

## Truly Interest Free in the US

By Liaquat Ali

**The purpose of this article is to explore various financing opportunities which Muslims in the US and Shariah finance houses around the world could tap into to expand the riba free transaction space in the country by providing stable and predictable investment options to investors as well as flexible and cost-effective funding options to real estate buyers.**

Muslims' understanding of riba, and their attitude toward it, varies greatly. Some believe that it refers to any kind of profit which is made on top of money and is disallowed regardless of how you interpret it. Some believe that only excessive interest constitutes riba, and yet others believe that simple profit taking is allowed but compound interest is not allowed.

Then you have the Islamic finance arenas where theological and historical understandings meet conventional financial market instruments. The discussion gets even more nuanced in terms of the existence and interpretations of maysir (generally understood as gambling or speculation), gharar (generally understood as situations where consequences of transactions are hidden or worse misrepresented), and of course risk.

Due to the stern denouncement of riba in the Quran, the demand for riba free transactions exists all around the world. In recent years various real estate financing products have hit the US market which claim to provide Islamic financing. Specific details about those products are beyond the scope of this article. However, it is important to note that the liquidity of those products is primarily provided by Freddie Mac (Federal Home Loan Mortgage Corporation) in the residential space, and by Wall Street "credit lines" in the commercial space.

The underwriting criteria of those Islamic finance outfits are therefore dictated by their respective money sources. Due to such criteria, a large segment of the Muslim population in the US is left without riba free transaction options even if they wanted to conduct business with those outfits.

The only way to service this demand is to work with sources of money that, due to reasons of their own, are as eager to create riba free transactions as those who demand them. These sources of money don't necessarily need to be of Muslim origin as long as their investment needs are satisfied while creating end-to-end and transparent riba free transactions.

This author's area of expertise is real estate investments and "private money" which he has used for his real estate transactions during the past six years. To him riba free transactions are simply a special case application of the private money space. The author defines private money as the source of funds where the owner invests directly. Intermediaries if any have low or no influence on the transactions. The second requirement for the private money is that the terms are flexible, individually negotiated among principals and are not dictated by institutional indexes or underwriting criteria.

The first large source of "money" is equity in real estate. According to the National Association of Realtors (NAR), as of February 2009, the size of "owner occupied" residential real estate was US\$20 trillion,

and the size of commercial real estate was US\$5 trillion. According to the 2000 census, 33% of all "owner occupied" residential real estate in the US was owned "free and clear." That is, there were no mortgages on those houses.

Due to the real estate boom and bust in the past eight years, the very houses which were "free and clear" may have been financed, and the houses which had mortgages on them may now be "free and clear" due to mortgage pay off or foreclosure. So until Census 2010 is released, we can safely assume that up to US\$6.6 trillion worth of "owner occupied" residential real estate is available "free and clear."

According to the Federal Reserve, at the end of the third quarter of 2008, the mortgage debt on commercial/multifamily properties was US\$3.4 trillion. This means that the owner equity in commercial properties is around 32% which is almost the same as the "free and clear" number for owner occupied residential properties.

Additional drill down into a property's title data, in terms of age of the owner and the length of ownership, could reveal potential candidates for "free and clear" residential and commercial properties. It is safe to assume that older owners would have more equity in their properties and may entertain alternative financing proposals.

Younger owners who may have mortgages may not be able to make independent decisions. According to Census 2000, 33.4% of the US population was 45 years old or older which means that today at least 33% of the US population is 54 years old or above.

NAR said that in 2008 approximately five million existing homes were sold in America at an average US\$198,000 each, for a total of US\$976 billion. Using the same ratio of the total number of sales with the total US population, in 2008 approximately 114,000 American Muslims (out of seven million) bought existing homes at US\$198,000 for US\$23 billion.

The seven million figure has been estimated by the Council on American Islamic Relations (CAIR) and was recently endorsed by US President Barack Obama. If Pew Research Center's 2.35 million number is used, then 38,400 homes were bought by Muslims in 2008 for US\$7.6 billion.

According to a Shariah finance insider in the US, there have been only US\$2 billion – US\$2.5 billion worth of Shariah finance mortgage originations including refinances thus far. This shows that the Shariah finance houses are not penetrating the market due to a variety of reasons, such as indifference, price sensitivity, theological concerns and distrust of the Shariah finance products.

With the availability of US\$6.6 trillion in residential equity spread over more than 40 million residential "free and clear" units as per the American Planning Association, Muslim individuals can enter into riba free transactions with Muslims as well as non-Muslims. These transactions could be carried out by totally bypassing intermediaries that must charge interest, profit or mark-up to sustain their existence.

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## Truly Interest Free in the US (continued)

This eliminates riba from transactions altogether and avoids the whole interpretation exercise of what riba is and what it is not. These transactions would most likely utilize Murabahah or ijarah contracts, and are limited to older, existing properties.

The second large source of funding is retirement accounts in the US. According to the Pension Research Council of Wharton School, those retirement accounts were estimated to be at US\$16.4 trillion in the fourth quarter of 2007. However, a news report said it shrank to around US\$8 trillion after the economic downturn began.

There are two broad categories of these retirement accounts. The “401(k)” is for employees of corporations and the “IRA” is for the self employed. There are limits to annual contribution to these accounts, and the invested principal and return on investment are either tax deferred or tax free depending on whether the account holder paid tax before contributing to those accounts. The owners of these accounts cannot generally withdraw money from their accounts until they reach the age of 59.5.

### “There are huge market opportunities for financial houses of all types to provide various investment products”

When the US Congress approved the Employee Retirement Income Security Act (ERISA) to create the IRA and 401(k) in 1974, it only prohibited retirement account holders from investing in life insurance and collectibles, such as painting and rugs.

However, Wall Street firms, where more than 96% of these retirement accounts ended up, restricted investment options to stocks, mutual funds and bonds, among others. Wall Street does offer the money market as a money parking option when investors get jittery due to the volatility of the market. However, as soon as the stock market recovers efforts are redoubled to get that money back into stocks.

Due to the distrust of Wall Street, many of those retirement account holders have started moving their money elsewhere, such as Self Direct Individual Retirement Accounts (SDIRA), specialized life insurance policies and other investment options. Unlike Wall Street, SDIRA custodians allow the full range of investing options as allowed by the ERISA:

- Residential real estate, including apartments, single family homes and duplexes.
- Commercial real estate.
- Undeveloped land.
- Real estate notes (mortgages and deeds of trusts).
- Promissory notes.
- Private limited partnerships, limited liability companies and C corporations (subject to Federal income tax laws).
- Tax lien certificates.
- Foreign currencies.
- Oil and gas investments.
- Publicly traded stocks, bonds and mutual funds.

- Private stock offerings and private placements.
- Judgments/structured settlements.
- Gold bullion.
- Car loans.
- Factoring investments.
- Accounts receivable.
- Equipment leasing.

Even though only 4% of retirement accounts were thought to be managed by non-Wall Street custodians before the recent stock market meltdown, the money exodus out of Wall Street would take hundreds of billions of dollars into those SDIRA accounts.

Unlike Wall Street, these custodians currently operate strictly as “money holders” and do not provide investment advice. Therefore, there are huge market opportunities for financial houses of all types to provide various investment products to these self directed retirement account holders.

At the current per capita income of US\$48,000 for the US population, seven million Muslims have a cumulative gross domestic product (GDP) of US\$336 billion. It is safe to assume that each Muslim has an equivalent of six months to one year’s worth of income saved up. That would be around US\$168 billion to US\$336 billion. As the general population moves towards SDIRAs, Muslims will move their money there as well.

If the total retirement account value of US\$8 trillion is proportionally applied to the Muslim population, they have US\$61 billion in their retirement accounts if Pew’s population estimate is used. They have US\$183 billion if the CAIR/Obama population estimate is used.

With the rapidly growing SDIRA capital from its current value of US\$320 billion (4% of US\$8 trillion), and several billion dollars in Muslim retirement accounts, Shariah finance houses can provide investment products to Muslim as well as non-Muslim retirement account holders to satisfy their flight-to-safety needs after being burnt by Wall Street’s never-ending maysir (speculation) and gharar (uncertainty).

Shariah compliant contracts among Muslims and non-Muslims can be created for real estate and other investment products as allowed by the ERISA. The state and federal securities laws, corporate structuring and the US legal system provide individuals and institutions with the ability to craft and enforce such contracts.

This will resolve the thorny issue of the availability of “willing and stable” sources of funding which prevented organic Shariah compliant financing products from taking root in the US in the past.☺

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