Guidance White Paper Series
Number One

MODERN FINANCE
TIMELESS VALUES

THE DECLINING BALANCE CO-OWNERSHIP PROGRAM

AN OVERVIEW

This paper describes and answers some of the most frequently asked questions about the Declining Balance Co-ownership Program, which is offered by Guidance Residential LLC, a wholly owned subsidiary of Guidance Financial Group, LLC.

Guidance Residential's mission is to offer the growing number of Sharia-sensitive households the opportunity to access financial products that are competitive and of the highest quality without having to compromise their values and principles.

With this in mind, Guidance has created the Declining Balance Co-ownership Program, a unique, soundly designed home financing program in the United States that is competitive and, most importantly, Shariah-compliant. In addition, Guidance has gathered a group of professionals committed to delivering this product with only the highest level of service. Customers can employ this product both to purchase a home as well as to replace an existing conventional mortgage.

THE SHARIAH SUPERVISORY BOARD

The Declining Balance Co-ownership Program was developed in close cooperation with Guidance's Shariah Supervisory Board and is formally certified for Shariah compliance. An independent body, Guidance's Shariah Board is comprised of distinguished scholars from around the world. The Shariah Board actively participates in developing and overseeing the company's products. It is responsible for certifying every product to ensure strict adherence to the principles of Shariah.

The Board includes Shariah scholars who are among the world's leading experts in Islamic law as applied to financial transactions. They are all internationally recognized authorities and serve on the Sharia boards of many of the world's leading Islamic banks and financial institutions. They are active in teaching and research, and have authored numerous books and articles.

Biographies of members of the Shariah Board can be found on page 12. A copy of the Shariah Board's fatwa certificate regarding the Declining Balance Co-ownership Program can be found on pages 10 and 11.

A UNIQUE PROGRAM

At the heart of the Declining Balance Co-ownership Program is a distinctive partnership that allows customers to purchase a home in a Shariah-compliant manner. The first step that the customer takes on this path to home ownership is to bring in Guidance as a co-owner in a home. This partnership is established by the use of a Co-ownership Agreement rather than conventional loan documentation. The rights and responsibilities of both parties while they own the home together are spelled out in the Co-ownership Agreement.

The customer and Guidance are co-owners who own specific shares in the home. Guidance acquires its co-ownership stake through a Limited Liability Company (or 'LLC') specifically created for this purpose. In the case of a home purchase, a customer finds a home that is priced to sell, for example, at $100,000. The customer can place 5% (or $5,000) into the transaction, while Guidance provides the remaining 95% (or $95,000). The customer is 5% owner; Guidance is 95% owner.

If replacing an existing mortgage, an appraisal will be done to determine the value of the home. For example, a home is appraised at $100,000 and has an existing mortgage with a balance of $70,000. Guidance would pay off the mortgage balance. Since the home was appraised at $100,000, Guidance would now be 70% owner of the home. If the customer requests the cash-out option in this example, Guidance could provide an additional $20,000 of financing by increasing its ownership in the property to 90%.

Guidance may introduce other investors to take a co-ownership stake in the property. In doing so, Guidance's objective is to continue to service its customers' needs to their satisfaction and to ensure that investors will always be bound by their rights and obligations as co-owners in the property.

MONTHLY PAYMENTS

Although both co-owners would have the right to occupy the property in this transaction, Guidance gives the customer the exclusive enjoyment and use of the whole property. In exchange for this exclusive right, Guidance requires a charge, or a 'Profit Payment', to be paid by the customer. This Profit Payment is based on a competitive rate of return that is charged on Guidance's ownership share. This charge is included in the regular monthly payment the customer will be responsible to pay.

The customer's monthly payment amount consists of two elements. The first portion is the Profit Payment described above. The remaining portion of the monthly payment allows the customer to acquire an increasing share of ownership in the home – this is called the Acquisition Payment. Together, these two amounts make up a predictable monthly amount that is competitive with the monthly payments offered in a conventional mortgage. As the customer makes Acquisition Payments to acquire a further share in the property, Guidance's ownership share decreases. This creates the declining balance nature of the program.

ACQUIRING A HOME AT ONE'S OWN PACE

In order to achieve over time full home ownership, the customer commits to buy Guidance's share of the property over a period of 15, 20 or 30 years. In the first example above, Guidance obtained a share of the home for $95,000. The customer acquires Guidance's share for the same $95,000 price through a series of monthly Acquisition Payments. At any time, the customer also has the option to acquire Guidance's share in the property at a faster pace than the predetermined Acquisition Payments or even entirely buy out the property. There are no additional fees or penalties associated with this option.

Suppose the customer decides to move out of the property before the end of the financing period. The customer can do so by first aquiring Guidance's remaining ownership share and then, in a second step, turning around and selling the property in the market. The second step normally takes place immediately after the first step during a single settlement, allowing the customer to use the proceeds of the sale to pay the amount owed to Guidance for its remaining share. Naturally, because the customer is 100% owner of the property at the point it is sold in the market, the customer will retain the full gain (or loss) resulting from this sale.

HOME OWNERSHIP WITH PEACE OF MIND

All of these unique elements, when put together, comprise Guidance's Declining Balance Co-ownership Program. This distinctive program enables homeowners to achieve a vision that is increasingly shared by many – to honor the principles of Sharia while benefiting from the best of what is available in the modern financial marketplace.

COMMON QUESTIONS

1. What is the difference between the Declining Balance Co-ownership Program and a mortgage loan?

The Declining Balance Co-ownership Program differs from a mortgage loan primarily by the nature of the transaction, in particular the relationship between the parties involved. In a loan transaction, the lender advances funds to the borrower in exchange for a future repayment of the funds plus interest. Interest on such a loan amounts to an exchange of cash for a greater amount of cash in the future and is considered prohibited riba under Sharia.

On the other hand, the Declining Balance Co-ownership Program is based on an entirely different concept known as diminishing musharaka. The relationship between Guidance and the customer is that of co-owners in a property and not one of lender-borrower. The initial financing provided by Guidance is applied to acquire a share in the property and not to provide a loan. The customer's monthly Acquisition and Profit Payments are applied, respectively, to acquire Guidance's share in the property and for the customer's exclusive use of the whole property. These payments do not constitute a repayment of a loan with interest. This transaction does not involve an exchange of cash for a greater amount of future cash, which would give rise to riba.

Notwithstanding its fundamental difference with a loan, the Declining Balance Co-ownership Program is designed to provide customers benefits equivalent to what is offered by a conventional mortgage, but in a manner that complies with Sharia. The Program allows customers to acquire their homes at their own pace through pre-determined monthly payments that are competitive with what is charged under a conventional mortgage. What is important is to ensure the integrity of the transaction by respecting the rights and obligations of the two parties throughout the co-ownership arrangement. [1]

An essential difference between modes of financing that are acceptable under Shariah and loans that incorporate riba is that the financier is not permitted to profit from financial distress. No interest may be charged on late payments. The only late payment fees that are acceptable are those that cover the expenses involved in pursuing the collection of such payments.

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[1] A financial transaction can be permissible even though it provides a similar benefit to another transaction of a prohibited type. The Companion Bilal (r) once informed the Prophet (s) that he exchanged two measures of low-quality dates for one measure of high-quality dates. To this, the Prophet (s) replied: "Woe! This is the essence of riba. Do not do so, but if you want to buy the [high-quality] dates, sell [the low-quality dates] in a separate bargain and then buy [the high-quality dates] with its proceeds." (*Bukhari and Muslim*)

2. How does Guidance determine the Profit Payment?

The Declining Balance Co-ownership Program has been designed to provide a Sharia-compliant alternative to conventional mortgage lending. Despite the distinct nature of this program, customers will naturally insist that their monthly payments be competitive with what they would have to pay in the conventional market. For this reason, Guidance determines the Profit Payment offered to its customers to be competitive with prevailing interest rates. However, the manner in which the Program is priced does not change its co-ownership nature and does not turn the monthly payments into a repayment of a loan with interest. This is so regardless of whether the Profit Payment is quoted as a dollar amount or a percentage rate. An analogy can be found in the following simple example. Halal potato chips may be offered at the same price as a famous brand of potato chips that contain lard. The pricing of the potato chips, though the same, does not alter the nature of the product.

Profit Payments may even be adjustable and linked to an interest rate index (subject to certain caps). Sharia scholars have determined this practice to be permissible for the same reasons discussed above. Pricing does not change the nature of the product. Naturally, the use of an Islamic financing index – if one existed – would be preferred.

3. Does Guidance charge interest on late payments?

No interest on late payments is charged under the Program. Such interest would amount to a form of riba, which is strictly prohibited by Shariah. The one type of charge that is permissible under Shariah is a fee that covers the expenses involved in pursuing the collection of a late payment. Under the Program, this fee is currently set at $50 per late payment and has been approved by the Shariah Supervisory Board. To determine the fee amount, Guidance retained the STRATMOR Group to conduct a study designed to estimate the cost of collecting late payments. The STRATMOR Group is acknowledged to be one of the most reliable providers of mortgage banking benchmarking data in the country.

4. Does Guidance utilize external funding for the Program?

The Declining Balance Co-ownership Program has been designed to comply with Shariah principles from A to Z – from the point when a customer enters a home financing transaction to the point where the ultimate funding for that transaction is provided. Guidance obtains external funding for the Program through an agreement with Freddie Mac, a corporation chartered by Congress to support the home financing market. In this agreement, Freddie Mac makes investments to take a co-ownership stake in properties financed under the Program. At a second stage, Freddie Mac creates Shariah-compliant securities invested in the co-ownership assets.These securities will be offered by Guidance to Islamic banks and other Islamic capital market participants around the world. These securities constitute a significant innovation that contributes to the development of the international Islamic finance market.

5. *What happens if a customer experiences difficulties in making monthly payments?*

In the unfortunate event a customer experiences difficulties in making monthly payments, a specialized team will be responsible for contacting the customer and discussing the situation. The team's objective is to work out a satisfactory arrangement that accommodates the customer's circumstances and allows for the continuation of the co-ownership relationship. At the same time, the team is also responsible to protect the rightful position of the customer's co-owner.

Under certain circumstances, the situation may call for foreclosure. Under the Co-ownership Agreement, the customer commits to make scheduled monthly payments and fully acquire the property over time. If the customer fails to abide by this commitment, the Co-ownership Agreement allows the co-owner to foreclose and sell the property in order to reclaim its rights. From the sale proceeds, the co-owner recovers the funds that it would have obtained had the customer fully bought out its share of the property as well as other amounts that may be due. After the co-owner has been compensated, any surplus from the sale proceeds would be given to the customer.

It is important to note that, under Shariah, the co-owner can recover funds it would have obtained in the absence of a default by the customer, but in no way would it be allowed to profit from the customer's financial distress by charging interest on late payments. In fact, the Co-ownership Agreement goes a step further. With a view of providing some ease in the case of financial distress, it incorporates a unique "non-recourse" clause that protects all of the customer's assets other than the property from being subject to foreclosure.

6. *Why do some of Guidance's disclosures use the word "interest"?*

State and federal government agencies, including the Department of Housing and Urban Development and the Internal Revenue Service, require home finance companies in the United States to provide their customers with various standard disclosures and representations. These mandatory disclosures utilize standard lending terminology – such as "loan", "interest", "lender" and "borrower" – that do not correspond to the nature of the Declining Balance Co-ownership Program. Furthermore, the government has yet to approve modifications to these disclosures to adapt them to the Program and other transactions in which interest is not present.

The Shariah Supervisory Board has reviewed this matter and issued a fatwa that can be viewed on Guidance's website. The Board concluded that these disclosures do not modify or invalidate the Shariah-compliant contract to which the customer is committing. Consequently, these mandated disclosures may be used without affecting the Shariah-compliant nature of the Program.

7. Would Guidance share in any gain or loss that may result from a sale of the property?

The Declining Balance Co-ownership Program is designed to create a co-ownership for the purpose of providing the customer with financing to acquire a home. It is not designed as a commercial partnership for the purpose of making profit from trading in real estate. Consequently, the Program is intended for the customer to fully buy out Guidance's share in the property over time, and not for the two co-owners to sell the property jointly and share the gains.

However, it is often the case that the customer decides to move out of the property earlier than the scheduled term of the financing. The Program provides customers with the flexibility to do so by first acquiring Guidance's remaining ownership share and then, in a second step, turning around and selling the property in the market. The second step normally takes place immediately after the first step during a single settlement, allowing the customer to use the proceeds of the sale to pay the amount owed to Guidance for its remaining share. In this case, the customer is 100% owner of the property at the time of the sale and, therefore, has the right to the full gain (or loss) resulting from this sale.

Although the Program is not intended for the two co-owners to trade the property in the market while they own it jointly, this can happen if the government were to impose on the co-owners to sell the property in order to make room for a road, a park or another public project. In that case, the Co-ownership Agreement specifically stipulates that the two co-owners would share the gains or losses from such a forced sale according to their ownership shares. As a result, Guidance may end up with proceeds that fall short of the amount of financing it had provided, in contrast with what would be owed under a conventional mortgage loan.

The principle that the two co-owners should share in the gains and losses of their respective shares in the property applies to situations other than a sale. Consider the example of a property that suffers total destruction and cannot be repaired using available insurance proceeds. In this case again, the Co-ownership Agreement stipulates that the two co-owners would share the insurance proceeds according to their ownership shares, resulting in an outcome quite different from that of a loan.

8. Who is responsible for property taxes?

Generally speaking, property taxes are imposed by local government authorities to pay for public services, such as public schools and libraries, police, fire and rescue, street cleaning and waste collection. Most of these public services directly benefit the occupant of the property as opposed to a non-resident co-owner. For this reason, it is fair that the customer, who is the exclusive occupant of the property and principal beneficiary of local public services, be responsible for property taxes.

9. Does Guidance go on record as a co-owner on the title of the property?

Guidance normally goes on record as co-owner on the title of the property in cases where this does not place the customer at a tax disadvantage. However, there are a number of states where adding Guidance to the title exposes the customer to additional taxes. In these circumstances, Guidance's Sharia Supervisory Board has found no objection to keeping Guidance off title. Under Shariah, the sale of an ownership stake takes effect upon the offer and acceptance of a contract and is considered valid even if it is not registered in the public records.

10. Who pays for insurance on the home?

Home insurance policies are typically offered as a standard package that includes three types of coverage:

a) property hazard coverage, which protects against damage to the structure of the home;
b) personal possessions coverage, which protects against damage to the contents of the home;
c) personal liability coverage, which protects against a third-party liability claim or lawsuit that may result, for example, from a visitor slipping and falling on an icy porch.

In principle, as co-owners in the property, Guidance and the customer should jointly be responsible for the cost of property hazard coverage. On the other hand, as the exclusive occupant of the property, the customer should solely be responsible for the cost of personal possessions coverage and personal liability coverage. Guidance does not own any of the home's contents and is not responsible for any actions of the occupant that may result in a third-party liability claim.

In practice, it is difficult to separate the cost of property hazard coverage from the other types of coverage. Home insurance policies usually offer a standard comprehensive package. Obtaining separately a property hazard policy and a personal possessions and personal liability policy can be significantly more expensive and is often unavailable. For this reason, the Program allows for the customer to be responsible for obtaining a comprehensive insurance policy and offers a cost of financing that reflects the fact that the customer is in charge of the full cost of insurance.

11. Does the Program require customers to take on mortgage insurance?

In the U.S. mortgage industry, private mortgage insurance (known as "PMI") is generally required for people who seek to finance a property by putting down less than 20% of its value. A down-payment below 20% increases the financier's financial risk. The PMI policy protects the financier against the risk of default.

While conventional PMI transactions are objectionable under Shariah, Guidance has developed an alternative arrangement that is designed to comply with Sharia. Under this alternative arrangement, a customer who puts down less than 20% of the value of a property is not required to obtain a PMI policy. Instead, the customer makes Profit Payments that are higher by an amount equivalent to the cost of PMI. This alternative structure has been approved by the Shariah Supervisory Board in a fatwa that can be found on Guidance's website.

بسم الله الرحمن الرحيم

Declining Balance Co-Ownership Home Acquisition Program

Fatwa

الحمد لله رب العالمين
والصلاة والسلام على خاتم الأنبياء والمرسلين وعلى آله وصحبه أجمعين

We, the Shariah Supervisory Board of Guidance Financial Group, LLC (Guidance) have examined the documents of the Declining Balance Co-Ownership Home Acquisition Programs, inclusive of the Co-Ownership Agreement, Security Instrument, Consumer's Obligation to Pay, and Assignment of Agreements, all of which are required for each program.

We have reviewed these documents and the purposes for which they have been designed, namely:

1. to assist Muslims and others residing in the United States of America to acquire their homes in compliance with Shariah,

2. to enjoy the tax benefits accorded by the federal government to home owners,

3. and for the investors to securitize their ownership investment in homes.

The basic concept behind these contracts and documents is that the property is purchased in joint ownership between an affiliate of Guidance (the Co-Owner) and the person who requires finance (the Consumer). The Consumer makes monthly payments which are comprised of Profit Payments and Acquisition Payments. Profit Payments represent the Consumer payments for the enjoyment and use of the whole property, while Acquisition Payments represent the Consumer's payments for his acquiring the Co-Owner's interest in the property.

It has been ascertained by the Shariah Supervisory Board that the documents comply with the Shariah requirement for a valid "Diminishing *Musharakah*" arrangement, and that both parties benefit and bear the risks of their respective shares in the property throughout the contractual arrangement.

The documents designed for "Replacement" are meant for a situation where a person has already acquired a property and wishes to enter into a Shari'ah compliant arrangement. In this case, he will sell a share of his property to the Co-Owner, and then both parties will have the same arrangement of "Diminishing *Musharakah*" as detailed above. Since the units of property will be purchased by the Consumer under this arrangement at cost, and without increase, there is no element of 'ina in this arrangement.

After reviewing the mechanism as well as the agreements and documents, and after suggesting amendments that have been incorporated, the Shariah Supervisory Board is of the view that given the circumstances prevailing in the United States, this arrangement conforms to the rules and principles of Shariah; and therefore, Muslims may avail themselves of this opportunity to acquire homes and properties by means of this method.

Agreed this 21st of October 2002

Justice Muhammad Taqi Usmani

Dr. Abdul Sattar Abu Ghuddah

Shaykh Nizam Yaquby

Shaykh Yusuf Talal DeLorenzo

Dr. Muhammad Imran Usmani

Dr. Mohamed Elgari

GUIDANCE FINANCIAL GROUP
SHARIAH SUPERVISORY BOARD

Justice (Ret.) Muhammad Taqi Usmani, *Chairman* (Pakistan)* - Justice Usmani is one of the leading Islamic scholars living today. He is an expert in the fields of Islamic law, Islamic finance and *hadith*. He has been teaching for 35 years at Darul Uloom in Karachi, which was established by his father, Mufti Muhammad Shafi, the late Grand Mufti of Pakistan. He is Vice President of Darul Uloom Karachi, Deputy Chairman of the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC) and a former Judge at the Sharia Appellate Bench of the Supreme Court of Pakistan. He is also the author of more than forty books, including the English-language reference work *An Introduction to Islamic Finance*. Justice Usmani has played a key role in the move toward interest-free banking and the establishment of Islamic financial institutions around the world. He is a member of the Shariah Supervisory Boards of Citi Islamic Investment Bank, Saudi American Bank, Abu Dhabi Islamic Bank, Dallah Al-Baraka Group and First Islamic Investment Bank, among others. Justice Usmani holds *Alimiyyah* and *Takhassus* degrees from Darul Uloom, Karachi, an M.A. degree from Punjab University and an L.L.B. degree from Karachi University.

Shaykh Abdul Sattar Abu Ghuddah (Syria)* - Dr. Abu Ghuddah is a Director of the Department of Financial Instruments at Al-Baraka Investment & Development Company and a member of the Shariah Supervisory Boards of several Islamic financial institutions. He is an active member of the OIC Islamic Fiqh Academy and of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOFI). He was responsible for research and compilation for the *Encyclopedia of Fiqh* of the Kuwait Ministry of Awqaf and Islamic Affairs and is a former member of the Ministry's *Fatwa* Board. He has taught *fiqh* and Islamic studies in Kuwait and Saudi Arabia. Dr. Abu Ghuddah obtained B.A. degrees in Islamic Sharia and in law from Damascus University. He then went on to earn his M.A. in Shariah and *hadith* and his Ph.D. in Sharia and comparative *fiqh* from Al-Azhar University, Cairo.

Shaykh Nizam Yaquby (Bahrain)* - Shaykh Yaquby has contributed important original research on many aspects of modern Islamic finance, and is considered a leading expert in the field. He is a member of the Shariah Supervisory Boards for several Islamic financial institutions, including Citi Islamic Investment Bank, HSBC Amanah Finance and Abu Dhabi Islamic Bank. Since 1976, he has taught *tafsir, hadith* and *fiqh* in Bahrain. He is also the author of several articles and publications on Islamic finance and other sciences in English and Arabic. Shaykh Yaquby received his M.S. in Finance from McGill University in Montreal. He was educated in the classical Shariah sciences in his native Bahrain and in Makkah.

Shaykh Yusuf Talal DeLorenzo (United States)* - Shaykh DeLorenzo is a scholar with over twenty-five years of experience in teaching, research and translation, in particular, of Islamic law relating to financial transactions and investments. He has authored numerous essential resource works on the subject of Islamic banking and finance, including the three-volume *Compendium of Legal Opinions on the Operations of Islamic Banks*. He was a pioneer in Internet education with a course entitled "Principles of Islamic Investing" and has been a contributor to the Harvard Islamic Finance Information Program. Shaykh DeLorenzo is a member of Shariah Boards of several Islamic financial institutions internationally. He has served as secretary of the Fiqh Council of North America and was also an advisor on Islamic education to the government of Pakistan. Following a university education in the United States, Shaykh DeLorenzo studied Arabic and the Classic Islamic Disciplines in Egypt and Pakistan under noted scholars.

Dr. Mohamed A. Elgari (Saudi Arabia) - Dr. Elgari is Professor of Islamic Economics at King Abdulaziz University in Jeddah, Saudi Arabia, and formerly Director of its Center for Research in Islamic Economics. He is a member of the OIC Islamic Fiqh Academy and of the Academic Committee of the Islamic Development Bank. Dr. Elgari advises numerous Islamic banks and financial institutions worldwide. He authored several books and research papers on the subject of Islamic finance – including a widely used textbook on Islamic Economics – and frequently lectures on the subject. He is a member of the editorial boards of the Harvard Law School's *Harvard Series in Islamic Law and of the Review of Islamic Economics*. Dr. Elgari holds a Ph.D. in Economics from the University of California.

Dr. Mohamad Daud Bakar (Malaysia)* - Dr. Bakar was an Associate Professor in Islamic Law and the Deputy Rector, Student Affairs and Development, at the International Islamic University, Malaysia. His areas of specialization include Islamic Legal Theory, Islamic Banking and Finance, Islamic Law of Zakah and Islamic Medical Law. Besides his teaching and research assignments, Dr. Bakar provides Sharia consultancy, structuring and advisory services to various Islamic financial institutions. Dr. Bakar is currently a Shariah Advisor to Guidance Financial Group and a member of the Shariah Supervisory Board of esteemed organizations such as the Securities Commission of Malaysia, the Central Bank of Malaysia, Takaful Nasional Berhad, HSBC (Malaysia), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain, the Dow Jones Islamic Market Index and the Malaysian Rating Corporation Bhd. Dr. Bakar obtained his Bachelor of Sharia from the University of Kuwait in 1988 and was later conferred with a Ph.D. from the University of St. Andrews, Scotland. He also recently obtained a Bachelor of Jurisprudence from the University of Malaya.

Dr. Muhammad Imran Ashraf Usmani (Pakistan) - Dr. Usmani has been teaching Islamic sciences for the past fifteen years in Jamia Darul Uloom Karachi and has published several books and articles, including Meezan Bank's Guide to Islamic Banking. Dr. Usmani also serves as a Shariah Supervisory Board Member / Shariah Advisor to: State Bank of Pakistan, HSBC Amanah Finance, Credit Suisse, Lloyds TSB, Meezan Bank, Pak Kuwait Takaful Co and others. Dr. Usmani holds LLB, M.Phil. and Ph.D. degrees in Islamic Finance from Karachi University as well as *Alimiyyah* and *Takhassus* degrees in Islamic Jurisprudence from Jamia Darul Uloom Karachi.

* Member of Shariah board for the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)