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Islamic Mortgage Guide

An Islamic Mortgage is one which is compliant with Sharia law. These mortgages differ from a traditional home loan as they do not involve paying any interest because under Sharia Law this is forbidden. Sharia Finance principles are derived from Islamic teachings and encourage fairer, more socially responsible ways of conducting financial affairs. Products and services that are ‘Sharia compliant’ are available to all and suitable for both Muslims and non-Muslims alike. The different types of Sharia Mortgages are described within this guide.

Diminishing Musharaka (Home Purchase Plan)

This is the standard Islamic mortgage for residential property purchases. This is a regulatory structure that was specifically created through legislation to assist the Islamic finance industry provide an Islamic alternative to mainstream mortgages.

For a product to be of legal HPP structure, the bank must hold the buyer’s beneficial interest in Trust. The buyer receives full legal title only when the mortgage used to purchase the property has been repaid in full. At this point the buyer will become the legal owner, and the title to the property will be transferred to them from the bank.

A legal owner of a property is also the formal owner - the one whose name is on the freehold title at the Land Registry. A beneficial owner is someone who has the right to enjoy or benefit from the property, and this can include the right to any income from the property, or to reside there.

The legal interest in a house can be freehold or leasehold. Leasehold interest is different from freehold in that it is necessarily time-bound. A leasehold could be for a few days, or many hundreds of years, but eventually it will expire. When it does expire, the freehold owner will be able to step in and take possession of the property.

HPP uses a combination of freehold and leasehold to deliver a diminishing musharakah/ijarah model, where the purchaser of the property slowly buys more and more of the property over time, and the rental payment covering the amount that is not owned decreases in the same proportion. Eventually the buyer owns the entire house and is no longer paying any rent.

Ijara (Rent-only Islamic mortgages)

An ijara arrangement is based on the principle of 'lease to own'. This is the equivalent of the Diminishing Musharaka, apart from there is no "diminishing". Under an Ijarah mortgage, you pay monthly rent on the banks portion of the house, but you do not make any payments towards buying the banks portion.

This sort of mortgage is typically not advisable for a home purchase where you plan to live, as it can mean you having to end up selling your house at the end of the term in order to pay the bank back.

This type of mortgage is often seen in a buy to let situation.

Murabaha

A murabaha structure is often used in commercial property finance structures and buy-to-let mortgages. It is not often used for a residential Islamic mortgage.

Murabaha is a simple concept. The bank buys the property on your behalf, and then sells it to you immediately for a marked-up price, to be paid over a number of years.

A murabaha structure is not to be confused with a commodity murabaha structure (also known as tawarruq).