AN EVALUATION ON MUSHARAKAH MUTANAAQISAH BASED HOUSE FINANCING BY ISLAMIC BANKS IN MALAYSIA

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ABSTRACT

Musharakah Mutanaqisah has been suggested as a better alternative of Islamic financing contract to replace the controversial Bay Bithaman Ajil contract in the house financing. However, to date, only a few Islamic financial institutions in Malaysia has implemented Musharakah Mutanaqisah as a housing financing tool to replace the Bay Bithaman Ajil, a Murabahah based contract, along with a few others still make both contracts available to provide the variety to the customers. Musharakah Mutanaqisah is said to be an ideal contract that is more Shariah compliant, free from the element of riba’, gharar and maysir and is asserted to abolish the major problems exist in the Bay Bithaman Ajil contract. However this statement never been tested. The purpose of this paper is to provide some insights and evaluation on this issue by examining the conformity of implementation of Musharakah Mutanaqisah in the housing financing by the Islamic financial institutions in Malaysia against the Shariah tenets and rules. The evaluation presents some problems, issues and challenges evolves in its implementation and the possibility of more effective implementation of Musharakah Mutanaqisah to replace Bay Bithaman Ajil based house financing contract.

Field of Research: Musharakah Mutanaqisah, Islamic house financing.

1. Introduction

Islamic house financing has grown rapidly as alternative to the conventional housing loan. Due to the continuous increment in the housing price, approaching the banks or financial institutions for house financing is the best way to gain the house ownership even though it would take longer time. Among the popular Islamic house financing facilities in Malaysia is Bai Bithaman Ajil which has been introduced along with the inception of first Islamic Bank in Malaysia, Bank Islam Malaysia Berhad (BIMB). However many comments and critiques went against this contract. It was asserted to be similar with conventional housing loan particularly after the variable rate of interest is used, besides had been strongly rejected by other Shariah scholars and Islamic financial institutions counterparts in the Middle East (Meera and Abdul Razak, 2009)
Along the way, Musharakah Mutanaqisah contract has been suggested by many scholars including Meera and Abdul Razak (2009) as a better alternative to replace Bai Bithaman Ajil contract. However, little study has tested this Musharakah Mutanaqisah house financing contract. This paper identifies the features and characteristics of Musharakah Mutanaqisah house financing contracts as implemented by the Islamic financial institutions in Malaysia and provides some insight by comparing it against the ideal concept of Musharakah Mutanaqisah as has been suggested and approved by the Shari’ah scholars.

2.0 Musharakah Mutanaqisah Concept

The Musharakah Mutanaqisah Partnership (MMP) contract is based on a diminishing partnership concept. The MMP consists of three contracts which are musharakah, ijarah as well as bay’. First, the customer enters into a musharakah under the concept of ‘Shirkat-al-Milk’ (joint ownership) agreement with the bank to co-own the asset being financed. Second, the bank leases its share in the asset ownership to the customer under the concept of ijarah. This is when the customer pays a% of the asset cost as the initial share to co-own the asset whilst the bank provides for the balance of b%. Third, the customer gradually buys the bank’s b% share at an agreed portion periodically until the asset is fully owned by the customer.

The periodic rental amounts will be jointly shared between the customer and the bank according to the percentage share holding at the particular times which keeps changing as the customer purchases the financier’s share. The customer’s share ratio would increase after each rental payment due to the periodic redemption until eventually fully owned by the customer. According to one report, Musharakah Mutanaqisah was implemented for the first time in Egypt by the Islamic banking division of a commercial bank in partnership with a tourism company. This concept has been approved by Islamic scholars at the First Conference for Islamic Banks, which was held in Dubai.

3.0 Literature Review

As has been mentioned before, Musharakah Mutanaqisah is based on three types of contracts, namely, partnership, ijarah and sale. The International Fiqh Academy of OIC in its 15th session has made a discussion on this contract where the Islamic scholars have discussed the fundamental characteristics of this contract, its permissibility in the Shari’ah, its conditions and other Shari’ah principles related to this contract. Few academicians have iterated wrote on the comparison between Musharakah Mutanaqisah and Bai Bithaman Ajil. Noreeta Mohd Nor (2008) compared the operational structures of the both contracts, their acceptance in the Shari’ah, problems in practicing the product, risks involved in the contracts and flexibility to use the contract. She concluded that Musharakah Mutanaqisah could be a better alternative to

1 Contemporary Financial Transactions of Islamic Banks, page 291.


3 International Fiqh Academy of OIC, 2004
BBA since it is more just and fair to the customers. Meera and Abdul Razak (2005) also agreed that Musharakah Mutanaqisah is better and more Shariah compliant compared to Bai Bithamn Ajil.

Nevertheless, Musharakah Mutanaqisah still has a few issues despite of its Shariah compliancy. Meera and Abdul Razak (2009) pointed out some practical issues of the implementation of the Musharakah Mutanaqisah, besides still there is tendency among the bankers to use the interest rate rather than rental rate. There are also legal issues regarding the implementation of Musharakah Mutanaqisah. Before that, Osmani and Abdullah (2005) analyzed the conformity of the implementation of Musharakah Mutanaqisah contracts by Islamic banks and Islamic bank window in Malaysia to the strict principles of Shariah. They found that although Musharakah Mutanaqisah is still overwhelming by the issues of rental rate, wa’ad, damage of property, tax and land ownership, there are still many rooms for improvement to make the Musharakah mutanaqisah more Shariah compliant otherwise it is just a replication to the conventional loan.

4.0 Shariah Rulings on MMP

The permissibility of the Musharakah is agreed by the majority of scholars. Most of them argue that there is no specific evidence in the Quran and Sunnah that prohibit the Musharakah Mutanaqisah. Based on the Quranic verse in Surah An Nisa 4: 12, Allah states that if a person dies without leaving behind any ascendants or descendants; but he has brothers and sisters more than two in number; then they will share a third of the property of the mortal. So, based on this verse the partnership of the property is legal in the shariah. Some contemporary scholars like Bendjilali and Muhammad Taqi Usmani (1995) also agreed on the basis of implementation of Musharakah Mutanaqisah.

International Fiqh Academy of OIC (2004) in its 15th session made resolution that MM is a valid contract in the Shari`ah. Similarly, Shariah Advisory Council (SAC) of Central Bank of Malaysia on its 56th meeting, held on 6th February 2006 / 7th Muharram 1427 issued a fatwa that Islamic financing product structured based on Musharakah Mutanaqisah contract is permissible because Musharakah Mutanaqisah is a recognized contract in Islamic muamalat. Besides that, SAC of Central bank of Malaysia allows to combine two contracts of Musharakah and Ijarah in one document as long as each contract is concluded separately and no mixture between each other. Besides that, they also allow the contracting parties to impose a pledge on the shares owned by the customer because the right of beneficial ownership is recognized by the Shari`ah.

There are some scholars who disagree due to the reason that it contains element of doubt and similarity to the interest based loan (Al-kameelah, 2008 in Osmani and Abdullah, 2010). However, this is not widely accepted.
5.0 Methodology

This case study was done on two Islamic banks in Malaysia; a local Islamic bank and a foreign Islamic bank’s branch in Malaysia. It was conducted using qualitative approach by interviewing two officers from both banks. Few discussions with the previous researchers on Musharakah Mutanaqisah also conducted.

Besides that, the analysis on the secondary data is done through past literatures on Musharakah Mutanaqisah contract and official website of both banks and previous articles. The analysis is done by comparing and evaluating the implementation of Musharakah Mutanaqisah by these two banks; representing a foreign bank and based bank in light of the Shariah principles whether it is truly reflects the essence of the Musharakah Mutanaqisah contract and able to be one of the tool to achieve the Maqasid Shariah.

7.0 Issues and Problems in MMP

7.1 Issues

7.1.1 Local Islamic bank

**Issue of using interest rate as rental rate**

The respective bank uses Islamic Bank Rate (IBR) with adjustment as the profit rate. The profit rate will be differing according to the financing amount and whether the property is already completed or under construction. For home financing range between RM 100 thousand to RM 500 thousand, the rate for the completed home will be IBR – 1.70% while for the under construction home, the rate is IBR – 1.60%. While for the home financing above RM 500 thousand, the adjustment rate is higher by 1% for both completed and under construction. The same goes to commercial property financing. The rate is different whether the amount of financing is RM 100 thousand below or above. For the completed property below RM 100 thousand, the rate is IBR – 1.30% while for under construction property, the rate is IBR – 1.20%. While for the financing amount above the RM 100 thousand, the adjustment rate is higher by 1% for both completed and under construction property. From here it seems that the bank still use conventional interest rate as a benchmark while if we follow the concept of Musharakah Mutanaqisah, the bank should use the rental rate. Besides that, as the IBR is based on Overnight Policy Rate of Bank Negara Malaysia, it may contains element of uncertainty as argued by Meera and Abdul Razak (2005) because the interest rate is fluctuating everyday and it may burdensome to the customer although the bank states that the profit rate is being capped at 10.25%. This benchmark will lead Musharakah Mutanaqisah to be similar with conventional financing contracts.
**Issue of property maintenance**

Customer has to bear the cost of maintenance and there is no clause in agreement between the bank and the customer which specifies the customer to bear the cost of maintenance. It is said to be done based on the mutual understanding between the customer and the bank. Furthermore, the bank asserts that since the legal title of the property is possessed by the customer, they are the ones that should be responsible for the maintenance. Besides that, the bank argues that it would be impractical for them to be in charge of maintenance works due to the nature of the bank’s operation besides at the end of the contract, the customer will own the home or property.

**Issue of risk sharing between bank and customer**

By analyzing how this respective local Islamic bank implements the Equity Home/Property Financing-i, it can be concluded that the bank do not bear any risk regarding the ownership of the home or property. The legal title of the home or property lies with the customer from the beginning of the contract and the bank just acts as a trustee. Thus, it can be inferred that the true concept of Musharakah does not exist here. The true concept of Musharakah acknowledges the joint ownership by both parties which are the customer and the bank. Secondly, in the case of the uncompleted home or property, if the home or property is found to be not completed, the bank will ask the customer to pay back the amount the bank has disbursed on the property. Again, it does not truly reflect the true concept of Musharakah whereby any loss should be borne by the both parties according to the capital contribution. Thus, it can be concluded the bank does not bear any 'Iwad in implementation of this contract, merely acts as financier, more or less similar with conventional financing.

**Issue of charges and fees**

Through Non Free Acquisition Cost policy, the bank acquires the customer to pay the legal fees and all fees related to the acquisition costs upfront before the financing amount is granted. This is contrast with the concept of Musharakah Mutanaqisah whereby both parties should bear the legal fees and charges. As a matter of fact, AAOIFI Financial Accounting Standard on Musharakah Mutanaqisah required the financial expenses arise from the contract are borne by the partners in proportion to their shares. The same goes to the issue of maintenance as have been discussed above.

**Issue of ownership of property**

As explained above, the legal title of the home or property lies with the customer from the beginning of the contract indicates the bank does not jointly share the ownership of the property with the customer. This practice does not imply the true concept of Musharakah whereby the bank would share the ownership of the property with the customer at the beginning and it would be gradually transferred to the customer according to the redeemed portion that would increase customer’s share of the property.

**Other issues**

In the process of implementing this contract, the respective local Islamic bank faces the problem in preparing the documentation of the contract due to the lack of the Shariah
lawyers that are experts and well understand the Musharakah Mutanaqisah contract. Besides that, there are many comments from their customers regarding the abolishment of Bai Bithaman Ajil and the replacement with Musharakah Mutanaqisah.

7.2.2 The foreign Islamic bank

**Issue of using interest rate as a benchmark for the rental rate**

Like other Islamic banks which use interest rate as their benchmark in determining the rental rate, this respective Islamic foreign bank also use interest rate as their benchmark in determining the lease rental rate, which is BFR- 1.9%. BFR or Base Financing Rate is the rate determined by Bank Negara Malaysia. According to some scholars, using interest rate as a benchmark would entail uncertainty (gharar) in the pricing of rental. Other than that, interest rate is riba. Islam strictly prohibits the usage of riba in transaction.

**Issue of maintenance of property**

One of components in Musharakah Mutanaqisah is the concept of ‘Shirkat-al-Milik which is the customer will make an agreement with the bank to co-own the asset being financed. It means that both parties, which are the customer and the bank, will co-own the property. This is what they called as joint ownership. So, every aspect regarding the house should be borne by both parties. However, in the real practice, the bank will push the maintenance of the property to the customer. In the case of this respective Islamic foreign bank, the banks push the maintenance of the property to the customer through Service Agency Agreement.

**Issue of risk sharing between bank and customer**

The respective bank hold the ownership of the property and the bank would bear all the risk along the period. This is in line with the concept of Shirkat-al-Milik, both parties need to share all the risk regarding the property. Most of the bank would push the risk to the customer as the property’s ownership is under the customer’s name

**Issue of charges and fees**

This respective foreign bank is they offer two types of package, which are Zero Entry Cost and Non Zero Entry Cost. According to the interviewee, mostly the customer will choose the first package whereby they do not have to pay all the fees and charges. However, the cost of financing for this package is bit higher compared to the second package. Yet, most of the bank nowadays does not offer this type of package anymore due to higher cost for the bank.

**Issue of ownership of property**

Most of the bank will transfer the ownership of the property to the customer at the first place from the beginning of the contract. As for this respective foreign bank, the bank will fully own the property first. At the end of financing, the bank will transfer the ownership of the property to the customer.
Other Issues

In the process of developing this contract, this respective foreign bank also faces a few problems regarding the taxation and legal title of the property. Since the legal title of the property belongs to the bank, they need to pay double taxation once the property is transferred to the customer after the completion of payment. However, the bank manages to get the problem solved through tax neutrality exemption by Bank Negara Malaysia. Besides, the bank needs to get an approval from State’s Land and Mineral Office from the state authority to hold the legal title and become the owner of the property and this will involve a lot of paperwork preparation. So far, the bank only manages to get the approval from the state authority of Selangor and Johor.

The comparison for the both Islamic banks could be seen in Table 1 in Appendix 1. It can be concluded that the practice of Musharakah Mutanaqisah contract by the foreign Islamic bank operates in Malaysia is more inclined to the true concept of Musharakah Mutanaqisah compared to the local Islamic bank. It is because the bank bears the ownership risk of the property from the beginning, thus reflecting the concept of *Iwad* is practiced here, and contradict with the practice of local Islamic bank whereby the legal title of the property lies with the customer from the beginning, thus bank does not bear any risk. However some discrepancies still exist in some areas such as the usage of the interest rate as the benchmark for the rental rate and the issues of the maintenance and charges and fees. By entering into Service Agency Agreement, customer is obliged to bear the maintenance costs. The same goes when the customer chooses Non Zero Entry Cost. It could be concluded that the respective local Islamic bank do not truly adopt the substance of the Musharakah Mutanaqisah in the contract, merely putting the legal title of the contract as Musharakah Mutanaqisah, whereby the substance is similar with the conventional loan.

8.0 Opportunities

Despite some issues discussed above, there is a bigger rooms for the Musharakah Mutanaqisah based financing contract to be further implemented by the banks because currently only nine banks has implemented Musharakah Mutanaqisah based financing contract which are RHB Islamic Bank, Kuwait Finance House, OCBC Al Amin, HSBC Amanah, Bank Muamalat Malaysia Berhad, Citibank, Affin Islamic Bank and Standard Chartered Sadiq Islamic Bank. Thus, there is high opportunity for this Musharakah Mutanaqisah contract to grow and replace Bai Bithaman Ajil contract since the implementation of Bai Bithaman Ajil contract has been surrounded by many controversial issues and still being debatable among scholars. In addition, Musharakah Mutanaqisah contract is internationally accepted and this gives the opportunity for the bank to attract the foreign customers and to explore the international market share.

Besides that, currently some of the Islamic banks only use this contract to cater the medium and high income customers. Thus, other alternatives should be explored in order to make the Musharakah Mutanaqisah based contract also accessible to low income group so that the Maqasid al Shariah is achieved. Among possible alternatives is the implementation of Musharakah Mutanaqisah contract through the cooperative, as suggested by Meera and Abdul Razak (2005). It may solve the problem of the usage of the interest rate as benchmarking because the house is owned by the cooperative and the share of the member who wants to own the house is increasing through the payment of the rental. Besides that, it provides the opportunity for the low income earners to own the house.
In addition, as a newly implemented product, Musharakah Mutanaqisah based contract is not excluded from having some flaws and limitations. However, there are still some rooms for improvements to make it a better product. Thus, collaboration from various parties and economic scholars is very important in improving Musharakah Mutanaqisah based contract to make it more Shariah compliant and assessable to all type of income group yet maintaining its commercial value. As asserted by Dusuki (2008), the true success of Islamic banks depends on how the banks can maintain its sustainability while observing its social responsibility to its various stakeholders. Currently, it can be seen that the bank stresses on profit making objective and consequently makes Musharakah Mutanaqisah based contract do not truly represent its true concept.

9.0 Challenges
How Islamic banks can utilize Musharakah Mutanaqisah based financing contract to cater the low income customers.

As discussed before, currently the Islamic banks offer Musharakah Mutanaqisah to the middle and high income customers. They do not offer this product to low income group due to the issues of creditworthiness. Nevertheless, they also have to offer this product to the low income group as they also need a shelter for themselves. Shelter is one of the Maqasid Syariah. However, most of the Islamic banks reluctant to offer this product to them because they want to reduce the percentage of Non Performing Loan (NPL). According to International Monetary Fund, NPL is when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full. Obviously, all banks, whether Islamic or conventional; they want to get rid of NPL as it is the loss to the banks and will reduce their profit. Thus, this is one of the challenges that the Islamic banks need to face so that they will cater the demand of housing financing for all level of income group.

To educate the representative of Islamic banks on the true objectives of Islamic bank.

As a Shariah-oriented business entity, Islamic bank is vigorously expected to be guided by the philosophies of Islamic business, which are, firstly, the philosophies will be used by the management or policy makers of the banks in the process of formulating corporate objectives and policies. Secondly, these philosophies serve as an indicator as to whether the particular Islamic bank is upholding true Islamic principles. The representatives should know these philosophies. Other than that, Islamic banking is a subset of the overall Islamic economic system. They must that strives for a just, fair and balanced society as envisioned and deeply inscribed in the objectives of Shariah (also popularly known as Maqasid as-Shariah). However, we are in opinion that not many representatives of Islamic bank knows and understand these philosophies and objectives. This is because most of them are from conventional bank. So, they will tend to act and think like a conventional banker rather than an Islamic banker.

To promote Musharakah Mutanaqisah

The implementation of Musharakah Mutanaqisah is still new and not all Islamic banks implement this type of contract. Thus, some Islamic banks have already familiar with Bay Bithaman Ajil contract and reluctant to move to Musharakah Mutanaqisah based contract as it involves cost to change from Bay Bitahman Ajil contract to Musharakah Mutanaqisah contract,
besides most of the Islamic banks are more familiar with debt based financing rather than equity based financing and there may be some objections from the customers regarding the changes.

**Islamic banks are bound to Bank Negara Malaysia’s regulations**

Besides that, Islamic banks are bound to the rules and regulations of Bank Negara Malaysia and the implementation of the interest rate benchmarking is one of the rules and regulations that need to be followed. Thus, the Islamic banks cannot simply change it with the rental rate. Besides that as found by Meera and Abdul Razak (2005), interest rate is usually higher than rental rate and only the yields of higher end properties like condominiums has positive correlation with the interest rate. The Islamic banks, as profit making entity, for sure would opt for the interest rate rather than rental rate.

**10.0 Conclusion**

To conclude, Islamic finance has continued to expand in the more challenging and competitive international financial environment. The products that they are offering now have been improved from time to time. One of the most popular financing products is Musyarakah Mutanaqisah. However there are lots of variance between the samples of this case study; respective local Islamic bank and the foreign bank which operates in Malaysia, in terms of the operation of this product. One of the obvious similarities is that both bank still using interest rate as their benchmark, rather than rental rate. While for the obvious differences between both banks, we can see in terms of the legal title and ownership of the property. For the respective foreign bank, the property belongs to the bank, until the customer acquire all of property’s shares. In contrast, the local Islamic bank practice that the property belongs to the customer from the beginning of the partnership. Besides that, the issues of interest rate as benchmark, maintenance of the property, charges and fees remain questionable. Yet there are also some opportunities, lots of room for improvements as well as challenges in order to make this product viable for the customers. With the cooperation among government, regulatory, bankers, Shariah scholars as well as customers, this product has lots of potential and more Shariah complaint compared to previous financing product, which is Bai’ Bithaman Ajil.
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