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Sale with the temporary exclusion of usufruct

A critical examination of its use in financing home purchases

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Exclusion of usufruct

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Abstract

Purpose – This paper aims to investigate sale with the temporary exclusion of usufruct, a format debated in classical Islamic jurisprudence. More specifically, it examines the application of this sale format in the diminishing partnership arrangement used by American Finance House LARIBA to finance house purchases. It analyzes the Shari'ah issues and assesses the risks involved.

Design/methodology/approach – The research is qualitative, surveying and critically analyzing classical *fiqh* literature and contemporary juristic resolutions, as well as LARIBA's financing documents. Finally, it systematically surveys the associated risk factors, first qualitatively, and then by quantifying them.

Findings – The research concludes that sale with the temporary exclusion of usufruct is a valid contract in Islamic law. When the usufruct is priced at market rate, the financing arrangement is genuinely Islamic and brings added value. Moreover, it is very effective in addressing risks for Islamic banks, particularly in countries with legal systems not designed to accommodate Islamic finance.

Originality/value – This study systematically examines all aspects of a contract that has not received sufficient academic attention, that has been underutilized by the Islamic finance industry and that is more fitting for implementation than many of the contracts currently being used.

Keywords Home financing, American finance house LARIBA, Diminishing partnership, Sale with exception, Usufruct

Paper type Research paper

Introduction

Modern Islamic finance was founded on the Qur'anic distinction between interest-based loans, which are prohibited, and deferred-payment sales with mark-ups, which are



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permissible (Qur'ān, 2:275; 2:282). The mark-up in a deferred-payment sale reflects the difference between the buyer's/debtor's immediate enjoyment of the purchased item and the seller's/creditor's delayed enjoyment of the price.

There are many forms of sales in Sharī'ah (Islamic law). The most common form transfers ownership of an asset and its usufruct to the buyer with immediate effect. A lease, on the other hand, transfers ownership of the usufruct for a specified period of time for a consideration. When the period expires, the asset and its usufruct revert to the original owner.

A much rarer form of sale transfers ownership of the asset to the buyer, but allows the owner to retain ownership of the usufruct for a stipulated period. The following question arises: Why would a buyer accept such a contractual condition? The ultimate point of a sale, after all, is to be able to enjoy the usufruct, either directly or by selling it. In the era of the Prophet (Peace Be Upon Him), the motive was primarily courtesy and largesse.

Some modern *fiqh* (Islamic jurisprudence) scholars have mentioned sale with the temporary exclusion of usufruct as a potential financing tool that offers benefits to both the buyer and the seller. The Islamic finance industry as a whole has, however, not used it much. A notable exception is American Finance House LARIBA, which uses it as the basis for financing the purchase of houses, real estate and cars, among other uses.

LARIBA's use of a sale with the temporary exclusion of usufruct, combined with diminishing partnership, has been the subject of criticism on Sharī'ah grounds. This calls for an investigation of the Sharī'ah issues related to sale with the temporary exclusion of usufruct in general and how LARIBA implements it in particular.

Research objectives

The research aims to achieve the following objectives:

- To explain the concept of sale with the exception of the usufruct and distinguish it from related concepts.
- To determine its legal status in the Sharī'ah.
- To examine how it is applied in Islamic finance by American Finance House LARIBA.
- To analyze the operational problems and risks associated with it.

Methodology

This research is qualitative. It surveys the classical and contemporary *fiqh* literature that discusses sale with the exception of usufruct. Moreover, it clarifies how the issue fits into the framework of juristic theories about the right of ownership and its subdivisions. It critically analyzes the evidence and arguments put forward by opposing schools regarding sale with the exception of usufruct. It chooses the weightiest view and points out the considerations that make it so. It then explores the numerous related *fiqh* issues that arise from the implications of the chosen view. On another front, it examines the way LARIBA implements sale with the exception of usufruct by scrutinizing its documents and the order of steps in the process. Due attention is given to financial, legal and regulatory environments in which it operates. Then the risks associated with this financing format are analyzed one by one – first, qualitatively and then by means of numerical weighting. These are compared with the risks of other contracts used in the Islamic finance industry. The aim is to determine the relative fitness of this novel financing format.

Sharī'ah issues in sale that excludes the usufruct

The major jurisprudential schools differed over the permissibility of a sale that excludes the usufruct for a stipulated period. The Shāfi'īs and Ḥanafīs disallow it (Al-Kāsānī, 1986; Al-Nawawī, 1996), whereas the Mālikīs and Ḥanbalīs allow it (Ibn Rushd, 1988; Ibn Qudāmah, 1997). The weightiest view is that it is permissible in the Sharī'ah.

The most important evidence in this regard is the *ḥadīth* of Jābir ibn 'Abd Allāh, who recounted that Allah's Messenger (Peace Be Upon Him) offered to buy his camel from him while they were both on a journey. Jābir accepted the offer on the condition that he be allowed to continue riding it until reaching home, which the Prophet accepted. When Jābir returned home, he delivered the camel to the Prophet, who paid him for it. After Jābir left the contract session, the Prophet sent someone to call him back. The Prophet then returned the camel to him (Al-Bukhārī, 2002; Muslim, 2006).

The *ḥadīth* is indisputably authentic so the scholars who did not accept its obvious implications attempted to explain it away. They argued that the Prophet's real intention was to give charity to Jābir; thus, the incident is not relevant to a real sale. This explanation is weak because all of the components of an actual sale were realized: a willing offer, willing acceptance, and delivery of each counter-value to the other party. It was only after the sale had been fully concluded that the Prophet called Jābir back to give him his camel. The argument that this was not a true sale is particularly surprising when presented by Shāfi'ī scholars. It is they, after all, who are famous for their dismissal of intention in judging the validity of a contract that meets the formal requirements.

Jābir's *ḥadīth* describes a specific incident; as such, it does not have a general indication. Its relevance to other cases would have to be established on the basis of analogy. However, there is also a statement of the Prophet (Peace Be Upon Him) which does have a direct general import: Jābir related that Allah's Messenger (Peace Be Upon Him) forbade *al-thunyā* unless it is defined (Al-Tirmidhī 1996, *ḥadīth* no. 1290; Al-Nasā'ī, n.d., *ḥadīth* no. 4647).

Both sides agree that *thunyā* means "exception" and that the exception he was referring to is an exception in a sale (Al-Nawawī, n.d., p. 981). The opposing side cites the *ḥadīth* by an unrestricted wording that mentions that only the Prophet (Peace Be Upon Him) prohibited *al-thunyā* (Muslim, 2006, *ḥadīth* no. 1536). It is, however, an established principle of *fiqh* that a general wording cannot be understood comprehensively when there is authentic evidence that excludes some members of the general set. In this case, it is an authentic variant wording of the same *ḥadīth*, which clarifies the intended meaning by limiting the prohibition to exceptions that are vague and open-ended.

Some of the *ḥadīths* cited by those who prohibit a sale with the exclusion of usufruct are not authentic. As for the authentic ones, the textual Sharī'ah evidence cited in favor of permissibility trumps them on the basis of specificity. These *ḥadīths* are more specific, while the opposing evidence is more general.

The main basis for the opposing view is actually a deduced juristic principle: that the exclusion of usufruct from a sale violates the *muqtaḍā al-'aqd* (the nature and purpose of the contract). Its proponents argue that the purpose of a sale contract is to transfer the price to the seller and the object of sale to the buyer. They further argue that the object of sale includes the asset along with its usufruct (Al-Zarqā, 2004). It is conceded that permanent exclusion of the usufruct would violate the *muqtaḍā al-'aqd*. However, the Sharī'ah evidence that allows its exclusion for a defined period is too authentic and too specific to be dismissed or convincingly explained away.

The Mālikīs prescribed certain periods of time for the valid retention of the usufruct by the seller, periods that vary according to the object of sale (Ibn Rushd, 1988). None of these periods is based on any Sharī'ah texts; they are purely the results of *ijtihād* (reasoning).

That being the case, it is not surprising that there was marked disagreement among Mālikī scholars regarding the specific time limits. The Ḥanbalī School refrains from prescribing any such period, leaving it to the contracting parties to negotiate a period satisfactory to both of them (Al-Zarqā, 2004). The wisdom of this approach is manifest in its conceptual clarity. It refrains from imposing abstract arbitrary numbers from the mind of a jurist upon rational adults capable of deciding what suits them in particular cases.

One of the most practical implications of the permissibility of a sale with the exclusion of usufruct relates to responsibility for maintenance of the sold asset that is the source of the usufruct. This was a sub-issue that only Mālikī and Ḥanbalī jurists would have discussed because the other schools disallowed the entire arrangement. Ḥanbalī scholars ruled that the buyer is responsible for major maintenance because he is the owner of the underlying asset (Al-Buhūtī, 1983). The expenses related to the asset whose usufruct has been excluded are the responsibility of the seller during the exclusionary period because he is the owner of the usufruct. However, if he leases it to the buyer, then the responsibility for the expenses transfers to the buyer. The reasoning behind that is clear: the buyer now owns the asset as well as its usufruct for the lease period.

This *fiqh* ruling makes this type of contract more Sharī'ah-compliant than the financing leases that many Islamic financial institutions (IFIs) use. These are structured as operating leases that end with a separate contract that transfers ownership of the leased asset to the lessee. During the leasing period the contract is supposed to be subject to the Sharī'ah rules for *ijārah* (leases). One of the fundamental rules of *ijārah* agreed to by all jurists is that the owner of the asset is responsible for major maintenance. This rule is routinely ignored in the stipulated terms of financing leases, which make the lessee responsible for major maintenance.

Implementation of LARIBA's declining participation in usufruct model

LARIBA uses a sale with the exclusion of usufruct in the following manner for home financing: it has negotiated with US Government-sponsored enterprises (GSEs) like Freddie Mac and Fannie Mae to act as agents for them in the home financing process (Abdul-Rahman, 2010). Some jurists have raised this as a Sharī'ah issue (Assembly of Muslim Jurists of America, 2014), but that is a hasty judgment. Although these GSEs normally securitize conventional mortgages, they have agreed to the contractual structure proposed by LARIBA for its home financing products. The GSEs do not mind because the effect of the arrangement is a monthly payment that adds up to a larger amount than the original financing amount.

When a customer approaches LARIBA to help finance purchase of a house, LARIBA's representative explains the process and how it differs from an interest-based loan. After gathering the necessary information, LARIBA submits a pre-approval form to the GSE, confirming that the customer is qualified to receive financing. The customer is given a copy of the Preliminary Term Sheet to read. It explains the financing process but creates no legal or Sharī'ah effects.

The two parties (LARIBA and the customer) sign the Purchase Agency Agreement, which authorizes the customer to search for a suitable property and purchase it on behalf of both parties (LARIBA, 2016a). When the customer finds it, they sign the purchase agreement of the property with the original owner on behalf of LARIBA and themselves. It includes an option to annul the contract for a specified period.

LARIBA then evaluates whether the purchase of that particular house makes economic sense. The way it does this may be unique and constitutes evidence that the subject matter of this contract really is the usufruct of the house and not the rental price of money (interest). The customer and a LARIBA employee each find three rental prices for comparable properties in the same neighborhood. These prices are fed into an algorithm that provides an average

monthly price for the usufruct of the purchased house. If, based on that, LARIBA can make the expected return on investment, it will agree to the purchase. Otherwise, it will exercise the option to annul. This pricing method allowed LARIBA to identify and avoid markets experiencing bubbles in the years preceding the 2008 financial meltdown (Abdul-Rahman, 2010). That crisis was itself the result of the bursting of a nationwide housing bubble, which was worse in some cities than others. LARIBA's portfolio of house financing contracts performed very well during and after the crisis, a reflection of its prudence and economic realism.

If LARIBA ratifies the customer's purchase, the two parties sign the disclosure documents required by federal law, which are also consistent with the Sharī'ah requirements. Both parties sign the Final Term Sheet by which LARIBA sells its share of the asset (the title and its usufruct) for a deferred price equal to the purchase cost, with the exception of the usufruct for a stipulated period that is the financing period. Then LARIBA leases the usufruct to the customer for the exclusionary period for a consideration that represents the return on the investment. This memorandum represents a contract of sale along with a lease (LARIBA, 2016b).

The entire asset is then registered in the name of the customer. A lien is placed on the property for the benefit of LARIBA. The customer signs the "deed of trust". Although this is a conventional document and uses terms like "loan" and interest", it is an auxiliary document that is not intended for its own sake. Rather, it protects the rights established in the Final Term Sheet. Moreover, it does so by means that are familiar to the American legal system. This makes it much more efficient and cost-effective than any exotic legal instrument that might be used to achieve the same purpose.

The property is then delivered to the customer. When the financing period ends, the period for exclusion of the usufruct also ends. The customer becomes the full owner of the asset's usufruct, and the operation ends. In case of full early settlement of the remaining financing amount (the price of the asset), LARIBA relinquishes its right to the usufruct for the remaining period. The customer becomes the full owner of the asset's usufruct, and the operation ends. The lien is cancelled when all outstanding financial rights have been fulfilled (LARIBA, 2016c).

Risk analysis of LARIBA's declining participation in usufruct model

This risk analysis uses the classification of risks adopted by the [Islamic Financial Services Board \(IFSB\), 2005](#):

- credit risk;
- equity investment risk;
- market risk;
- liquidity risk;
- rate of return risk; and
- operational risk.

Quantitative risk analysis

Measurement of the level of risk involves assessing the magnitude and importance of risks, which is calculated as follows:

Level of risk = probability that the risk will occur × the possible impact of the risk
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According to [Central Bank of Bangladesh \(2014\)](#), the probability that a risk will occur is divided into three levels:

- (1) *Unlikely*: Unlikely to occur but not impossible.
- (2) *Possible*: May occur once a year.
- (3) *Recurring*: May occur many times a year.

The possible impact of risk is also divided into three levels:

- (1) event would not affect the product;
- (2) event would have intermediate impact on the product; and
- (3) event would have substantial impact on the product.

The relationship between the probability that a risk will occur and the level of impact such an occurrence would have can be described in a risk matrix. The risk matrix calculates risk levels (probability × impact), as shown in [Table I](#).

[Table II](#) explains the risk rankings found in the risk matrix above.

Applying the risk matrix to LARIBA’s model

It is possible to apply a risk matrix to the format of sale of an asset with the exception of the usufruct as implemented by LARIBA. This would be by quantifying the most important risks discussed previously, as described in [Table III](#).

[Table III](#) shows the major risk exposures of LARIBA’s implementation of the sale of an asset with the exception of the usufruct, the subsidiary risks and LARIBA’s method of mitigating them. The probability of risk occurrence was calculated as 1 for each of them and the risk impact was calculated as 2. The resulting degree of risk was calculated as $2 \times 1 = 2$, which is low. Therefore, the risks of financing using the format of a sale of an asset with the

Table I.
Risk matrix

	Substantial 3	Level of impact Intermediate 2	Slight 1
<i>Level of probability</i>			
Repetitive 3	High risk 9	High risk 6	Intermediate risk 3
Possible 2	High risk 6	Intermediate risk 4	Low risk 2
Unlikely 1	Intermediate risk 3	Low risk 2	Low risk 1

Source: Central Bank of Bangladesh (2014)

Table II.
Risk rankings found
in the risk matrix

Points	Risk	Practice
6-9	High	Very likely to occur and would have major impact Executing transaction is not permitted until risk is reduced
3-4	Middle	Could occur and would have intermediate impact The operation could be permitted, but it would be preferred to reduce the risk; additional supervision advised; should be reviewed in 30 days
1-2	Low	Not likely to occur and would have minor impact Could be permitted

Main risk	Subsidiary risk	LARIBA's risk management strategy	Probability of risk occurrence	Risk impact	Risk rank	Evaluation
Credit risk Equity investment risk	Risk of non-payment	Lien	1	2	2	Acceptable
	Risk that capital will be consumed	Rapid exit by selling share right after taking ownership	1	2	2	Acceptable
Market risk	Risk that customer will renege on purchase	Including option of annulment in purchase contract	1	2	2	Acceptable
Liquidity risk	Risk of not being able to convert debt or asset into liquidity	Act as investment agent for GSEs	1	2	2	Acceptable
Rate of return risk	Risk of not being able to increase profit rate during the financing period	Act as investment agent for GSEs	1	2	2	Acceptable
Operational risk	Taxation risk	Register asset in name of customer from beginning	1	2	2	Acceptable
Operational risk	Legal risk	Use certain conventional contracts to fit legal environment	1	2	2	Acceptable
Operational risk	Shari'ah non-compliance risk	Appoint external Shari'ah auditor to upgrade design of procedures and documents	1	2	2	Acceptable

Table III.
Quantitative analysis of the risks of financing by the format of sale of an asset with the exception of the usufruct as implemented by LARIBA

exception of the usufruct, as implemented by LARIBA, are acceptable according to the analysis above.

It is worth noting, in particular, the way LARIBA has handled operational risks. These include the risk of loss resulting from incompetence or failures in internal processes, or persons, or systems, or these could result from external events. Operational risk increases as the number of procedures required to execute an operation increase. It is also increased by legal risks and taxation risks resulting from the incompatibility of the legal system, taxation system and judicial system with the contracts used. The risk is further increased by the lack of standardization of the documents for the contracts that IFIs use. The risk is also increased in case the courts are unfamiliar with the contractual formats and the documents used. That raises the need for explanation and interpretation by specialized experts in every case, which means added expenses. These considerations make LARIBA's financing format comparatively efficient, as it uses auxiliary contracts with which American courts are already familiar. LARIBA also has the property registered in the name of the customer from the beginning of the operation (the joint purchase of the property with the customer) to conform to the tax environment

Conclusion

Sale of an asset with the temporary exclusion of the usufruct is a promising tool for modern Islamic finance. It is a low-risk instrument that is particularly useful for mitigating operational risks in legal environments where Islamic finance is barely recognized. LARIBA uses this format in conjunction with declining partnership in usufruct. When the usufruct is priced at the market rate for comparable usufruct, the arrangement can be a genuinely Islamic alternative to interest-based financing. The constructive use of this format calls for the development of an international Shari'ah standard on it.

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