It is used in Middle Eastern, North American, European and Asian jurisdictions.

³ This paper assumes that the Funding Company is a disregarded entity for income tax purposes. That is not the case in many jurisdictions, and in those jurisdictions additional expense items may be structured at the Funding Company level to offset the “rental income” of the Funding Company. The exact compensatory mechanism will depend upon the tax characteristics of the governing jurisdiction.

⁴ Variable rate leasing arrangements are widely used, and are expressly authorized in *Ijāra* Standard, § 5/2/3 (the “AAOIFI *Ijara* Standard”), *SHARI’A STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS* 1432 H - 2010, Accounting and Auditing Organization for Islamic Financial Institutions (1432 H – 2010) of the Accounting and Auditing Organization for Islamic Financial Institutions (the “AAOIFI Standards”).

⁵ The rent may not increase as a result of delays in payment of the rent (*see, e.g.*, AAOIFI *Ijāra* Standard, at § 6/3) although an “interest” or “late payment” charge may be imposed if it is donated to charity (*see, e.g.*, AAOIFI *Ijāra* Standard, *supra* note 4, at § 6/4).

The lease structure may be a “bifurcated structure”, involving a conventional loan arrangement for leverage (or gearing), or purely *Shari`ah* compliant. Referring to Figure 3, a bifurcated structure will entail a conventional interest-bearing loan from the Bank to the Funding Company pursuant to the Financing Documents (to the left of the dotted red line). All documents and transactions to the right of the dotted red line will then be compliant with the *Shari`ah*. Bifurcated structures are quite common as they allow conventional banks to participate in *Shari`ah* compliant transactions.⁶ The reasons for the widespread acceptance of this structure by interest-based financiers is apparent: those financiers make conventional loans, as they would in any financing; the relevant credit, underwriting and risk criteria are essentially the same as in any conventional financing, as is the analyses of those elements; there are no changes to financial reporting conventions; and there are no changes to the financier’s back office operations. The entirely compliant version is more frequently encountered in jurisdictions within the Organisation for Islamic Cooperation.

In most jurisdictions, banks are not permitted to own real property.⁷ In order to take control of a house (and related land) for the purpose of leasing it to a home purchaser, the Bank will arrange to have the property owned in a special purpose entity (a Funding Company) by a third party.⁸ While title to the house (and possibly the land) will be in the Funding Company, that entity will usually have no ability to make any decisions or determinations with respect to the property; all such decisions and determinations will be made by the Bank, a process that is established and controlled pursuant to the Financing Documents.

As noted above, and in Figure 1, the Home Buyer will inject a down payment and the Bank will provide the leverage financing. In a bifurcated structure, the leverage will be in the form of a conventional interest-bearing loan. If an Islamic Bank is providing the leverage financing, the structure for the contribution of funds by the Bank will vary from one jurisdiction to another, but it will not be a conventional interest-bearing loan. For example, the Bank may inject equity funds into the Funding Company. Or the Bank may purchase a *sukuk* issued by a Funding Company or another vehicle that effectively securitizes the rent flows from one or more Funding Companies. Alternatively, the Bank may take a participation interest in a Funding Company, with the profit being all of the rent flow on the Lease (*Ijara*) between that Funding Company and its related Home Buyer(s). Or, with greater complexity, the Bank may structure a *musharaka* or *mudaraba* arrangement that controls the Funding Company, with essentially all (but not all) of the profits (derived from rental income) of the *musharaka* or *mudaraba* going to the Bank.

⁶ Consider, for example, Western jurisdictions that have no Islamic banks.

⁷ Other than certain specific and limited categories of properties: for example, those necessary for the bank’s operations (*e.g.*, offices) and those held on a permissible temporary basis, such as those that have been foreclosed upon.

⁸ Often the Funding Company is owned by a corporate service company. Ideally, there will be one Funding Company for each property, which isolates liability, bankruptcy, tax and other exposures on a per-property basis. In many jurisdictions, it is difficult to establish corporate (or limited liability company) vehicles and one Funding Company may hold multiple properties, each leased to a different Home Buyer. Other important concerns relate to tax treatments in each specific jurisdiction. For example, will a Funding Company be a taxable entity or an entity that is disregarded for tax purposes? Will the Funding Company or the Home Buyer be the tax owner for local law purposes? These types of considerations, while critical, are not discussed in this introductory paper.

The Funding Company will lease the home to the Home Buyer pursuant to the Lease (*Ijara*). In a jurisdiction in which the Funding Company is a disregarded entity for tax purposes, the basic rent payable by the Home Buyer to the Funding Company under the Lease (*Ijara*) will be structured to be exactly equivalent to the debt service payable by the Funding Company to the Bank under the Financing Documents.

The transaction will be structured such that any default on the Lease (*Ijara*) (which will include defaults on other related documents) (a "*Lease Event of Default*") will constitute an event of default under the Financing Documents (a "*Loan Event of Default*"). That is relatively easy to achieve by inserting a cross default to the Lease (*Ijara*) as an event of default in the Financing Documents. The obverse is more difficult to achieve because applicable *Shari`ah* precepts preclude having a Loan Event of Default as a Lease Event of Default. The earliest structures achieved the desired result by mirroring, with precision, the representations, warranties, covenants and other provisions of the Financing Documents in the Lease (*Ijara*) and related documents. This was a tedious and costly process and more expeditious methods of achieving this result have since been developed.

The Understanding to Purchase is a *Shari`ah*-compliant sale and purchase agreement that allows the Funding Company, at the direction of the Bank, to cause the Home Buyer to purchase the house upon a Lease Event of Default (and upon the occurrence of any other mandatory prepayment provision). This is necessary because the *Shari`ah* prohibits acceleration of future rents, and future rents will include all the outstanding principal of the financing at any given time. The purchase price will be equal to the outstanding principal under the Financing Documents from time to time, and, particularly, at the time the purchase and sale occurs under the Understanding to Purchase. The Home Buyer may also desire to prepay the financing, in whole or in part. The Understanding to Sell is a purchase and sale agreement that allows this result. The purchase price will be equal to the amount of the financing prepayment at any given point in time and, in particular, at the time the purchase and sale occurs under the Understanding to Sell. In the case of each Understanding, the purchase price will be initially paid by the Home Buyer to the Funding Company; the Funding Company will then use those funds to make payment under the Financing Documents.

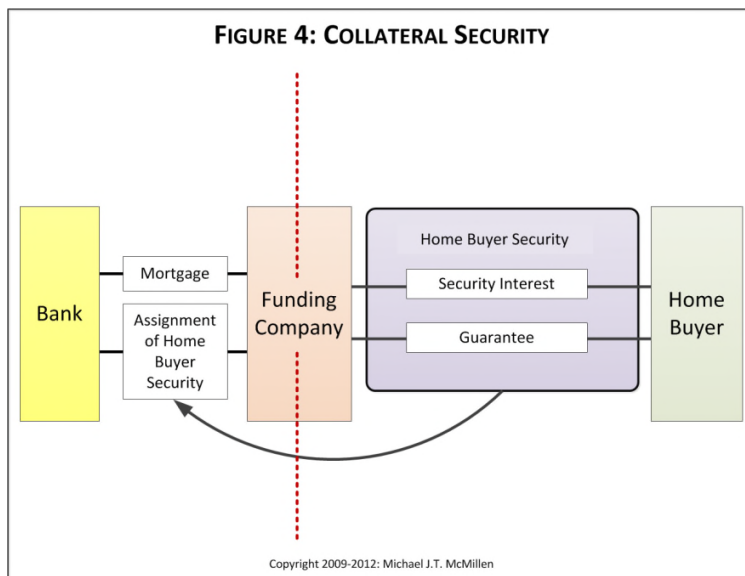
Shari`ah principles and precepts applicable to leasing preclude the lessor from passing structural maintenance obligations (and correlative obligations) to the lessee pursuant to the Lease (*Ijara*), thereby precluding "triple-net" leasing that is so common in Western financial arrangements. To bring the *Shari`ah*-compliant financing transaction into harmony with existing Western markets, a mechanism is invoked to shift the structural maintenance obligations (and correlative obligations) to the Home Buyer (lessee). This occurs in the Managing Contractor Agreement, a mechanism outside the Lease (*Ijara*), where the Funding Company (lessor) hires the Home Buyer to perform structural maintenance and to undertake defined correlative obligations.

The Managing Contractor Agreement contains a second set of provisions that address the making of decisions and determinations and the direction of actions of the Funding Company. Basically, these provisions provide that any decision or determination to be made by the Funding Company (a) with

respect to the Lease (*Ijara*) and the Understanding to Purchase will be made by the Bank,⁹ and (b) with respect to the Financing Documents will be made by the Home Buyer. The result is the removal of the Funding Company from decision-making. Of course, nothing is quite so simple as one would like. Frequently, the Bank is not willing to make these decisions and determinations on behalf of, or to direct actions by, the Funding Company. This reluctance may relate to lender liability or other liability concerns or internal institutional practices. Similarly, for *Shari`ah* reasons, the Home Buyer is unable to make decisions and determinations and have responsibilities in respect of the Financing Documents and related conventional interest-bearing arrangements. Harmonization of these positions with the principle stated in the first two sentences of this paragraph entails some careful structuring and drafting, but is achieved in the Managing Contractor Agreement.

Collateral Security

Collateral security structures for the lease transaction are quite similar to those in a conventional interest-based home financing, although the exact structures will vary from jurisdiction to jurisdiction. FIGURE 4: COLLATERAL SECURITY graphically depicts a generic collateral security structure for a lease-based financing.



There is a mortgage from the Funding Company to the Bank with respect to all right, title, interest and estate of the Funding Company in and to the house and the land. In addition, the Funding Company will collaterally assign to the Bank whatever collateral security the Funding Company received from the Home Buyer. This security package will secure the obligations of Funding Company to the Bank under the Financing Documents: *i.e.*, the repayment of the financing. It is exercisable by the Bank upon a Loan Event of Default.

The Home Buyer will provide to the Funding Company a security interest in and to all of the Home Buyer's right, title, interest and estate in and to the house and the land, whatever that may be (given

⁹ The Bank should not and will not make decisions or determinations with respect to (a) the Understanding to Sell or (b) the Managing Contractor Agreement itself. The former allows the Home Buyer to prepay the financing by way of voluntary prepayment. These rights are unrestricted in conventional financings and the *Shari`ah*-compliant should be in no more disadvantageous situation. The decision making provisions of the Managing Contractor Agreement are self-effecting in all situations, including non-default and default scenarios, and those arrangements should not be modified by security documents that shift decision making to the Bank in all default circumstances.

that title is held by the Funding Company). That security interest may also include other assets of the Home Buyer, possibly including monies in the Home Buyer's bank accounts. It may also include a personal guarantee of the Home Buyer in respect of the rent and purchase payments under the Lease (*Ijara*), the Understanding to Purchase and the Understanding to Sell. These security interests are exercisable by the Funding Company (at the direction of the Bank, directly or indirectly) upon a Lease Event of Default, but not a Loan Event of Default that is not a Lease Event of Default. This collateral may not secure the Financing Document obligations: only certain obligations under the Lease (*Ijara*), the Understanding to Purchase and, if it shall have been irrevocably exercised, the Understanding to Sell.

MUSHARAKA ALTERNATIVES

The diminishing *musharaka* (*musharaka mutanaqisa*) or diminishing partnership is one of the two most common home purchase financing structures. In summary, a diminishing *musharaka* home purchase financing makes use of a modern hybrid contract (the *musharaka*). It takes the form of a partnership in which one of the partners (the home buyer) promises to buy the equity interests of the other partner (the bank providing the financing) on a periodic basis until such time as the equity is completely transferred to the purchasing partner (home buyer). During the course of the purchase transaction, the bank partner leases its undivided interest in the property (the home and related land interests) to the home buyer partner.

Before discussing the transaction in greater detail, it is prudent to consider a few of the relevant *musharaka* principles.

Musharaka Principles

Al-sharika is a broad term based on its meaning of "sharing". In the commercial and financial realm, the term encompasses various joint ownership arrangements and partnerships for profit effected by mutual contract. *Sharikat al-'aqd* is a partnership effected by mutual contract (a 'joint commercial enterprise'), and there are various subdivisions of this type of partnership arrangement.¹⁰ One such primary subdivision is comprised of partnerships in which all partners invest capital in a commercial enterprise (*sharikat al-amwaal*), and it is a secondary subdivision of this primary subdivision (*sharikat al'inan*) that is most frequently referred to when the term "*musharaka*" is used.¹¹

In summary, and as a broad definitional statement, a *musharaka* is a type of *fiqh*-nominate partnership in which each of the partners may contribute capital and in which, subject to the terms of the partnership (*musharaka*) agreement, each of the partners may participate in management. If all partners participate in the management of the *musharaka*, each partner is treated as the agent of all

¹⁰ See, for example, *Shari'a Standard No. (12), (Sharika (Musharaka) and Modern Corporations)* (the "AAOIFI Partnership Standard") in the AAOIFI Standards, *supra* note 4. The AAOIFI Partnership Standard applies to all forms of traditional *fiqh*-nominate partnerships that operate on the basis of the contractual partnership (*sharikat al-'aqd*), except as expressly set forth in the AAOIFI Partnership Standard), and to *musharaka mutanaqisa* structures.

¹¹ Occasionally, the term *musharaka* is used to refer to *sharikat ul-a'mal*, a type of partnership in which the partners contribute services.

other partners. As a general statement, and subject to relevant *Shari`ah* principles, profits are allocated in accordance with the *musharaka* agreement and losses are allocated in accordance with the ratios of capital contributions.¹²

Musharaka agreements are quite similar to Western partnership agreements in scope and coverage. In the context of a home purchase financing, the *musharaka* agreement may be expanded to include the full range of provisions that are found in documents governing conventional home purchase financings. Thus, for example, *musharaka* agreements may specify the term of the partnership, the purpose of the *musharaka*, limitations on the powers, rights, authorities and practices of each of the partners, the terms of dealing that are required and those that are permitted, circumstances in which the various partners will have consent rights, and the full panoply of representations, warranties, covenants, insurance requirements, events of default, remedies and termination rights. In some structures, a portion of the foregoing (such as covenants, events of default and remedies) are included in the lease (*ijara*) of the bank partner's undivided interest in the property to the home buyer partner.

There are significant differences between the *madhahib* regarding the rules applicable to capital contributions, especially as to the permissibility and effect of in-kind contributions.¹³ However, the schools all seem to agree that capital, once contributed, is the property of the *musharaka* (rather than any individual partner) and inures to the benefit of all partners. Capital must be specified at the inception of the *musharaka*, including as to the total amount and the share of each partner. The capital contributions of the different partners need not be equal. In accordance with historical requirements, there is a pronounced preference for cash capital contributions. Absent agreement to the contrary in the *musharaka* agreement, the liability of each partner is unlimited. It is not permissible for one partner to assume liability for the capital of another partner, whether by way of guarantee or otherwise. There is an exception to this last rule in limited circumstances of misconduct, default, breach of contract, and negligence.¹⁴

A partner in a *musharaka* may purchase the shares or interests (*hissas*) of the other partner(s). Any such purchase may be of the whole or it may be partial and incremental. The AAOIFI Partnership Standard allows any partner to purchase the assets of the *musharaka* at their market value or at a price agreed at the date of the purchase of the assets.¹⁵ This has obvious implications for *hissa* purchases as well. However, it is not permissible to agree to buy the assets on the basis of face value. Some scholars are of the opinion that the provisions relating to the purchase of *hissas* should be in a document separate and apart from the *musharaka* agreement. Others allow the provision to be in the *musharaka* agreement. Usually, these provisions allow a partner to buy another partner's *hissas* within an agreed period for a fixed price.

¹² This Client Alert addresses personal home financings, and not commercial ventures involving subletting or the generation of profits from the operation of the acquired asset(s). Thus, profit and loss principles are not discussed.

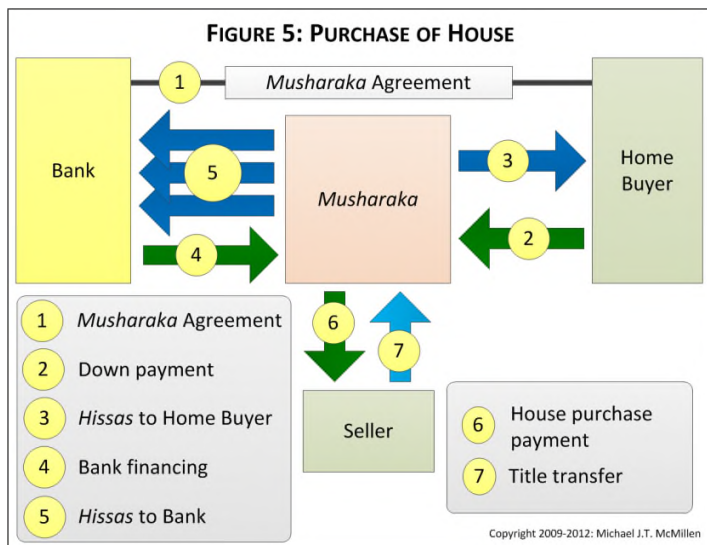
¹³ This Client Alert does not address complexities of in-kind contributions because the current scope is limited to personal home financings.

¹⁴ See, e.g., the AAOIFI Partnership Standard, *supra* note 1, at § 3/1/4/1.

¹⁵ See, e.g., the AAOIFI Partnership Standard, *supra* note 1, at § 3/1/6/2.

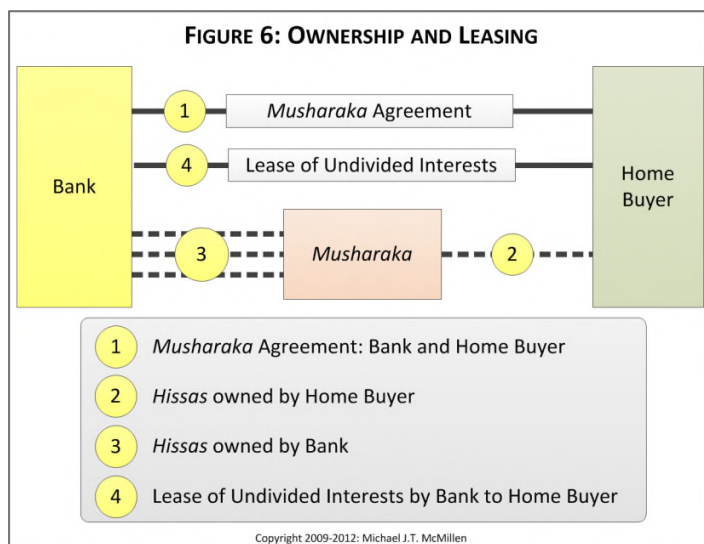
Diminishing Musharaka Home Financings

The funding, financing and purchase of a home (including land or interests in land) is illustrated in FIGURE 5: PURCHASE OF HOUSE. FIGURE 6: OWNERSHIP AND LEASING illustrates the status of ownership and leasing prior to and during the course of the *Hissa* purchase transactions that are used to effect repayment of the Bank financing.



In the diminishing *musharaka* structure, the Home Buyer identifies a property to be purchased and negotiates a home purchase agreement with the third party Seller. That home purchase agreement (not illustrated in Figure 5) must be acceptable to the Bank that will provide the home purchase financing.

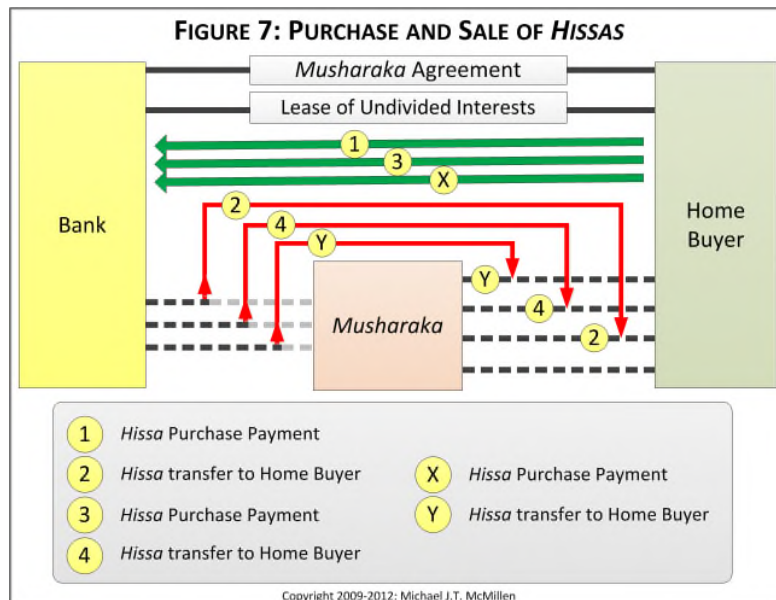
The Bank and the Home Buyer then enter into a *musharaka* agreement (step ① in each of Figure 5 and Figure 6) and form a partnership (the *Musharaka*) that will acquire the property. The *Musharaka* Agreement governs the acquisition, financing and use of the property and provides for the purchase of the Bank's interests in the *Musharaka* by the Home Buyer over time. The Home Buyer contributes the down payment for the home as a capital contribution into the *Musharaka* (step ② in Figure 5) and receives *Hissas*, or equity interests, in the *Musharaka* (step ③ in Figure 5 and step ② in Figure 6). The Bank providing the financing contributes the remainder of the purchase price of the property as its capital contribution into the *Musharaka* (step ④ in Figure 5) and it also receives



Hissas (step ⑤ in Figure 5 and step ③ in Figure 6). The *Musharaka* then purchases the property from the Seller (step ⑥ in Figure 5) and takes title to the property (step ⑦ in Figure 5).¹⁶

Thereafter, the Bank leases its undivided right, title and interest in, to and under the property to the Home Buyer. This is illustrated as step ④ in Figure 6. The leasing arrangements allow the Home Buyer to occupy and use the property. The leasing arrangements may also include a managing contractor arrangement (as a separate document) pursuant to which the Home Buyer agrees to maintain the property and maintain casualty insurance on the property. This is necessary because these are obligations that may not be passed to the tenant in a *Shari`ah*-compliant lease.¹⁷ The leasing arrangements may also provide for rents that, combined with the *hissa* purchase payments, ensure the adequacy of the amortization schedules desired by the Bank, rendering considerable financial flexibility to the structure.

The financing provided by the Bank is paid and retired through the purchase and sale of the Bank's *Hissas*, which are incrementally and periodically acquired by the Home Buyer from the Bank. This



sequence of transactions is illustrated in FIGURE 7: PURCHASE AND SALE OF *HISSAS*. In Figure 7 (and the other Figures in this section), the undertaking of the Home Buyer to purchase the *Hissas* of the Bank is not separately shown; it is assumed to be included in the *Musharaka* Agreement.

The Home Buyer makes periodic *Hissa* purchase payments to the Bank. These payments are illustrated as steps ①, ③ and ⑩ in Figure 7. Corresponding to each such payment, the Bank

transfers *Hissas* to the Home Buyer. These transfers are illustrated as steps ②, ④ and ⑪, respectively, in Figure 7. At such time as all of the *Hissas* are owned by the Home Buyer, the *Musharaka* is terminated and the property is owned solely by the Home Buyer.¹⁸

¹⁶ In some jurisdictions, the Home Buyer takes title to the property, acting as an agent for and on behalf of the *Musharaka*. This variation may be used in jurisdictions that impose a transfer or similar tax on the movement, to the Home Buyer, of title to the property upon dissolution of the *Musharaka* (as discussed below).

¹⁷ In some transactions, these obligations are addressed in the *musharaka* agreement.

¹⁸ Under the laws of most jurisdictions, a partnership must have greater than one partner (and cannot exist if there is only one partner). In those jurisdictions, the partnership is automatically dissolved upon the sale of the last of the Bank's *Hissas* to the Home Buyer, whereupon the Home Buyer becomes the sole and direct owner of the property.

The amounts of the *Hissa* purchase payments are determined in accordance with the amortization schedule used by the specific Bank providing the financing. Each payment includes both a profit component and a principal component, with the relative amount of each component varying over time in much the same manner as the relative amounts of interest and principal on a conventional interest-bearing mortgage loan vary over time. Frequently, the amortization schedule is essentially identical to that on a conventional 30-year or 15-year mortgage financing. However, the structure of the amortization schedule will be determined in discussions with the *Shari`ah* scholars that supervise the home purchase finance program for the Bank. Different scholars have different views of the permissible pricing for purchases of the *Hissas* and these pricing considerations will influence the exact amortization schedules (and the allocations of amounts as between the purchase price and rent). The lease payments provide additional flexibility with respect to overall pricing of the transaction and the sum of the lease payments and the *Hissa* purchase payments, taken together, will often equal the combined profit and principal amortization that is desired by the Bank.

There are two variations in the termination provisions of the diminishing *musharaka* structure. One variation, and the less common variation, involves termination without an undertaking to purchase (*wa`d*). In this variation, the exercise of remedies in connection with an event of default entails selling the property in the market and sharing the proceeds between the Bank and the Home Buyer in accordance with their respective capital contributions at the time of the sale.

The more common structural variation involves the use of an undertaking to purchase (a *wa`d*) pursuant to which the Home Buyer agrees to purchase all of the *Hissas* of the Bank at the time of the event of default and demand by the Bank. It is the mechanism by which the Bank accelerates and unwinds the structure prior to the scheduled final maturity. The Home Buyer is obligated to purchase all Bank *Hissas* immediately at a fixed price (equal to the outstanding principal plus accrued profit plus fees, costs and expenses). Typically, there is full recourse to the Home Buyer in respect of the payment of these amounts. If the Home Buyer is not able to make payment in full for all of the Bank's *Hissas*, the property will be sold at an auction and the proceeds are applied to make payment in full to the Bank, including in respect of its fees, costs and expenses in exercising remedies, and the excess, if any, is distributed to the Home Buyer.

MURABAHA AND TAWARRUQ ALTERNATIVES

Murabaha and *tawarruq* structures, in different forms, are especially prevalent and their use has been increasing in recent years, particularly since the onset of the global financial crisis in 2007-2008.¹⁹ For example, forms of these structures are used to implement home purchase financings in Malaysia and Brunei. In some forms, they are not permissible in other parts of the world.

¹⁹ See Michael J.T. McMillen, *Trends in Islamic Project and Infrastructure Finance in the Middle East: Re-Emergence of the Murābaha*, available at <http://ssrn.com/abstract=1753252>.

Murabaha Definition and Principles

Bay'u al-murabaha is a sale of venerable lineage under the *Shari'ah*; it is acceptable to all four of the main orthodox Sunni *madhhahib*. As originally conceived, it was a trade-based, “cost-plus” sale contract in which the cost is ascertained and expressly disclosed and had nothing to do with financing.²⁰ Current conceptions are focused on financing transactions.

The *murabaha*, in any context, is a sale, and must conform to *Sharī'ah* requirements applicable to sales. It is essential to begin with some fundamental sales principles, including some specific to the *murabaha*.²¹ The following are general principles and may be subject to limited exceptions in different contexts.

Each of the object of the sale (*mabi'*) and the price must be in existence, with certainty, have a determinable value, and be deliverable at the time of the contract and, absent certain destruction scenarios, at the time of the sale. The *mabi'* must be precisely identified and not a *haram* object. A condition for conclusion of a sale is that the sale object be a valued good with legitimate uses. A sale contract that does not name the price is defective and invalid (*fasid*); not naming the object of sale voids the contract. If the *mabi'* perishes prior to delivery, the sale is void, which is not true of perishing of the price prior to delivery. The buyer must deliver the price before he, she or it has a right to receive the object of sale, unless the seller otherwise agrees.

The object must be in the actual or constructive possession of the seller (the initial buyer) at the time of the sale. Constructive possession here means that the seller has assumed all liabilities and obligations of ownership and possession, including in respect of destruction or “perishing”, even though the seller has not taken physical delivery of the object. The *mabi'* must be deliverable at the conclusion of the sale. Delivery of the object must be certain and not contingent or dependent upon conditions, events or circumstances.

The sale must be immediate and not contingent on future conditions, events or circumstances. If not immediate, or if contingent, it is void as a present sale and will have to be renewed and reaffirmed at the specified future date or upon the occurrence of the contingency. Certain “customary trade usage” conditions are permissible (e.g., the validity of a warranty), and these should be determined with the advising *Sharī'ah* scholar.

The *murabaha* is a trust or fiduciary sale (*bay' al-amanah*) requiring disclosure. Disclosure begins with the initial costs, but extends to all essential transactional elements. Disclosure to the second buyer of the cost to the first buyer/seller entails consideration of what constitutes the “cost” to the first buyer

²⁰ Compare the *musawamma*, which is essentially identical to the *murabaha* except that cost and profit are not disclosed to the purchaser.

²¹ This paper does not address cornerstones (*'arkan*) of a sale transaction, such as offer and acceptance, conditions of conclusion, conditions of validity, conditions of execution and bindingness conditions. Those are all assumed to be satisfied. Nor does this paper address the six categories of conditions of validity relating to sales contracts generally: (i) ignorance or uncertainty (*al-jahala*); (ii) coercion; (iii) timing; (iv) deception and *gharar* (*gharar al-wasf*); (v) harmful sales (*al-darar*); and (vi) corruption (*al-shurut al-mufsida*).

(i.e., initial cost), and thus what must be disclosed. This determination is important in ascertaining what is entitled to earn a profit.²² Certain normal costs and expenses associated with the object of sale which result in an increase in the value of the object or are “effective in the essence” of the object (such as tailoring or dyeing), may be included as part of the “cost”, even if not determinable at inception. Other expenses that may constitute a portion of the “cost” include non-recurring expenses incurred by the first buyer in effecting the transaction (e.g, freight and transportation charges, customs duties, sales intermediation fees and costs, feeding costs, and other normal and customary transactional costs). Recurring business costs and expenses of the seller are not permissible additions to the sale price: e.g., employee salaries, premises rent, normal storage and warehousing, veterinarian's costs, and the fees of herdsmen. Disclosure of the initial cost must include disclosure of any financing and deferred payment arrangements pertaining to the object or its initial purchase. Consultation with the advising *Shari'ah* scholar is advisable in connection with determinations as to expenses which may be included.

If the object of the sale suffers damage or defect while in the possession or under the control of the first buyer (seller) or a third party, the damage or defect must be disclosed to the second buyer.²³ If the *mabi'* is increased whilst in the possession or control of the first buyer (seller) (such as by giving birth, creating milk, bearing fruit or growing wool), the sale may proceed, but only after disclosure of the increase. If the *mabi'* was purchased by the first buyer (seller) in exchange for a debt owed by the initial third party seller to the first buyer, that information need not be disclosed to the second buyer. However, if the *mabi'* was accepted as compensation for an unpaid loan, then it may not be sold in a *murabaha* to the second buyer at a cost equal to the amount of the unpaid loan (this is a debt forgiveness arrangement rather than a negotiated sale).

Inability to determine the initial price, or unwillingness to fully disclose that price, voids the sale as a *murabaha*.²⁴

The profit may be a lump sum or a percentage. It may be higher if the date of payment is more distant: consideration of time in establishing price is permissible. The price need not reflect the current, or any future, market price. It may be different for cash and credit transactions, reflecting different risk assessments relating to each. One of the options must be chosen at inception, and the price then fixed.

Different prices for different maturities or payment dates, leaving an option to the second purchaser as to election, are impermissible. The due date for payment must also be unambiguously fixed and determinable at inception. It is acceptable to make reference to a specific date or a specific period. But the date may not be fixed by reference to an unknown or uncertain event. In deferred payment transactions (*bay' muj'ajjal*), including most *murabaha* financing transactions, additional rules apply.

²² Particularly to the Mālikīs, who discern three categories: (i) that which is permissibly appended to the cost and has a right to earn a profit; (ii) that which is appended to the cost but may not earn a profit; and (iii) that which may not be appended to the cost and may not earn a profit. The Ḥanafīs tend to include in the capital or principal a broader range of costs associated with the purchase and sale of the *mabi'* (essentially all such costs).

²³ There are differences of opinion where the *mabi'* is damaged as a result of ‘natural causes’.

²⁴ There are various options available to the second buyer in cases of betrayal of trust, including non-disclosure or inaccurate disclosure of price and quality characteristics.

Many *Shari'ah* scholars allow for late payment and default payment charges of some type. These are of two types: actual fees, costs and expenses (actual damages) of the seller resulting from late payment or default, which may be retained by the seller; and penalty charges, which may not be retained by the seller, but must be donated to charity. The latter, where permitted, are allowed as incentives for timely payment by the second buyer.

Acceleration of the entire purchase price upon a default is generally permissible. Collateral security for the payment and performance obligations is acceptable.

For a sale to be binding on both parties, there must not exist any options that allow one of the parties to void the contract. Examples of such options include options by condition (*khiyār al-shart*), description (*wasf*), price payment (*naqd*), identification (*ta'yīn*), inspection (*ru'ya*), defect (*'ayb*), and deception (*ghubn ma'a al-taghrīr*).

Delivery and receipt of each of the *mabi'* and the price are critical elements of a valid sale.²⁵ Receipt, and thus possession, by the purchaser may be established in various different ways. If the purchaser is provided full access and permission (*pal-takhliya*) to the *mabi'*, delivery and receipt will have occurred. Delivery and receipt will also have occurred if the purchaser shall have damaged the *mabi'* while it is in the seller's possession, as the precondition to such infliction of damage is the ability to affect the *mabi'* and the related implication of access and permission. Similarly, delivery and receipt are concluded if the *mabi'* suffers spoilage or a defect caused by the purchaser while the *mabi'* is in the possession of the seller. Should the purchaser, or a third party at the suggestion or direction of a purchaser, take possession of the *mabi'* for safekeeping or as a loan during the pendency of the sale contract, delivery and receipt will be presumed.²⁶ There are differences of opinion among *Shari'ah* scholars as to whether delivery and receipt have been concluded in circumstances where the purchaser prosecutes a third party for damages or compensation caused by transgressions or acts or omissions of that third party.

Murabaha Home Financings

The financing of the purchase of a Property (a house and related land interests) is illustrated in FIGURE 8: *MURABAHA PURCHASE OF A HOUSE*. This discussion of a pure *murabaha* transaction is illustrative only; it is never used in practice as a result of a wide range of bank regulatory, tax, real estate and other reasons.²⁷

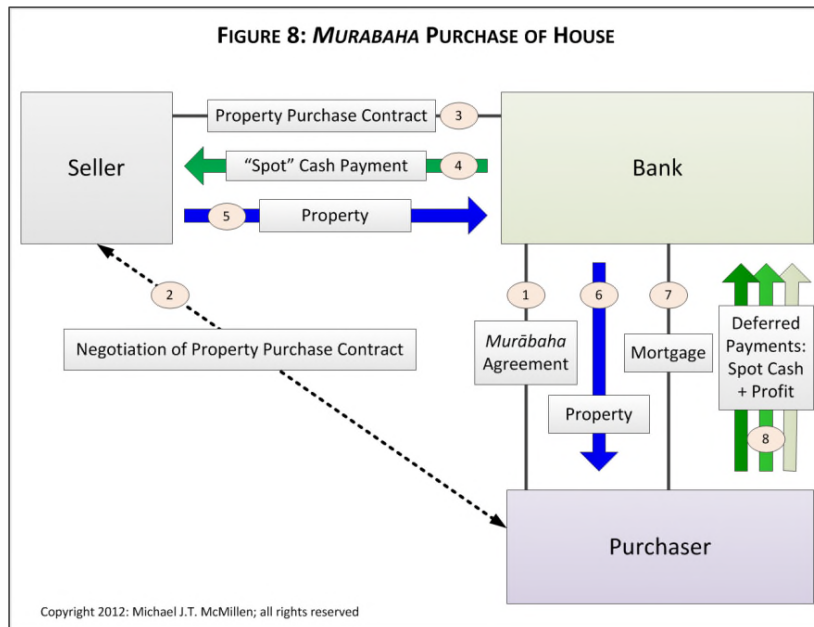
The Purchaser desires to purchase a Property. The Purchaser requests the Bank to engage in a *murabaha* transaction pursuant to which the Bank purchases the Property from the Seller on a cash, spot-payment basis at an amount equal to the "Spot Cash Amount" (which is the financing amount) and then immediately sells that Property to the Purchaser, on a deferred payment basis, at an amount equal to the sum of the Spot Cash Amount *plus* a Profit Amount. The Profit Amount may be determined based

²⁵ In most cases, absent deferral or other consensual arrangements, delivery of the *mabi'* and the price must be concurrent, except in the case of an exchange of non-fungibles for fungibles. However, there are variations among the *madhāhib*, and variations in respect of specific exchanges.

²⁶ It is necessary to carefully distinguish agreed "trustee" and *rahn* arrangements in transactions where those elements are present.

²⁷ The discussion is a prelude to the *tawarruq* discussion.

upon a variable or fixed rate. It is approximately equal to the interest rate used for conventional interest-based home loan mortgage financings on equivalent properties. Similarly, the payment structure often mimics that of a conventional interest-based home loan mortgage financing.



The Bank and the Purchaser execute the *Murabaha* Agreement (step ①) that governs the group of transactions, including the Property purchase by the Bank and the Property sale by the Bank to the Purchaser. The *Murabaha* Agreement contains customary financing provisions, such as conditions precedent to the Property purchase by the Bank, the Purchaser's promise to purchase the Property from the Bank if the Bank purchases the Property, the Purchaser's representations,

warranties and covenants, the deferred payment terms pursuant to which the Purchaser will pay the Bank, events of default, remedies, and other provisions. The Purchaser's obligations pursuant to the *Murabaha* Agreement, including payment obligations, are secured by a first mortgage in favor of the Bank (and possibly other pledges, security interests and guarantees) (step ⑦ in Figure 8). Title to, and ownership of, the Property is in the Purchaser from the time of the initial transfer of possession pursuant to the *Murabaha* Agreement.

The Purchaser negotiates the Property Purchase Contract with the Seller (step ② in Figure 8), but does not execute that contract. Instead, upon Bank approval of the Property Purchase Contract, the Bank executes the Property Purchase Contract (step ③ in Figure 8) and purchases the Property pursuant to that Contract (steps ④ and ⑤ in Figure 8) for a purchase price equal to the financed amount (the Spot Cash Amount) plus an equity contribution from the Purchaser. Thereafter, the Bank sells the Property to the Purchaser pursuant to the *Murabaha* Agreement (step ⑥ in Figure 8). The Purchaser makes periodic deferred payments (step ⑧ in Figure 8) of the financed amount, as set forth in the *Murabaha* Agreement.

Tawarruq Home Financings

The term "*tawarruq*" derives from *tawarraqa*, meaning "to eat leaves". The term "*wariq*" refers to dirhams of silver (minted and unminted). The term *tawarruq* therefor referred, historically, to the seeking of silver money; it now refers to the seeking of paper money or money generally – to

monetization. In the Islamic finance and investment realm, the term generally includes the concept of a person buying a commodity (other than gold, silver and other prohibited commodities) on a deferred payment basis and thereafter selling it to a third person for immediate cash. The purpose of the transactions is monetization of the commodity and acquisition of the cash.

There is a distinction between “organized” *tawarruq* (*al-tawarruq al-munazzam*) and unorganized or individual *tawarruq* (*al-tawarruq al-farid*). In organized *tawarruq*, the seller manages the process by which cash is acquired for the monetization beneficiary or *mutawariq*. The seller (a bank in a banking *tawarruq*), acting as an intermediary or agent, sells a commodity to the *mutawariq* on a delayed payment basis and then sells or arranges for the sale of the commodity on behalf of the *mutawariq* for an immediate cash payment. In an unorganized *tawarruq* that seller has no role in assisting the *mutawariq* in selling the commodity.

The permissibility of organized *tawarruq* is strenuously debated. Various *tawarruq* structures, including organized *tawarruq* structures, are widely used in the Islamic finance and investment industry, including in connection with home purchase financings transactions. The Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”), in the AAOIFI Monetization Standard, has provided parameters to ensure the appropriate implementation of organized *tawarruq* transactions.²⁸ In addition to requirements pertaining to the nature of the commodity, its receipt by the *mutawariq*, and its sale by the *mutawariq* to a third party, the AAOIFI Monetization Standard:

- (a) prohibits a linkage between the contract for the *mutawariq*’s purchase of the commodity on a deferred basis and the contract for the sale of the commodity by the *mutawariq* to a third party;
- (b) prohibits the entity that sells the commodity to the *mutawariq* on a deferred payment basis from acting as, or arranging for, the sales agent for the *mutawariq* in its cash sale to a third party, unless required by law; and
- (c) requires the *mutawariq* to itself sell the commodity it acquired on a deferred payment basis or to sell that commodity through an agent other than the entity that sold the commodity to the *mutawariq* on a deferred payment basis.

FIGURE 9: *TAWARRUQ* HOME PURCHASE FINANCING illustrates the use of a *tawarruq* structure to provide funds to the Purchaser to enable the Purchaser to purchase the Property.

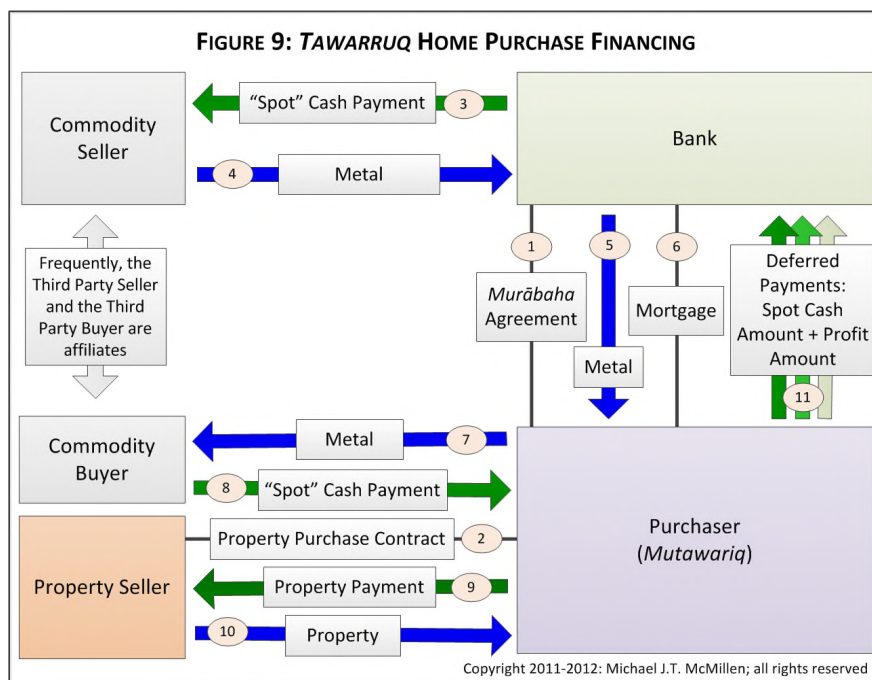
The Purchaser (*Mutawariq*) requests the Bank to engage in a *murabaha* transaction to provide the Purchaser (*Mutawariq*) with cash to enable the Purchaser (*Mutawariq*) to purchase the Property. The Bank does not itself purchase the Property and sell it to the Purchaser. Instead, the Bank purchases a commodity – usually a permissible metal or palm oil – at the Spot Cash Amount (which is equal to the amount of the desired financing) and sells that commodity to the Purchaser on a deferred basis at an

²⁸ *Shari`a Standard No. (30), Monetization (Tawarruq), AAOIFI Standards, supra note 4 (the “AAOIFI Monetization Standard”). This standard applies to both deferred payment murabaha and deferred payment musawamma transactions.*

amount equal to the sum of the Spot Cash Amount plus the Profit Amount. Arrangements are made to enable the Purchaser to immediately sell that commodity, for cash on the spot market at the Spot Cash Amount, in order to obtain the cash to be used to purchase the Property. Frequently, this is structured as an organized *tawarruq*. The Profit Amount is a variable or fixed rate that is approximately equal to the interest rate used for conventional interest-based home loan mortgage financings on equivalent properties. Similarly, the amortization structure often mimics that of a conventional interest-based home loan mortgage financing. In any event, it is clear that the commodity is a vector to arrange for the Purchaser (*Mutawariq*) to obtain cash; obtaining the commodity is not the substantive object of the transaction.

The Bank and the Purchaser (*Mutawariq*) execute the *Murabaha* Agreement (step ①) that governs the series of transactions, including the purchase of the commodity by the Bank and the sale of that commodity by the Bank to the Purchaser (*Mutawariq*). The *Murabaha* Agreement contains customary financing provisions, such as conditions precedent to the purchase of the commodity by the Bank, the promise of the Purchaser (*Mutawariq*) to purchase the commodity from the Bank if the Bank purchases the commodity from the Seller, the representations, warranties and covenants of the Purchaser (*Mutawariq*), the deferred payment terms pursuant to which the Purchaser (*Mutawariq*) will pay the

Bank, events of default, remedies, and other provisions. It also contains covenants and conditions precedent to ensure that the proceeds of the *tawarruq* transaction are used to purchase the Property and mortgage that property to the Bank to secure the deferred payment obligation under the *Murabaha* Agreement. The obligations of the Purchaser (*Mutawariq*) pursuant to the



Murabaha Agreement, including payment obligations, are secured by a first mortgage on the Property in favor of the Bank (and may be secured by other pledges, security interests and guarantees) (step ⑥ in Figure 9). Title to, and ownership of, the Property will be in the Purchaser (*Mutawariq*) pursuant to a direct sale from the Property Seller (rather than pursuant to a transfer of possession pursuant to the *Murabaha* Agreement).

The contracts for the purchase of the Metal by the Bank from the Commodity Seller and the sale of the Metal by the Purchaser (*Mutawariq*) to the Commodity Purchaser are standardized commodity purchase and sale contracts, rather than individually negotiated contracts. This emphasizes the fact that the commodity is a vector in this series of transactions, rather than the substantive object of the transactions. These contracts are not shown in Figure 9.

The Purchaser (*Mutawariq*) negotiates and executes a Property Purchase Contract with the Property Seller (step ② in Figure 9). The Bank approves, but does not execute, the Property Purchase Contract the Property Purchase Contract.

The Bank purchases the commodity (*i.e.*, the Metal) from the Commodity Seller (steps ③ and ④ in Figure 9) on a cash spot purchase basis. The amount of Metal purchased equals the amount of financing desired by the Purchaser (*Mutawariq*) in respect of the Property purchase. The Bank then immediately sells the Metal to the Purchaser (*Mutawariq*) on a deferred payment basis (step ⑪ in Figure 9). The deferred payment terms are set forth in the *Murabaha* Agreement and are comparable to the terms of a conventional interest-based home purchase financing. The deferred payment obligation of the Purchaser (*Mutawariq*) is secured by a mortgage on the Property (step ⑥ in Figure 9). Immediately after purchasing the Metal, the Purchaser (*Mutawariq*), or an agent on its behalf, sells the Metal to the Commodity Buyer on a cash spot market basis (steps ⑦ and ⑧ in Figure 9). The amount of this spot market sale is equal in amount to the amount of the spot market purchase of the Metal by the Bank that is referred to in steps ③ and ④ of Figure 9.

The Purchaser (*Mutawariq*) now has sufficient cash to purchase the Property from the Property Seller. That is, it has cash equal to the amount financed (the Spot Cash Payment amount) plus the amount of equity contributed by the Purchaser (*Mutqawariq*). The Purchaser (*Mutawariq*) purchases the Property from the Property Seller (steps ⑨ and ⑩ of Figure 9) pursuant to the Property Purchase Contract.

The financed amount is repaid to the Bank over time as deferred payments in respect of the commodity *murabaha* for the Metal (step ⑪ of Figure 9).

BAY BITHAMAN AJIL

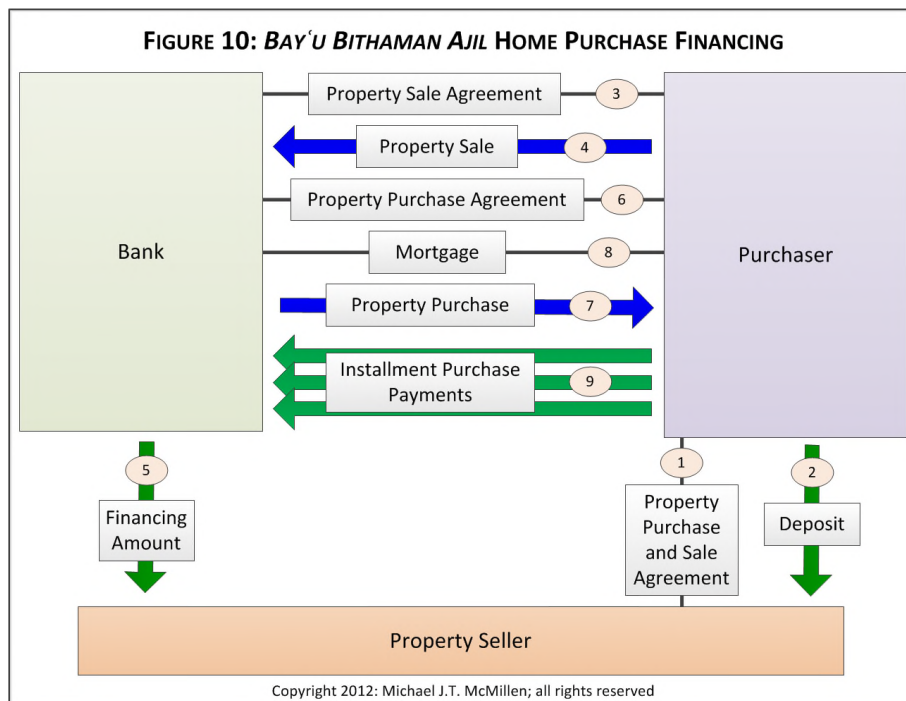
Definition and Principles

The *bay'u bithamin ajil* or “BBA” contract is a contract of sale, utilizing deferred payment concepts. Importantly, it is not a separate kind of sale under the *Shari'ah*.²⁹ The payment of the price is deferred and is payable at a particular time in the future, usually on an installment basis. Elements of sale that have been previously discussed are applicable and must be satisfied. For example, the sale and purchase price must be agreed and fixed at the inception of the transaction – at the time the contract is made. Thus, the profit rate for a BBA transaction is fixed at the inception of the transaction for the entire period of the transaction.

²⁹ This type of contract is also known as a *bay muajjal* in Southeast Asia and is commonly referred to as a *bay murabaha* in the Middle East.

The fixed rate nature of the BBA contractual transaction has led to various criticisms pertaining to its competitiveness and appropriateness as a banking tool. Addressing some of those criticisms, Bank Negara Malaysia introduced a rebate (*ibra'*) mechanism that use variable rate financing techniques.³⁰ Using this mechanism, the sales price bears a fixed profit rate that is designated as the 'ceiling profit rate'. The ceiling profit rate is set at a rate that is greater than the actual variable rate that will be charged to the home purchaser (which is referred to as the 'effective rate'). The difference between the payment calculated at the ceiling profit rate and the payment calculated at the effective rate is the amount of the rebate to the home purchaser for the relevant period.

Different types of sale arrangements may be embedded in the BBA transaction. In Malaysia, Indonesia and Brunei, the *bay' al-'inah* (sale and buy-back) structure is frequently used. This type of structure is not used with any frequency outside Malaysia, Indonesia and Brunei. FIGURE 10: *BAY'U BITHAMAN AJIL*



HOME PURCHASE FINANCING provides a graphic depiction of a BBA transaction using this mechanism.

In this transaction, the Purchaser identifies the property that the Purchaser desires to acquire (say, from a developer), enters into a Property Purchase and Sale Agreement (step ① in Figure 10) and pays a Deposit amount to the Property Seller (step ② in Figure 10).

As a result of paying the Deposit amount to the Property Seller, the Purchaser is deemed to have become the beneficial owner of the property. The Purchaser then approaches the Bank to seek financing for the acquisition of the property in an amount equal to the balance of the purchase price over the amount of the Deposit (the "Financing Amount"). That is, the property purchase price is equal to the sum of the Deposit and the Financing Amount.

Upon arranging that financing, the Purchaser enters into a Property Sale Agreement (step ③ in Figure 10) and sells the property to the Bank for an amount equal to the Financing Amount (step ④ in Figure 10)

³⁰ See Introduction of Islamic Variable Rate Mechanism, in *The Islamic Financial System*, 187-89 (2003), BANK NEGARA MALAYSIA, available at http://www.bnm.gov.my/files/publication/ar/en/2003/cp05_003_whitebox_intro.pdf.

10). The Bank will consummate the purchase of the property by making payment of the Financing Amount, which is usually disbursed directly to the Seller as shown in step ⑤ in Figure 10.

Thereafter, pursuant to the Property Purchase Agreement (step ⑥ in Figure 10), the Bank sells the property to the Purchaser at an amount equal to the sum of (a) the Financing Amount plus (b) a profit amount on the Financing Amount, which may be determined using either a fixed or floating rate (the “Total Purchase Amount”) (step ⑦ in Figure 10). The Purchaser then makes installment payments of the Total Purchase Amount to the Bank, as illustrated in step ⑨ in Figure 10. The obligation of the Purchaser to make the installment payments of the Total Purchase Amount will often be secured by a *rahn* (mortgage) on the property from the Purchaser to the Bank, as illustrated in step ⑧ in Figure 10.

ISTISNA’A ALTERNATIVES

Istisna’a – Parallel Istisna’a Home Construction Financings

The term “*istisna’a*” (or *’istiṣnā’*) means requesting a *san’ah*, which is the work of a small or large scale manufacturing worker. In jurisprudence and the modern Islamic finance and investment industry, the term is used to refer to a type of forward sale contract involving the request to manufacture (or construct) a specific item in a specific form for a specific price. The commission to manufacture contract is thus a contract to purchase the item to be manufactured by the worker, where the worker provides both the raw materials and the labor to produce the final product.³¹ Historically, the *istisna’a* contract is derived from situations in which custom production was required or desired, although it now refers more broadly to both manufacturing and construction undertakings. The *ṣāni’* or *sane* is the seller, the *mustaṣni’* or *mustasne* is the purchaser, and the *maṣnū’* or *masnou* is the object of the sale transaction.

The *istisna’a* is similar to the forward sale contract (*salam*) in that it involves the future delivery of a traded item, it is a sale of an object that is not existent at the time of the entering into a binding sale and purchase contract, and the object of the sale is a liability of the seller. In the *istisna’a* contract, the sales price need not be paid immediately at the time of entering into the contract, in contrast to the *salam* contract.³²

The nature of the *istisna’a* contract in a situation where a purchaser desires to have a house constructed is seemingly straightforward. The purchaser/*mustasne* commissions the seller/*sane* to build a house (*masnou*) and sell it to the purchaser upon completion of construction, whereupon the purchaser will make payment in full. In the normal course, and classically, this arrangement does not involve instalment payments of the purchase price by the purchaser. The seller would have to be qualified to

³¹ If the raw materials were provided by the purchaser, the contract would be one of employment of the labor of the worker.

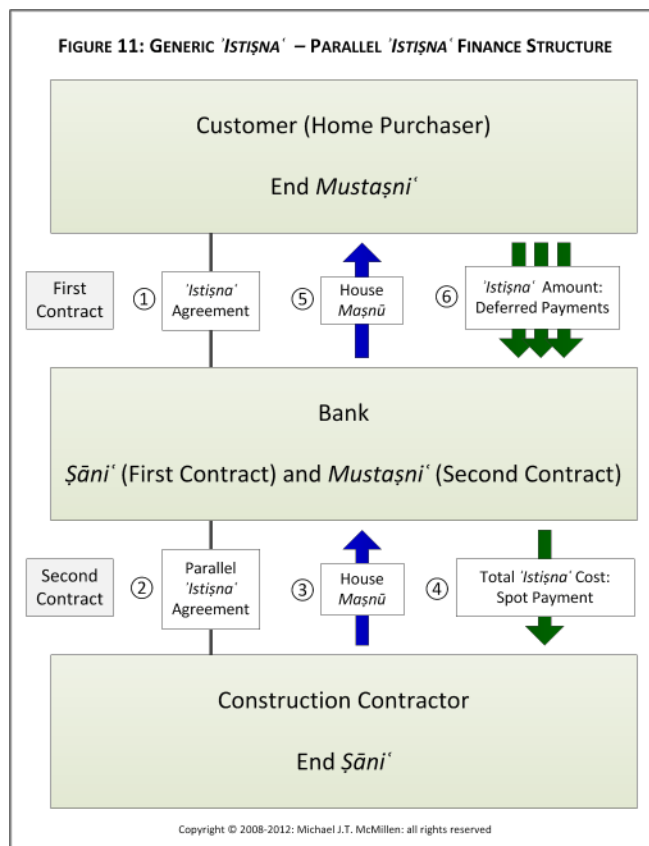
³² See Wahbah Al-Zuhayli, *AL-FIQH AL-ISLAMIA WA-ADILLATUH (ISLAMIC JURISPRUDENCE AND ITS PROOFS), FINANCIAL TRANSACTIONS IN ISLAMIC JURISPRUDENCE*, Mahmoud El-Gamal, translator, and Muhammad S. Eisaa, revisor, which is a translation of Volume 5 of *AL-FIQH AL-ISLAMIA WA ’ADILLATUH, FOURTH EDITION (1997)*, volume 1, at 267-79, for discussions of the jurisprudential positions regarding whether the *istisna’a* is a contract of sale or a promise to sell or a form of employment of the manufacturer, of appended conditions, of the legal status of the contract, and of legal characteristics of the contract, and for a detailed comparison of the *istisna’a* and the *salam* contracts.

construct the house, or at least to cause the construction of the house (or the acquisition of the *masnou* in the markets).

The pure *istisna'a* contract does not seem well suited to situations in which the purchaser of the house is in need of financing to effect the purchase and the payment of the house purchase price. Additionally, the pure *istisna'a* does not seem well suited to situations in which the purchaser desires to make instalment payments of the purchase price, particularly instalment payments over an extended period of time. And construction contractors and manufacturers are not well positioned to provide long-term financing of house acquisitions. With respect to each of these matters, the introduction of banks and/or financial institutions into the equation seems both appropriate and beneficial.

This line of thought leads to the contemporary *istisna'a* – parallel *istisna'a* transactional form. This form involves two *istisna'a* contracts, one between the house purchaser as the *mustasne* (the “end *mustasne*”) and the bank as the *sane*, and one between the bank as the *mustasne* and the constructor as the *sane* (the “end *sane*”).

FIGURE 11: GENERIC 'ISTIŞNA' – PARALLEL 'ISTIŞNA' FINANCE STRUCTURE provides a graphic depiction of the overall transaction involving both *istisna'a* contracts.



The “First Contract” is comprised of the *Istisna'a* Agreement (step ① in Figure 11) between the Customer (Home Purchaser) as the End *Mustasne* and the Bank as the *Sane*. The Bank agrees to construct the House (*Masnou*) (which will be delivered in step ⑤ in Figure 11) in accordance with the plans and specifications set forth in, and otherwise as agreed in, the *Istisna'a* Agreement and for a price (the “*Istisna'a* Amount”) set forth in the *Istisna'a* Agreement (which will be paid in instalment payments in step ⑥ in Figure 11). The *Istisna'a* Amount is equal to the sum of (a) the cost to construct the House, which is the “Total *Istisna'a* Amount” referred to in step ④ in Figure 11, plus (b) the financing costs

to be paid to the Bank. Those financing costs may be calculated using either a fixed or a floating rate. The Bank is obligated to the Customer (Home Purchaser) in respect of the construction of the House. The Customer (Home Purchaser) agrees to purchase the House for the *Istisna'a* Amount on the instalment payment terms set forth in the *Istisna'a* Agreement.

Of course the Bank is not in the business of constructing houses. Thus, the Bank, as *Mustasne*, arranges for the “Second Contract”, being the “Parallel *Istisna’a* Agreement” (step ② in Figure 11), with the Construction Contractor as *sane* (or “End Sane” because it is the ultimate *sane* in the overall *istisna’a* – parallel *istisna’a* arrangement). Pursuant to the Parallel *Istisna’a* Agreement, the Construction Contractor agrees to the construct the House and deliver it to the Bank (step ③ in Figure 11), which will make payment to the Construction Contractor in one or more spot market payments (step ④ in Figure 11) during or at the end of the construction period. All construction terms pertaining to the House to be constructed pursuant to the Parallel *Istisna’a* Agreement (*e.g.*, the plans and specifications) are identical to the construction terms set forth in the *Istisna’a* Agreement between the Customer (Home Purchaser) and the Bank. That is, the two contracts are “parallel” in all regards other than the price and the timing of the payment of the price. The price to be paid to the Construction Contractor under the Parallel *Istisna’a* Agreement is the “Total *Istisna’a* Cost” (step ④ in Figure 11). It is the cost to construct the House without regard to any financing costs that are included in the *Istisna’a* Amount.

It is to be noted that the *Istisna’a* Agreement and the Parallel *Istisna’a* Agreement are, and must remain, totally independent obligations and arrangements, rather than interdependent obligations and arrangements. Thus, for example, pursuant to the Parallel *Istisna’a* Agreement, the Construction Contractor is obligated to the Bank, but not the Customer (Home Purchaser), in respect of the construction and delivery of the House. Pursuant to the *Istisna’a* Agreement, the Bank is separately and independently obligated to the Customer (Home Purchaser) in respect of the construction and delivery of the House. These obligations are independent and unrelated. Failure by the Construction Contractor to construct and deliver the House in accordance with the plans and specifications will not relieve the Bank of its obligation to the Customer (Home Purchaser) to deliver the House in accordance with the plans and specifications; the Bank will continue to be liable to the Customer (Home Purchaser).

Conclusion

This paper is intended as a conceptual introduction to *Shari`ah*-compliant home purchase financings. The structures discussed in this paper are generic, and relatively simplified, forms that are used throughout the world, in advanced economies and emerging economies. The hope is that this paper will entice the reader to further explore the available financing alternatives under the *Shari`ah*.

The discussion in this paper is general, and does not consider nuances of the principles that are discussed or numerous other principles that should be considered in implementing a transaction. Not all structures are permissible in any given jurisdiction or under the principles of the *Shari`ah* as applied by any given *madhhahib*. Anyone considering the use of any of these structures should consult with a qualified *Shari`ah* scholar as to the principles that may be applicable in a given transaction.