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The Islamic Implication of the Standard Benchmarks in the American Islamic Mortgage Product

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Abstract

This paper examines the permissibility of the American Islamic mortgage sector use of the standard metrics synonymous with the conventional and conforming mortgage; debt to income ratio and loan to value. For this purpose, section one will discuss the formation of the traditional conventional mortgage juxtaposed with the reduction in the savings as well as an increase in spending by Americans.The second section will explore the relevant Islamic financial views on overspending and the correlation with negative societal effects such as excessive debt, grief as well as the lack of fulfillment of the rights of other.The conclusion will correlate the current American Islamic finance mortgage options to the overspending mentality due to the overwhelming adherence to the standard benchmarks.The conclusion suggests that mortgages structured with the conventional benchmarks have hada detrimental effect on personal and societalwell-being, albeit labeled Islamic or not. Suggested further is themoving away from the conventional benchmarks in the next evolutionary model of the American Islamic mortgage product.

Keywords: Islamic finance, mortgage, debt-to-income, loan-to-value, musharaka, ijara, murabaha

1. Government Sponsored Enterprise

In 2013, nearly 90% of real estate mortgages written in America were backed by Fannie Mae or Freddie Mac[i]. The main product of this enterprise is the conforming mortgage. Without exception, it does serve its purpose; it is extremely convenient, affordable payments and an unlimited amount of loans could be written. Simply put, the mortgage backers provide a robust and 'sustainable' borrowing model. Borrowers now have access to hundreds of thousands of dollars to purchase a primary home, vacation home or rental property - determined by a few primary metrics; loan to value [LTV] and debt to income [DTI]. Current Fannie guidelines allow for an LTV up to 97% and a DTI of 45%[ii].

However, access to such funds weren't always so easy.

Prior to the New Deal [1932], local banks would lend funds that were actually on hand via deposits. Terms were extremely short; 3 to 7 years and loan to value rates were low, ~60% Mortgages required larger down payments and had very short terms.

Several New Deal measures created government sponsored enterprises [GSE's] in the finance sector. The most notable GSE was Fannie Mae and later joining was Freddie Mac. Their goal was simple; make it far easier for Americans to borrow money to purchase a home - the American dream (of homeownership) was born!

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Upon initial formation, the lengths of GSE backed loans were bumped up to 25 years. Relative home payments decreased, which corresponded with a large increase in home values [60% after after adjusting for inflation]. Consumers were not complaining as it was far easier to buy a home, and move from the proverbial poor to the middle class.

Currently the DTI and LTV limits set by Fannie/Freddie are reflective of ALL conforming loans - from any bank, even those formed under the auspices of Islamic Banks in America. If moving away to a non-conforming loan, which exclude the bulk of Islamic financing houses, DTI can increase to 55% and down payments could be as low as zero. Not so surprisingly, these types of loans played a large role in the formation of the real estate bubble we witnessed in 2007. The DTI includes debt from most revolving and fixed debt, such as loans on real estate, automobiles, student loans, credit cards and child supports. Monthly obligations such as utilities, food, medical, federal and state taxes are not factored. It is weighed against the pre-tax income. Hence financial advisors are not surprised that Americans are able to stay afloat in the sea of borrowed money.

Since the inception of GSE's in the mortgage place, the saving rates of Americans have also consistently declined. In 2006 the respective value was negative; indicating that Americans were spending more than they are earning! The value has since risen to above zero[iii]. Further statistical analysis shows that U.S. households are becoming less saving-oriented and more consumption-oriented. The U.S. consumption binge has been accompanied by an exponential rise in household debt; the ratio of total household debt to personal disposable income[iv].

The paradoxical relationship between the *ease of availability* of funds and overspending, i.e., lack of savings, has caused a great deal of concern to analysts. Lansing, of the Federal Reserve Bank of San Francisco, has concluded that this exponential rise is mortgage related, and 'Failure to boost saving in the years ahead may lead to some painful adjustments in the future[v].' Guidolin concludes that as a result of the plummeting saving rate among the middle class since the 1980s [in large part due to a surge in debt - in particular mortgage debt and student loans], middle class wealth formation is bound to stall[vi].

Following the recent housing crash, and subsequent reduction is lending, the corresponding savings rates as well as indebtedness ratios have corrected slightly, confirming the relation to ease of accessibility of mortgage funds. Ultimately the US has been dubbed a spendthrift nation. The secular view of poor economic practice is that such behavior subsequently results in a predicament which will come to fruit upon retirement of the individual. Islamic teaching not only focuses on the individuals near future, but concern beyond the individual is emphasized. This vicious cycle of debt coupled with a lack of savings will present disastrous problems not only for the individual, but also those who are given a right of the wealth, i.e., the poor and needy, as well as those pursuing capital for business and societal formation.

The question that needs to be considered, in lieu of such lax borrowing opportunities [not only present with mortgages, but across the board] is; 'what ramifications do mortgage funds, with such ease of availability, have on a society?'

2. Mortgage-Overspending Paradox

Muslims have long been warned of such detrimental spending habits. Prior to the immigration of the Prophet (S) to Madinah. A series of verses in Surah Al Isra [17:23- 39, labelled by some as the 10 commandments] were revealed. They were meant to be amongst the cumulative wisdom revealed to formulate an Islamic community and society. The verses begin with the hierarchy of rights upon an individual that are due; from Allah (SWT) down to the wayfarer. A stern warning is given regarding squandering wealth; 'and do not squander recklessly. Surely, squanderers are the brothers of satans [17:26-27].'

Alluded is the correlation between squandering of wealth and the antithesis of such; the fulfillment of the rights of others. From a practical view, the verse begs the question, 'how could one spend in the way Allah ,or give to the needy (or fulfill any others due right), if the very custodial provisions that one handles, are being directed elsewhere or, more strongly put, being mishandled?' Further clarification is given; 'And do not keep your hand tied to your neck, nor extend it to the full extent, lest [avoid the risk] you should be sitting reproached [disappointed], empty-handed [17:29].' Reaffirming that misappropriating your financial resources by either being overly greedy and/or conversely overly superfluous will put one **at risk** of sitting empty-handed; financially and spiritually.

The relationship between such negative attributes as (burdensome) debt and worry, grief and stinginess are linked and brought to life in this context the dua of the Prophet(S):

اللهمإنيأعوذبكمنالهموالحزنوأعوذبكمنالعجزوالكسلوأعوذنكمنالجبنوالبخلوأعوذبكمنالغلبةالدينوقهرالرجال

O Allah, I take refuge in You from anxiety and sorrow, weakness and laziness, miserliness and cowardice, the burden of debts and from being overpowered by men

The fact that such negative qualities are linked with the burden of debt, and subsequently being overpowered by men, in one dua is not alarming. In a recent study by the American Psychological Association, the primary stressor for Americans is money. The leading manifestation of given stress is fatigue, anxiousness, the feeling of being overwhelmed, lack of motivation/energy and feeling depressed[vii]. The pinnacle of these verses from Surah Al Isra [17:30] revolves around the simple understanding that not only does sustenance come from your Lord, but it is also restricted from your Lord; 'Indeed, your Lord expands sustenance for whomsoever He wills, and constricts (for whomsoever He wills). Surely, He is All-Aware of His servants, All-Seeing.'

In his tafseer of these verses, Mawdudi comments that attempting to upset this balance, set by the creator, by the influx or redistributing of provisions, is a direct contradiction to this verse, as Allah (SWT) is All-Aware and All-Seeing of His servants. The ease of availability of funds, and its attributes of a large liability relative to income, and length of term, can be analogous to the influx and/or redistribution of funds warned of. In essence, the conforming method of home finance is the epitome of what the Quran warns against in these verses.

The correlation between reckless financial habits and the fulfilment of the established rights of others are further present in the Quran. In Surah Al Baqarah, spanning nearly 3 pages [lines 2:261-281] the etiquette and reward of charitable givings is maintained. Referenced is a wide array of topics from overt/covert givings to seeking out those who do not ask. After lengthy discussion on the method of handling the provisions given by the creator, a stern warning is given to those who practice poor financial habits initiated with usury. This beautiful juxtaposition illustrates the acceptable, as well as the unacceptable, methods of handling finances.

Poor financial habits, in these particular verses embellished with riba, can be discerned as a threat to the practice of giving, and practically a gateway to excessive spending. The end result is, as the verse of Surah Al Isra reminds us, 'lest [avoid the risk] you should be sitting reproached [disappointed], empty-handed.' The warning of this denial of the fundamental right of a portion of society was so stern that it could only have been revealed at the formation of the first Islamic society. Similarly, in Surah Al Nisa, verses 4:161-163, Allah (SWT) references the wrongdoing of the Jewish people, 'And their taking of Riba though they were forbidden from taking it, and their devouring men's substance wrongfully...' The very next line references those among them, who were firm in knowledge, 'But that firm in knowledge among them and the believers believe in what has been revealed to you, [O Muhammad], and what was revealed before you. And the establishers of prayer [especially] and the givers of zakah and the believers in Allah and the Last Day - those we will give a great reward.'

The correlation between the fulfillment of the rights of others and the threat of substandard financial habits are a common theme in the Sunnah of the Prophet(S) and the Quran. Secular financial advisors contend that the availability of excessive financing clearly puts the person at risk of being a spendthrift. Islamically the fear is further expounded; foregoing the rights of others. Dave Ramsey, financial guru and author, has recognized this link. The culmination of Ramsey's financial plan includes not only removing all forms of the borrowed funds, but ultimately giving in the form of charity[viii]. The fulfillment of the rights of others is recognized by the trained in the field of religion and economics. Similarly, the primary hindrance of said fulfillment is also recognized; overbearing debt facilitated by the availability of funds.

The threat of overbearing debt is even more so dangerous in our day and age as the availability of easily financed funds are now present in a wide array of products and services; department stores, automotive, cell phone carriers, pet stores, and even bicycle shops. This leveraging the long term for the immediate possession of goods is often facilitated via overzealous employees with reward incentives for having the consumer opening such finance accounts!

The most famous psychology ever experiment conducted, by Walter Mischel, revolved around the quintessential dilemma of short term satisfaction vs long term gain. Dubbed the Marshmallow Experiment, children were asked to sit in front of a marshmallow. If they were able to resist the temptation of the marshmallow for a short period of time, they would be rewarded with a larger treat for their patience.

The children were followed up later in life, and the ones who were able to sacrifice the short term satisfaction were more successful due to their discipline; higher SAT scores, greater social and cognitive competence, greater educational attainment, and less drug use and criminal record. Despite the fact that this experiment was conducted over 40 years ago, this Quranic dua encapsulated the very essence of short term satisfaction (dunya) whilst not sacrificing long term (akhira) gain.

"اللهمآتنافيالدنياحسنة، وفيالآخرةحسنة، وقناعذابالنار

O our Lord gives us in this world that which is good and in the Hereafter that which is good, and save us from the punishment of the Fire

The essence of Islamic teaching is not only recognizing, and avoiding, that which is an obvious prohibition of the religion, but also the implementation of diligence in avoiding that which *leads* to the prohibited matter. The following verse serves as a warning of such items that have been beautified and subsequently desired.

زُيِّنَ لِلنَّاسِ حُبُّ الشَّهَوَاتِ مِنَ النِّسَاءِ وَالْبَنِينَ وَالْقَنَاطِيرِ الْمُقَنطَرَةِ مِنَ الذَّهَبِ وَالْفِضَّةِ وَالْخَيْلِ الْمُسَوَّمَةِ وَالْأَنْعَامِ وَالْحَرْثِ ۗ ذَٰلِكَ مَتَاعُ الْحَيَاةِ
الدُّنْيَا ۖ وَاللَّهُ عِندَهُ حُسْنُ الْمَآبِ

'It has been made attractive for people to love the desired things; that is, women, children, hoarded heaps of gold and silver, branded horses, cattle and tillage. That is an enjoyment of the worldly life; but with Allah lies the beauty of the final resort.' Surah Ali Imran (3:14)

In fact, such guidance was given to the first of mankind; Adam (pbuh) and Eve, as told in Surah Al Baqarah (2:35):

وَلَا تَقْرَبَا هَٰذِهِ الشَّجَرَةَ

"and do not go *near* the tree!" From the infinite wisdom of our Creator, He knows that the best method for Adam (pbuh) and Eve was to simply distance himself from the tree.

The children most successful in the Marshmallow experiment, referenced above, did exactly that; they distanced themselves, physically and/or mentally, from the marshmallow. The children who did not fare so well would often be lost in the allurement and intrigue of the *beautiful* marshmallow; touching, smelling, tasting… ultimately eating! This observation has lead Mischel to conclude that the most practical way to restrain from overindulgence is simply to avoid the situation altogether, as similarly commanded of Adam (pbuh).

Similarly, celebrity financial guru Suze Orman's financial model for success primarily revolves around self-control and avoiding that which enables spending. She further warns the allure of excessive financing is as tempting as that of a narcotic!

Conclusion

The path to overindulgence has evolved into, and revolves around, the allure of easily available financing. *Conventional mortgages, being the largest financed product of Americans, are the proverbial marshmallow.*

The statistics show that we, as an American society, not only have been offered said marshmallow, in the form of easily available money, but that we have binged on them.

What is more frightening, for the American consumer, is that the answer of the financial sector to this convoluted problem is to increase lending! This subtly appears in the form of reducing the monthly obligation, interest only products or lengthening the term of borrowed funds. Hence it is now common to see car loans up to 7 or even 10 years. Home loans have seen such things as interest only loans and even 40 year terms. Credit card minimum payments similarly decreased to as low as 1% of the principal balance; translating to a payment (and balance) that will continue on practically for an indefinite time!

The current approach of the American Islamic Finance sector to this complex scenario of [home] finance revolves around the exclusion of interest from the transaction between the homeowner and the financing entity [the primary transaction]. The de facto result is, regardless of your view on the respective permissibility, a finance method focusing on the *mechanism* of the transaction while inadvertently utilizing the industry benchmarks. Currently the most common American Islamic mechanisms are based on leasing or partnership that removes riba from the primary transaction. The standard benchmarks [DTI, LTV, term, rate] observed with conventional loans are utilized with the Islamic alternatives. As a result, the ability to procure an Islamic loan product is practically identical with that of the conventional counterparts. The issue of overextending and the negative individual and societal ramifications are not taken into consideration. The respective payment amounts and terms are also similar. The similarity of the many such Islamic products naturally resulted from the inclusion of the GSE's in the process. Abdul-Rahman, the father of Islamic Banking in America, also recognized this link between excessive debt and the standard benchmarks[ix], i.e., low down payment and the 15 to 30 year term. Similarly, Dave Ramsey constantly advises individuals to make the conscious effort to move away from the standard benchmarks, e.g., a shorter loan term vs longer, a lower debt-to-income ratio vs the norm, higher down payment vs the minimum.

There has been a mainstream jurisprudence shift recently [AMJA opinion][x] questioning the involvement of the GSE's. The standard benchmarks, or said consequences of such, have not been addressed in the recent shift. The troubling questions must be asked; in lieu of the *mechanism* of the transaction [between the lender and lendee], are the standard benchmarks [set by Fannie and Freddie], which were instrumental at the arriving of such Islamic products, *Islamic*? What are the ramifications of a society that is allowed to allocate 45% of its pre-tax income to paying debt for 30 years while putting as little as 3% down? The adherence to these conventional benchmark values have been held strongly by the GSE's, which ultimately trickle into Islamic products. Their view is quite clear; more money to lend, longer terms and ease of access. The reality is that the mortgage sector's purpose is to create loans. Revenues are directly correlated to the generation of loans. Accordingly, there will always be a mortgage sector creating products that suit the largest amount of borrowers, from Islamic, subprime, reverse, etc. Fannie Mae alone, for example, earned more than 84 billion dollars in 2013. Simply put; more borrowers (regardless of the criteria) equate to more revenues. The question must be asked, when the Federal Housing Administration [FHA] says, 'Another American dream comes true,' one has to wonder, who is the beneficiary of this dream, the homeowner or the bank?

Although interest is effectively serving as a gateway towards over embellishment and a spendthrift mentality, these detrimental practices can easily be implemented in a manner, label as halal, via ease of accessibility of borrowed funds. Hence, while riba aversion is focused on, the gateway to the squandering of wealth and overburdening debts, which are inherently built in with conventional loans, albeit halal or haram, must be reproached. The next evolutionary phase of the American Islamic Mortgage should question the standard benchmarks currently set by the GSE's. An Islamic solution to this mortgage/overspending paradox could be attained.

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