

RESIDENTIAL MORTGAGE CRISIS - AN ISLAMIC FINANCE PERSPECTIVE

Mostafa Beheshti Seresht*, Hasna Haj Najafi**

Abstract

In this paper, we try to analyze the US residential mortgage crisis in the light of the financial principles of *Shari'ah*. For this purpose, we will firstly present a summary of the US residential mortgage crisis. Then, in the second part of the paper, we will explore relevant financial principles of *Shari'ah* law. In this part, special attention is paid to analyze the residential mortgage crisis according to *Shari'ah* principles and *Shia* interpretation of *Shari'ah* through Civil Code of Iran. The main claim is that if mortgage transactions had been concluded in compliance with the principles of *Shari'ah* law, the whole chain of crisis would not have occurred.

Keywords: Credit Crisis of 2007, Islamic Finance, *Shari'ah* Law

* PhD Student of Finance, Allameh Tabatabaee University, Iran

Email: beheshtiseresht921@atu.ac.ir

** Master of Laws, McGill University, Canada

Email: hasna.hajnajafi@mail.mcgill.ca

1. Introduction

The severity of the recent financial crisis has resulted in the evaluation of the roots of the problem and the exploration for alternative ideas and possible solutions. Different legal, economic, regulatory, financial, and political reformations are proposed in order to find a means for escape from the current credit crisis. In this respect, attention has been turned, mainly by Muslim economists and jurist, to principles of Islamic finance as a potential cure for ailments of the capitalist financial system. Also, capacity of Islamic finance was implicitly or explicitly emphasized even through the works of non-Muslim scholars.¹

Islamic finance is based on ethical precepts of *Shari'ah*, an Arabic term that is often translated into "Islamic law". *Shari'ah* provides guidelines for multiple aspects of Muslims' life, including worship, personal life, economics, politics, banking, business and aspects of the legal system. *Shari'ah*-compliant finance seeks to shape financial practices and legal instruments that conform to Islamic principles. The

expression "Islamic finance" comprises two competing forces at its core. On one hand, the word "finance" suggests that Islamic financial institutions, similar to conventional institutions, deal with the allocation of financial credit and risk. On the other hand, the term "Islamic" implies that there are some fundamental differences between Islamic finance and its conventional counterparts.

It is worth to mention that since *Shari'ah* law is not a single codified framework of legal rules and is open to interpretation, the opinions of *Shari'ah* scholars may differ on the same question of *Shari'ah* law depending on the school of thought of which particular scholars are adherent. However, there are still fundamental *Shari'ah* principles derived from primary Islamic sources (*Quran*, and prophetic words (*Hadith*)) accepted by all Islamic schools such as prohibition of interest (*riba*).¹⁴ For the purpose of this paper, we try to study financial crisis from the viewpoint of these fundamental *Shari'ah* principles commonly accepted by nearly all interpretations. Also, wherever necessary, reference is made to *Shia* interpretation of *Shari'ah* law that has been the basis for legal rules in Iran especially after the Islamic Revolution of 1979.

Summary of Residential Mortgage Crisis

A "financial crisis" is generally defined to be "a wider range of disturbances, such as sharp declines in asset prices, failures of financial intermediaries, or

¹ For example, Nobel Prize Winner, Maurice Allais believes that the way out of such financial crises is best achieved through structural reforms by adjusting the rate of interest to 0% and revising the tax rate to nearly 2%. This proposition has attracted attention to principles of Islamic finance, since many believe that what Allais proposes is the core element of Islamic finance. See Hussein Alasrag, Global Financial Crisis and Islamic finance, published online at: <http://ssrn.com/abstract=1591563>, at 3-4.

disruption in foreign exchange markets".² Financial crises are common phenomena in history hitting the market from time to time. Current financial crisis, which started in the summer of 2007, is the severest and most widespread crisis after the Great Deprecation of 1929-1943.³ The Bank for International Settlement (BIS) has mentioned on its 2008 annual report that the root of almost all crises has been excessive and imprudent lending by banks.

Almost every one agree that the root of current financial crisis returns to high-risk and high-cost subprime mortgage lending, which was an established part of the market by the mid-1990s and exploded during 2001-2006. Subprime mortgages were issued to borrowers who were perceived to pose a high risk of default. These loans had substantially higher interest rates than prime mortgages, and were more likely to include costly terms such as prepayment penalties.

In the past, bankers who originated loans and held them to maturity, avoided to lend to subprime customers. By emerging financial innovations such as CDO⁴ and CDS⁵, bankers eagerly competed to attract as more customers, including subprime customers, as possible through originate-to-distribute model. Originate-to-distribute is a model in which the originator of the loan sells it to someone called Special Purpose Vehicle (SPV) who combines the loan in a portfolio of similar loans and then issues new securities that hold a claim against the income provided by the loan portfolio. The process of SPV works as a type of securitization for originator banks.

The purpose of securitization is either to transfer the risk involved with underlying assets, or to refinance the assets, or both. Through securitization, the default risk was no longer a concern since mortgage originators passed the risk to investors who bought mortgage-backed securities (MBSs). Moreover, bankers reached to the new source of financing as securitization increased the liquidity of their assets.

A large portion of the financial institutions (investors) that were potential purchasers of these mortgage-backed securities were restricted from buying subprime debt because it was considered too risky. To solve his problem, the SPVs enhanced the risk of MBSs through tranching, a process in which the SPV held MBSs in a pool as the underlying assets and divided the cashflow originated from them into different levels (tranches). Senior tranches were paid completely before the junior tranches and equity tranches. When any of the subprime borrowers in the pool defaulted, losses were first borne by the equity securities, next by the junior tranches, and finally by

the senior tranches. Next SPVs got the rating agencies to assign credit ratings to each tranche. The higher levels (senior tranches) which were the last to take losses if mortgages defaulted were given the highest credit ratings and the lower levels (equity tranches) that were the first to take losses were given the lowest ratings. Through this procedure, SPVs could easily sell high-rated tranching MBSs to potential buyers (investors). For the low-rated tranching MBSs and in order to provide protection against default, either the SPVs or the buyer of MBSs (investors) purchased an especial type of insurance called Credit Default Swap (CDS). By owning this instrument, the creditor (holder of MBSs and CDSs) pays a premium to an insurer⁶ for the compensation it will receive when the debtor defaults.⁷

The combination of low-rated MBSs and CDSs made some investors to think that there are arbitrage opportunities in the market.⁸ So, these investors purchased MBSs only for the purpose of securitization through issuing Collateralized Debt Obligations (CDOs) and sold them to other investors. Also, some investors who expected default for MBSs (or CDOs) just purchased CDSs from insurance companies without owning the debt security. Moreover, since the credit risk to be transferred in the swap might be very, very large, insurance companies arranged synthetic CDOs which were a portfolio of credit default swaps, and offered them to the investors. The investors who sold the synthetic CDO got premiums because they were betting the referenced securities (MBSs or CDO's) will perform. The investors who bought the synthetic CDO paid premiums because they were betting the referenced securities will default. The buyer received a large payout from the seller if the referenced securities default.⁹

The economic incentives provided to the originators of mortgages loans, along with the rapid appreciation of house prices in the US market, increased the number of subprime mortgages from 7.2% of total loans in 2001 to 20.1% in 2006.⁹ Approximately 80% of these mortgages were adjustable-rate mortgages. In June 2004, the Federal Reserve had begun to increase shortterm interest rates from 1% so that it reached to 5.25% in 2006. When US house price began to decline in 2006 and into 2007, adjustable-rate mortgages began to reset at higher rates, and refinancing became more difficult. The decrease in home prices resulted in many owners finding themselves in a position of negative equity - with mortgage debt exceeding the value of the underlying property. The dramatic rise in mortgage

² Roy E. Allen, *Financial Crises and Recession in the Global Economy*, 3rd ed., (Cheltenham: Edward Elgar Publishing, 2009), at 116.

³ Marc Jarsulic, *Anatomy of A Financial Crisis*, (New York: Palgrave MacMillan, 2010), at 55.

⁴ Collateralized Debt Obligation

⁵ Credit Default Swap

⁶ These insurers, known as monolines, unlike regular insurance companies, which are required by law to keep capital reserves, did not maintain appropriate reserves for their exposures. *Supra* note 8 at 63.

⁷ *Supra* note 12 at 66-70.

⁸ Jochen Felsenheimer & Philip Gisdakis, *supra* note 13 at 106.

⁹ *Supra* note 6 at 6.

delinquencies and foreclosures in the United States

triggered borrowers' defaults, and bankruptcies.

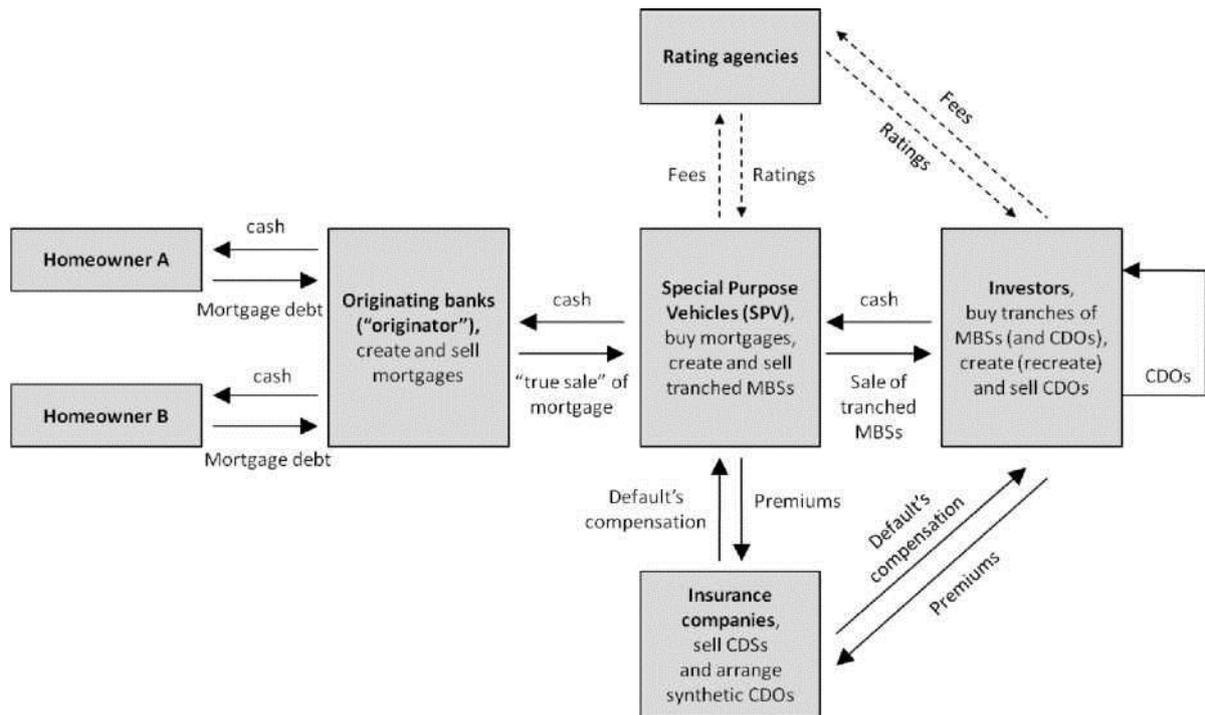


Figure 1. Residential mortgage crisis at a glance

Source: Larry Cordell et al, "The Contribution of Structured Finance to the Financial Crisis" at 241, (with adoption)

Residential Mortgage Crisis in the light of Shari'ah principles

There are a number of key Shari'ah principles and prohibitions relevant to finance and commercial transactions which were violated in the issue of residential mortgage crisis in the US

These Shari'ah principles include prohibition of interest (riba), prohibition of uncertainty (maysir and gharar), and prohibition on securitization of unreal assets.

Prohibition on interest (riba)

Shari'ah principle:

The prohibition of interest or riba, which is based on a number of verses from the Quran, is the most distinguishing feature of Islamic finance. The literal meaning of riba is "increase", "addition", or "surplus". In the Shari'ah, the word "riba" stands for any unjustifiable addition to the principal whether through loans or sales. More precisely, any positive, fixed, and predetermined rate that is guaranteed regardless of the performance of the investment is considered riba and is prohibited. Islamic scholars believe that riba covers not only usury (to fix the interest rate higher than what is declared as legal), but also charging, paying, or receiving any kind of predetermined interest.

Prohibition of interest is so crucial to Islamic finance that some scholars describe Islamic finance simply as an "interest-free" financial system. This description, however, does not provide a true picture of the system as a whole. Undoubtedly, prohibition of interest is the nucleus of Islamic finance, but Islamic finance also includes other financial principles.

Prohibition of riba is mainly based on the argument that Shari'ah does not recognize the time value of money; therefore it is not permissible to make money by lending it. Making money from money is unfair, exploitative in nature, and thus forbidden. Money must be used to create real economic value and it is only permissible to earn a return from investing money in permissible commercial activities which involve the financier or investor taking some commercial risks. According to Shari'ah principles, money is only a means of exchange and not an independent commodity per se. Therefore it cannot grow without being invested in a permitted investment to realize returns. As a result, Islamic finance establishes more connections to the real economy rather than financial sector.

Islamic finance is based on the core principle of risk-sharing instead of risk-transferring. Shari'ah law requires both the financier and the entrepreneur to equitably share the profit as well as the loss. The financier can not shift the whole burden of losses to the entrepreneur or the borrower by fixing a predetermined interest rate. As a result of distribution of risk, financial institutions try to assess risks more

carefully. They also monitor the use of funds by borrowers more precisely. Some scholars believe that the double assessment of risks by both the financier and the entrepreneur results in a higher level of performance in Islamic finance in comparison with the conventional financing.¹⁰

Residential Mortgage Crisis Analysis:

Interest (riba) played a significant role in the gravity of the situation. According to the Shari'ah principles, making money from money is forbidden. The prohibition of interest and the rule of profit-and-loss-sharing in Islamic finance guarantee that both the lender and the borrower will rarely face with negative equity and default. Since loss of the borrower is also at the expense of the lender, banks and financial institutions are more prudent and are not caught in the trap of lending too much money to earn fixed interests. As it was discussed in the first part, the BIS believes that the root of almost all crises is excessive and imprudent lending by banks.

Financial crisis statistics show that nearly 80% of subprime mortgages issued in the US especially between 2004 and 2007 had "adjustable" rates of interest. As a result, when house prices began to decline in 2006, refinancing became more difficult and as adjustable-rate mortgages began to reset at higher rates, mortgage delinquencies soared. On one hand, subprime borrowers faced with the decrease in the price of their houses and on the other, they were required to pay more interest rates to the financier. In a word, it could be said that adjustable rates of interest consist the first step of the catastrophe.

Prohibition of uncertainty (maysir and gharar)

Shari'ah principle:

Certainty of terms in commercial transactions is a key requirement under the Shari'ah law. As a result, Islamic finance prohibits transactions based on gambling or speculation (maysir). Gambling in the context of Islamic finance refers to any transaction in which each party relies on pure chance, unknown events or contingencies. Gambling transactions are comparable to the notion of zero-sum game.¹¹

Also prohibition of uncertainty in commercial agreements requires that contractual agreements should be cleared from any uncertainty or hazard caused by lack of clarity regarding the subject matter

or the price in a contract or exchange. In other words, transactions based on principles of Islamic finance should not include any effective contractual ambiguity (gharar). The ban on gharar in commercial agreements implies that every party should know exactly the counter-value of what is offered and what is accepted in a transaction.

The word "gharar" in Arabic means "risk". According to the prophetic words (hadith), Muslims are forbidden from participating in transactions that they do not know completely. However, of course a degree of commercial uncertainty is acceptable but there must not be any major uncertainty about the key terms of the transaction resulted in major risk-taking by one party. For instance, in a sale agreement, in order to avoid gharar, parties should make sure that both the object of the sale and the price exist. Also, characteristics, quantity, quality and method of delivery of both the object of the sale and the price should be specified.

Residential Mortgage Crisis Analysis:

One of the major causes that considerably intensified the current financial crisis was the huge transaction of CDSs and synthetic CDOs by those who did not own MBSs or CDOs. These investors who bet speculatively on the default rate of mortgages, exposed insurers with extra risk whose obligated amount was several times more than the real mortgages issued by the lenders.

Under the principles of Islamic finance, it is acceptable that the lender asks the third party to give security for the borrower. In this way, it is also acceptable that the lender pays premiums, usually on the behalf of the borrower, to the third party for the compensation it will receive when the debtor defaults. So, the purchase of CDSs by the owners of MBSs (or CDOs) was Shari'ah-compliant. But, if someone who does not own MBSs, just purchases CDSs (or synthetic CDOs) due to his expectation of default for mortgages, acts as a gambler regarding to Islamic finance principles. This kind of transaction is considered as gambling since both the buyer and the seller of CDSs (or synthetic CDOs), without having any real economic interest, rely on pure chance and unknown events.

Furthermore, the increasing complexity of CDOs, which were the result of "securitization of securitizations", hid the underlined risk of these securities. So the investors, insurers and the rating agencies entered into a game with the huge "uncertainty". Under the Islamic finance principles, buying and selling complex CDOs are forbidden due to the lack of clarity regarding the subject matter of these securities.

¹⁰ Supra note 2 at 7; also Waleed Khana, Fatimah B. M. Iliasub, and Sajjad Chowdhry, supra note 25 at 7-8.

¹¹ Sami Ibrahim Al-Suwailem, "Decision-making under uncertainty: an Islamic perspective", in Munawar Iqbal, and David T. Llewellyn, eds., *Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk*, (Cheltenham: Edward Elgar Publishing, 2002), at 24-25, also Waleed Khana, Fatimah B. M. Iliasub, and Sajjad Chowdhry, supra note 25 at 5.

Prohibition on securitization of unreal assets

Shari'ah principle:

According to the popular opinion in Islamic law, securities should be definite real assets and pledges of intangibles are not admissible. Securitization is a means to assure the secured creditor that he will get his claim even if the debtor refuses to pay his debt. According to principles of Islamic finance, a collateral or pledge can not be a debt, since the assurance that securitization of a debt brings about for creditor is conditional; because the third party debtor whose debt has been securitized for another debt may not pay the debt on time. As a result, to provide the high level of assurance, Shari'ah law prescribes that "the object of collateral must be real, and pledging of a debt or a profit is void".¹²

According to the Shari'ah law the secured asset still remains in the property of the debtor. However because of the security right, secured creditor has legal power to sell the property on the behalf of the debtor and take his claim provided that the debtor refused to pay the debt on time. If the secured property is sold for the higher price, the remainder is for the debtor; and if it is sold for lesser price, secured creditor refers to the debtor for the remainder of his claim.

Residential Mortgage Crisis Analysis

The securitization of debt obligations was the engine of current financial crisis. Putting debt as the pledge of new debt not only increases the risk of defaults, but also makes the financial activities far from the real economy. For example, in 2006, the financial innovations such as collateralized debt obligations, attracted net financial inflow of approximately \$800 billion from the rest of the world to the United States; an amount that explicitly was greater than the absorption capacity of the US real economy.¹³

Regarding to Islamic finance principles, securitization of unreal asset, such as debt, is forbidden. Fundamental to Islamic finance is the requirement that financial transactions must be supported by real economic activity. So, the originate-to-distribute model, as well as issuing tranching mortgage backed securities and especially issuing collateralized debt obligations, could not be practiced under Islamic finance principles.

Conclusion

The current financial crisis resulted in a search for understanding the roots of the catastrophe and proposing potential solutions. While some economists and conventional finance scholars try to find cures for

current financial crisis through better economic policies, better resolutions, better regulations, and better supervisions, Muslim scholars believe that Islamic finance has the capacity to propose incomparable insights in the search for a new financial architecture.

The inherent features of Islamic finance have the potential to serve as a basis to address several of the issues and challenges that have plagued the conventional financial system. According to Shari'ah law, charging, paying, or receiving any kind of pre-determined interest (riba) is forbidden. Islamic finance emphasizes on a strong linkage to productive real economic activities and profit-and-loss sharing. Also, Islamic finance requires high level of transparency and certainty in commercial transactions. As it was discussed in this paper, if Shari'ah law had governed the residential mortgage transactions, the credit crisis would have been avoided.

The future of Islamic finance is promising; however its further growth and development depends on introducing organizational and jurisprudential regulations that would ensure its precise application. Also, it worth mentioning that the ultimate objective of Islamic finance (i.e. social justice and economic prosperity) can not be fully achieved only through legal stratagems trying to make conventional financing superficially compatible to Shari'ah law. Islamic finance scholars should go beyond finding Shari 'ah-compliant financial instruments, and try to innovate Shari 'ah-based ones.

References:

Legislation

1. Civil code of Iran

Secondary material: books

2. Bank for International Settlements, 78th Annual Report, (Basel: BIS Press and Communications, (Online available at: www.bis.org).
3. Hans Visser, Islamic Finance: Principles and Practice, (Cheltenham: Edward Elgar Publishing,
4. Jochen Felsenheimer & Philip Gisdakis, Credit Crises, (Germany: Wiley-VCH, 2008).
5. Mahmoud A. El-Gamal, Islamic Finance: Law, Economics, and Practice, (New York: Cambridge university press, 2006).
6. Marc Jarsulic, Anatomy of a Financial Crisis, (New York: Palgrave McMillan, 2010). Muhammad Ayub, Understanding Islamic Finance, (England: John Wiley & Sons Ltd, 2007).
7. Roy E. Allen, Financial Crises and Recession in the Global Economy, 3 ed., (Cheltenham: Edward Elgar Publishing, 2009).

Secondary material: articles

8. Aaron Unterman, "Innovative Destruction-Structured Finance and Credit Market Reform in the Bubble Era", (Winter 2009), Hasting Business Law Journal, 53.

¹² Article 774 of the Civil Code of Iran.

¹³ Supra note 5 at 113.

9. Hussein Alasrag, Global Financial crisis and Islamic finance, (published online at: <http://ssrn.com/abstract=1591563>)
10. John D Martin., "A Primer on the Role of Securitization in the Credit Market Crisis of 2007", in Robert W. Kolb, ed., *Lessons from the Financial Crisis*, (New Jersey: John Wiley & Sons, Inc., 2010), 199.
11. Larry Cordell, "The Contribution of Structured Finance to the Financial Crisis: An Introductory Overview" in Robert W. Kolb, ed., *Lessons from the Financial Crisis*, (New Jersey: John Wiley & Sons, Inc., 2010), 239.
12. Robert W. Kolb, "Incentives in the Originate-to-Distribute Model of Mortgage Production", in Robert W. Kolb, ed., *Lessons from the Financial Crisis*, (New Jersey: John Wiley & Sons, Inc., 2010), 209.
13. Sami Ibrahim Al-Suwailem, "Decision-making under uncertainty: an Islamic perspective", in Munawar Iqbal, and David T. Llewellyn, eds., *Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk*, (Cheltenham: Edward Elgar Publishing, 2002).
14. Waleed Khana, Fatimah B. M. Iliasub, and Sajjad Chowdhryc, "Preventing Residential Mortgage Crises: An Islamic Finance Perspective", (online published at <http://ssrn.com/abstract=1481984>).