

Musharakah Mutanaqisah Home Financing: A Review of Literatures and Practices of Islamic Banks In Malaysia

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This paper analyzes the practice of Islamic Banks in Malaysia in home financing. While conventional banks deal with interest in financing home, car or other appliances, the Islamic banks limit to transactions that are free from interest, usury, ambiguity, cheating etc. Islamic Banks in Malaysia implement certain well-known systems in home financing. The most popular ones are Bay` bi Thaman 'Aajil (BBA), which is sale on a deferred payment; and Musharakah Mutanaqisah (MM), which means, diminishing partnership. The paper would deal specifically on this MM home financing as it is implemented in Malaysian Islamic banking systems, while drawing a clear line of distinctions between well-known BBA and less practiced MM. It would survey the existing literatures on Islamic Banks in Malaysia and also their practices to reach conclusions on such transactions. Many Islamic banks today accept MM home financing as an alternative to BBA or Murabaha sale, which was in existence since the inception of Islamic Banks in Malaysia. The paper would look into MM from Jurisprudential point of view to see if it could be adopted as it is practiced today, or needs some modifications. It will highlight the characteristics of MM and related issues like ownership and liabilities, shares and ownership transfer, Ijarah and rentals etc. The paper expects to draw certain principles governing the implementation of MM in Islamic home financing to keep it free from interest and making it vibrant and relevant to the financial markets.

Field of Research: Islamic Banking and Finance, Islamic Home Financing.

1. Introduction

Home financing is a noteworthy segment of investments in our present banking practices. Islamic banks adopt several products to keep itself free from *Riba* or usury. In Malaysia Islamic banks commonly practice *al-Bay` Bi-thaman Ajil* (BBA)ⁱ which is disputed by some jurists. *Musharakah Mutanaqisah* (MM)ⁱⁱ is regarded to be much convenient, better compliant to *shari`ah*ⁱⁱⁱ regulations. Therefore, the scholars tend to prefer MM over BBA. Several Malaysian Islamic banks prefer MM over BBA, though the later has predominantly been practiced by all Islamic

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banks. *Musharakah Mutanaqisah* is a contract of partnership between two parties, where one partner gradually buys the whole parts of the property. Kuwait finance house has first offered MM in Malaysia in 2006 although this contract existed since 1995. At present home financing through MM has widely begun in Malaysia. This paper will focus on the basic characteristics of MM, its implementation in Malaysian banks, its compliance to *Shari`ah* principles, the difference between MM and BBA and the advantages of practicing MM in lieu of BBA, issues and problems in the operation of MM.

2. Literature Review

MM is the combination of three contracts which are partnership, *Ijarah*^{iv} and sale. It has been invented through the gradual development of Islamic banking products. The concept of partnership and its *Shari`ah* ruling is discussed in the classical Fiqh books. (Al-Sarakhsi, 1978; Al-Kasani, 1983).

In the late eighties and the beginning of nineties when Islamic banking and finance started its journey; the partnership business was the main concern at that time, and MM was non-existent at that time. Al-Harran (1993) defined the concept of partnership in Islamic finance and discussed its historical background. He explained different types of partnership and its practices focusing on the management issues like the distribution of profit, liability of loss, withdrawal of members etc. He also described the modes of equity investment in Islamic finance. He furnished some suggestions which must be followed to convert the interest based financial system to equity based financial system.

Haron (1997) provides the overview, philosophy, history and regulation of Islamic banking and finance. He mentioned different types of Islamic financial products including *Musharakah* or partnership, but did not explain MM in his book. Bendjilali and Khan (1995) defined the diminishing partnership and perpetual partnership in their study. They mentioned the need and importance of diminishing partnership. However, their study does not reflect the features of MM as a whole.

On the other hand, *Ijarah* or lease was a popular mode of financing in Islamic banking. Ramli & Onn (2007) described the features of *Ijarah thumma al-Bay`* from the *shari`ah* perspective. They also illustrated its application, the mode of operations and legal restrictions in Malaysia. Issues such as the guarantor, documentation of this contract and the transfer of ownership were explained. Furthermore, the computation of *Ijarah thumma al-Bay`* which includes the selling price, total rental, compensations, security deposit, monthly rental etc. are being discussed.

MM was practiced outside Malaysia for long. It was regarded as one of the modes of financing in Pakistan Islamic banks. Meezan Bank of Pakistan has been implementing this mode of finance for house financing. Usmani (2002) has described the characteristics of MM in Pakistan and made a detailed discussion on the operational method of house financing in Meezan Bank. The International Fiqh^v Academy of OIC in its 15th session has made a discussion on MM where the *Shari`ah* 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. (International Fiqh Academy of OIC, 2004). Usmani (2005) has defined the MM contract and described its mode of applications in home financing, trade and business services while maintaining *Shari`ah* principles.

Al-Kawamelah (2008) made a detailed explanation of MM and its *Shari`ah* ruling. He critically analyzed every aspect of this contract and made judgment on it. He also mentioned different opinions of the Islamic jurists relating to this issue. He analyzed the current practices of MM in Jordan Islamic Bank and evaluated it under the framework of the *Shari`ah*. Thani, Abdullah & Hassan (2003) provided a chapter on Islamic financial products where they briefed about MM. It merely gives the idea of this contract and its legal ruling, but does not describe the features and method of implementation of this contract. They argued, "The concept of the partnership does not involve the practice of any general prohibition on transactions such as *Riba* and ambiguity (*gharar*) of goods." (Thani, 2003, Abdullah & Hassan, p. 56). BBA was a popular mode of home financing in Malaysia. Abdul Razzak (2006) has explained what BBA home financing is, its mode of operations, the mechanism of determining selling price, issues in BBA home financing, legal documentation and value proposition in BBA home financing.

Some writers attempted to make a comparison between BBA and MM. Smolo (2007) in his dissertation has defined firstly, the BBA, its basic feature, determination of price, operational mechanism, *Shari`ah* ruling, risks related to BBA. Secondly, he attempted the same points in MM while comparing it with BBA. Thirdly, he illustrated the nature of *Ijarah Sukuk*^{vi} in comparison with BBA and MM. Meera & Abdul Razak (2005) argued that MM is a better alternative to BBA home financing. They compared between BBA home financing and MM home financing and concluded that MM is more *Shari`ah* compliant. They argued that the current practice of BBA does not change the interest based system as it follows the similar computation formulas to the interest based system where the profit rate is quite similar to the interest rate in the market. Furthermore, the profit rate in BBA is fixed as it is a fixed selling price which cannot be changed. This leads the financiers and the customers in difficulties. On the other hand, MM is

very flexible to use in home financing as it is based on rental price. So, the Bank has the choice to revise the rental rate periodically. The authors also illustrated the current practice of MM in different countries of the world.

A comprehensive comparison between BBA and MM has been done by Noreeta Mohd Nor (2008). She 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. It is comprehended from her article that MM could be a better alternative to BBA since it is more just and fair to the customers. She stated, "The MMQ can be seen as more just as there is no interest charge or "advanced" profit involved. It is based on the concept of rental payments and redeeming the bank's shares in the property." (Noreeta, 2008) Nevertheless, MM faces some problems in implementation. Meera & Abdul Razak (2009) explained the theory of MM contract and then discussed some practical issues like whether this contract is similar with the formula of conventional loan or not and they concluded that house rental is different from the interest rate. They pointed out that still there is tendency among the bankers that they try to replace the rental rate with the interest rate but in a real Islamic economy interest should be avoided totally and the rental rate would be decided by the actual rental price of the house in the market. However, there are some difficulties in estimating the rental rate of houses for different situations. Also, there are some issues related to the early termination of the contract which are highlighted and the authors proposed some suggestions for that.

Boon Ka (2009) in his article mostly focused on the legal issues in MM financing. He discussed the way of agreement between the bank and the client, legal issues in ownership, promise to buy the property gradually by the client and issuing penalties in the event of late payment by the customers. Some Islamic banks are practicing MM in home financing. They publish the features of this product, mode of operations, conditions for the customers, the continuous development of the products and other necessary things in their official websites. (Kuwait Finance House, 2009; RHB Islamic Banking, 2009; Maybank Islamic, 2009; Citibank Malaysia Islamic Banking)

3. Methodology:

This study adopts qualitative method as it describes the features of MM home financing in Malaysia. It is descriptive in nature and depends on the modern literatures, databases and the official websites of the relevant banks in Malaysia. A critical analytical method is adopted to analyze the existing practices of Islamic Banks in Malaysia and to see critically if it conforms to the strict principles of

shari`ah. It also follows a comparative approach as it compares MM home financing with the prevalent practices of home financing in Malaysia and elsewhere such as BBA.

4. Discussion of Findings:

Musharakah means partnership and *Mutanaqisah* Means to diminish. So *Musharakah Mutanaqisah* means diminishing partnership. It is a joint partnership contract between the financial institution and its client. The client begins to purchase the share of the financial institution until he owns the whole property. Also, the financial institution leases his portion of share to the client at the same time. The client needs to promise that he will buy the share of the bank. So this contract is a combination of partnership of a business, buying and selling the share of the property and leasing. (Kuwait Finance House, 2009). For example, a customer wants to buy a house then he proceeds to the bank and fills up an application form. If the application is accepted by the bank then the bank and the customer purchase a house where the bank pays 90 percent of the total price and the customer pays only 10 percents. Based on this, the bank owns 90 percent of the property and the customer owns 10 percent of the property. After the purchase, the bank rents his portion to the client. The client moves to the house and pays monthly house rents and he gradually buys the share of the bank. So, every month the client pays the house rent plus a specific amount to buy the bank's shares. At the end, the client buys the total share of the bank and the bank transfers the ownership to the client.

Implementation of MM in Malaysia

At present, only four banks are practicing MM home financing which are RHB Islamic Bank, Kuwait Finance House (Malaysia), Maybank Islamic Berhad and Citibank Malaysia with its Islamic Banking window. In RHB Islamic bank, MM home financing is called as equity home financing-1. In Maybank Islamic, the operational features of MM are as follows (Maybank Islamic, 2009):

1. The client and the bank make partnership between them to get the capital to buy the property.
2. The customer and the bank become the owner of the property based on the ratio of payment in purchasing the property.
3. The bank leases its share to the client and takes rentals monthly for a predetermined period. The client buys the bank's share step by step.

4. Finally, the bank's share comes to an end and the client gets the full ownership of the property.

The above steps are also followed by RHB Islamic bank and Kuwait Finance house and Citibank. Kuwait Finance House offers the customers to pay the rental within 30 years tenure or within 65 years of age (whichever is earlier). They finance up to 90 percent of the property. Moreover, the investment is insured by Islamic insurance. This product is opened for all Malaysians and Non-residents. Individual and joint application is accepted. (Kuwait Finance House, 2009).

***Shari`ah* Principles for MM contract**

Though most of the Islamic jurists agreed upon the permissibility of MM, there are some scholars who hold different opinions. The majority believes that it is permissible and shari`ah compliant. As stated in the Qur'an:

*"If the man or woman whose inheritance is in question, has left neither ascendants nor descendants, but has left a brother or a sister, Each one of the two gets a sixth; but if more than two, **they share in a third**; after payment of legacies and debts; so that no loss is caused (to any one). Thus it is ordained by Allah. Allah is All-knowing, Most Forbearing."* (Surah al-Nisa' 4: 12).

In this verse, Allah (s.w.t.) describes the partnership of the property. 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 *Shari`ah*. (Al-Kawamelah, 2008). *Shari`ah* scholars generally agreed on the validity of a sale contract which is combined with lease contract. Also, there is no clear text in the *Shari`ah* that prohibits MM. Considering the public interests and benefits of MM in the investment, it should be permitted in the *Shari`ah*. (Smolo 2007). Some scholars however, disagreed to the validity of MM contract. To them, it should be declared invalid as it contains some elements of doubts. They claim that it is similar to interest as the primary purpose of MM is to give loan to the clients and to derive extra money from the amount of loan. (Al-Kawamelah, 2008)

This view of some scholars seems to be short-sighted. It is quite clear from the definition and features of MM that it is a joint ownership plus sale and leasing contract. Both the financier and the client share the profit and loss of the business together. Therefore, the claim that MM is similar to interest based loan is unfounded. Moreover, the International *Fiqh* Academy of OIC (2004) in its 15th session made resolution that MM is a valid contract in the *Shari`ah*. Besides, the *Shari`ah* Advisory Council of Bank Negara Malaysia in its 56th meeting decided that MM is a recognized contract in the *Shari`ah* and the current practice of the

contract is permissible as well. (Bank Negara Malaysia, 2007) Therefore, we could safely infer that MM is a permitted contract in Islamic *Shari`ah*. However, scholars suggest some principles and guidelines that are needed to be observed strictly, so that this contract does not exceed the boundary of the *Shari`ah* and does not get assimilated with the interest based contracts. (Al-Kawamelah, 2008; International Fiqh Academy, 2004) The principles are as follows:

1. The goods must be present. So, the property which is not present or on loan is not allowed for having a transaction.
2. The proportion of the profit must be specified and the profit will be in proportion not by amount of money.
3. Both the financier and the client must share the profit and loss of the property.
4. The *Shari`ah* advisory board must have the right to monitor the contract.
5. The contract of partnership and the contract of sale should be done separately, and not collectively.
6. A binding promise can be taken from one partner to purchase the share of the other partner gradually.

Comparison between BBA and MM

BBA (*al-Bay` Bi-thaman Ajil*) is a sale contract which is based on *Murabahah*^{vii} concept. The bank purchases the house with lump sum price and immediately sells it back to the client with the cost plus profit, which is to be paid back on installments. (Noreema, 2008) For example, a client proceeds to the bank and applies to the bank to buy for him a house according to his interest which costs RM 100,000. Upon acceptance of the application, the bank purchases the house by RM 100,000 with cash price and then sells it back to the client by RM 150,000 with installments of 20 years. So, RM 50,000 is the profit of the bank which will be paid within 20 years. In reality, the profit rate is determined based on the interest rate in conventional banking. Besides, in practice some banks just provide money to the client but do not purchase the house from the very outset. Therefore, BBA has been criticized by many Islamic scholars.

Based on the above, the difference between MM and BBA home financing could be inferred. While MM is a joint ownership of the property, the BBA is a debt type financing which resembles to conventional loan. The return of BBA is fixed selling price which cannot be changed but the return of MM is the rent of the property which can be revised anytime. In MM the customer can withdraw the contract at the middle if he gets difficulties but in BBA the client is obliged to pay the fixed amount. In BBA the client owns the house immediately after the contract, but in MM he becomes owner of the house after the tenure. Therefore, MM should be

the better alternative to BBA home financing as it is more flexible for the customers since they can pay the rentals according to the market price. MM is globally accepted contract; but BBA is allowed only in Malaysia and the South Asian countries. MM is closer to the objective of the *Shari`ah* as the bank and the client become co-owner of the property thus they co-operate each other. Besides, Meera and Abdul Razzak argued that MM can prevent the creation of new money if it is implemented by the housing cooperatives. This is because Islamic Banks under the fractional reserve banking system are allowed to create fiat money out of nothing to disburse in the Islamic financing modes which creates a macroeconomic problem. (Meera & Abdul Razak, 2005)

Problems in Implementing MM Home Financing

With the advantages as mentioned, MM also faces some challenges and problems in its implementation. The house rent. The house rent varies based on the location and time. The fluctuation of rental price of a house is a terrible problem that MM has to face. Usually, the rental price increases with the passage of time which places the customers into difficulties. This contract also raises the question, who will pay the tax? Meera (2005) urged that the tax should be paid from the profit added to the bank's equity not from the profit added to the customer's share.

Another important issue is the promise (*wa`d*) from the client to buy the share of the bank gradually until he owns the whole property. Islamic jurists are divided in determining whether fulfilling this promise is obligatory or recommended. If the promise is obligatory then the bank has the legal right to impose a fine to the client if the client does not fulfill his promise. Conversely, if the fulfillment of promise is recommended, then the client has the freedom to carry it out or terminate it at any time. The bank should not have any legal right to impose fine on the customer. The International Fiqh Academy under OIC decided that a promise is legally binding. Therefore, compensation must be paid to the bank if the client fails to fulfill the promise except that if there is a valid excuse. (International Fiqh Academy, 1988)

Another significant issue in this contract is the damage of the property. If the property is damaged by the client because of his negligence, then he should pay the compensation. Besides, if the damage is due to natural calamities and so on, then both the partners have to share the loss according to their proportion as the condition of partnership.

5. Conclusion

Though MM has some shortcomings, its overwhelming benefits and public interests surpass them. Most of Malaysian banks still provide home financing through BBA contracts. We urge more Islamic banks will come forward and adopt MM home financing to provide benefits to the clients and also to keep it more compliant to the *shari`ah* principles. However, some legal rules related to Islamic banking contracts, tax and land ownership needed to be modified to implement MM. Besides, the *Shari`ah* prescribed conditions must be observed in MM; otherwise, it would not be other than the shadow of interest based loans.

Endnotes:

ⁱ BBA means, sale with deferred payment.

ⁱⁱ MM refers to diminishing partnership.

ⁱⁱⁱ *Shari`ah* refers to Islamic law and complete code of life.

^{iv} Lease Contract.

^v Islamic jurisprudence.

^{vi} Islamic Bond.

^{vii} One kind of sale contract, the capital provider buys the specific commodity from third party and sells it to the customer at a higher price with deferred payment.

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