

## A new beginning

**Several prominent countries have seen their economies being battered by falls in real estate prices as the effect of the credit crunch has taken hold, but Ralph Y. Liu believes that a new type of Islamic home finance, SwapRents, could create the kind of situation where mortgage foreclosures, securitisations and credit default swaps could become a thing of the past**

The more I looked into the concept of SwapRents as an Islamic finance application, the more I found out that ideologically, Islamic finance adherents could be much more receptive to the concept of newly shared economic ownership because of its inherent restriction on burdening people by borrowing and lending.

I believe that it would be much easier to introduce SwapRent-based economic ownership by letting renters gain the appreciation potential gradually, in order to achieve full home ownership, rather than from the opposite end, i.e. by letting homeowners give up the appreciation opportunities.

Loose credit rules for home loans created a situation whereby 'instant homeowners' tried to own more than they could actually afford (something that led to subprime) under the Western financial system which eventually led to the current undoing of some countries. The US, Ireland and Spain, for instance, being a case in point.

With SwapRents, a home-seeking person could start out as a regular renter for a residential property in a location of his choice. What happens then is that the bank will buy the property and put it into a trust or into a co-ownership legal structure for him. In the case of the trust, the person could buy into a portion of the legal ownership between zero per cent to 100 per cent. Five, 10 or 20 per cent could be a good starting point depending on the issuing bank's credit standard.

The 'homeowner' could, if he wanted, gradually buy into more of the legal ownership vehicle sooner or later at the then prevailing market price. Meanwhile through these new 'economic owning' or 'economic renting' concepts, the new home-occupier could make proper arrangements with the bank to become an 'economical owner or renter' for whatever proportion of the total value of the property any time, in a totally flexible and reversible manner (either by buying or selling) for whatever length of time through making SwapRent transactions.

Being a renter gives a person the rights to occupy and use a property. However, being an owner creates a situation where he could benefit financially if the value of the property has increased by the time he decides to sell. This is naturally in addition to the same rights to occupy and use that a typical renter would have during ownership. Of course the homeowner will also have to bear the risk of depreciation if he has to give up ownership prematurely at any given time.

**"IF THERE IS ENOUGH MONEY AT HAND THE HOME OCCUPIER COULD BUY INTO THE ENTIRE REMAINING LEGAL OWNERSHIP AT THE THEN CURRENT PRICE IN ORDER TO GAIN COMPLETE OWNERSHIP AT ANY TIME HE/SHE WISHES"**

Put simply, the cost differential between the cost to rent and the cost to own will determine whether a person will be entitled to future financial gains in the event the value of the property appreciates, but will bear the responsibility of any losses in the event of depreciation. Meanwhile he could continue to occupy and use the property regardless what the financial value of the property is.

For simplicity reasons, let's assume a property costs \$800,000. Since the real physical rental rates may be higher or lower than the SwapRent rates (especially the short term rates) depending on the market conditions in each country, let's assume the real rental rate of the property is 1.5 per cent per annum (\$1200 per month). It could certainly be lower or higher, say 2.5 per cent at other times,



as market supply and demand forces dictate.

The corresponding SwapRent for a five-year contract may be two per cent (\$1600 per month) and cost of ownership (e.g. MFC or Mortgage Funding Cost, in the Western financial system) may be five per cent per annum (\$4000 per month). The cost difference between economically renting and owning in this five-year SwapRent contract example is \$2400 a month.

Therefore, upon agreeing to pay \$1200 a month in real rental payments, the person could occupy and use the property for the next five years, say in this five-year contract example. He could decide to reversibly buy into the economic ownership units of between zero per cent to 100 per cent of the home value with a price tag of \$0 to \$2400 more a month in additional monthly payments. This would be on top of the rental payments (\$1200) he is already paying in his legal rental agreement, through Generic SwapRent contracts.

He could also sell the number of units of economic ownership for the remaining maturity of the contracts that he already bought before, for whatever reasons he may have at any time during the five-year period before maturity.

Furthermore, if he is only interested in obtaining future appreciation potential, he may pay a bit more in monthly payments to acquire that appreciation potential only with AG SwapRent contracts instead, so that he would not have to bear the downside risk if the property value goes lower in the future.

It should be easily understandable that an AG SwapRent contract will be more expensive than a corresponding Generic SwapRent contract since it will only give the acquirer the right of future appreciation without the responsibility of the risk of downside losses.

In a non-recourse mortgage loan, as is currently uniquely practiced in the US, the same financial profile could be simulated by conventional renting plus owning AG SwapRent contracts, i.e. appreciation only, by the home occupier.

Whereas for the rest of the world, where recourse mortgage loans are usually practiced, the financial profile is equivalent to conventional renting plus Generic SwapRent contracts, i.e. the ownership units (either conventional legal or the new economic) always come automatically with the responsibility of downside depreciation risks for the owners.

In addition to economic owning and renting, the home occupier could of course also decide to buy into the underlying legal ownership in the trust in a lump sum fashion (money obtained from savings, work related bonus compensations, a sale of other financial assets etc any time he wishes at the then future price level with the bank, which has been his co-owner in the trust.

If there is enough money at hand the home occupier could buy into the entire remaining legal ownership at the then current price in order to gain complete ownership at any time he/she wishes. However, since the legal ownership comes with very high transactional costs and many other legal and tax complications, it does not offer the same liquidity, flexibility and reversibility that making SwapRent transactions could easily provide.

For example, to sell back portions of the legal ownership would be quite difficult under the current Islamic mortgage practices. With the innovative economic owning/renting concepts, when the home occupier does not have enough monthly income to sustain this economic ownership, he/she will simply lose part of the future appreciation potential that is represented by the economic ownership units that he/she owns.

There will no longer be a reason for foreclosing and eviction, unless the occupier/owner cannot even pay for the normal real rental payments. The social safety net of providing rental payment assistance to unemployed people is a totally separate issue and it is usually provided in each developed country.

Most likely the social safety net would kick in to allow the home occupiers to continue to stay in their homes to look for another job. This is exactly how the newly created flexible economic ownership concept set facilitated by the SwapRent methodology could help avoid defaults and foreclosures and enhance social stability in a new housing finance system.

Banks which provide SwapRent-based Islamic mortgages could similarly use SwapRent contracts traded at places like REIDeX.com with other investors around the world to hedge off their own financial and property risks from being a temporary co-owner in the co-ownership trusts with the local homeowners. The provider bank could then act solely as a middleman without having to hold any of the market risks of these real estate properties.

The middleman banks, local governments or housing agencies could charge a fee or a spread for the services provided either as a for-profit business or as a self funded not-for-profit entity.

None of these new transactions or mortgage products described above involves the Riba concept, or the charging interests on the use money, that Shari'ah forbids.