

House Financing of Islamic Banks under Diminishing *Mushārah*: An Analysis of Islamic Banks' Related Provisions

• Dr. Mufti Muhammad Mushtaq Ahmad

•• Dr. Muhammad Farooq

ABSTRACT:

Home is considered a basic requirement of human being and its shortage is a major problem worldwide especially in less developed countries. Islamic banks offer Diminishing Mushārah /Decreasing Partnership product for house financing, which contain contract of partnership, Ijārah, and a sale purchase transaction. The paper will discuss the home financing product as it is implemented in Islamic banking industry; it will also examine issues in Diminishing from Jurisprudential point of view and the views of Shāriah scholars in this regard.

Key Words: Islamic Banks, House Financing, Diminishing *Mushārah*, Sharia Issues.

1. Introduction:

Home is a basic necessity for human life. Every individual needs a shelter for rest, sleep, comfort and protection from sun and rain. It is a place to dwell in comfort with family. Therefore, owning a good home is an aspiration of everyone. People fulfill this need by building a house of their own, purchasing it or renting it from others. Indeed payment for home mortgage normally takes a good chunk of one's monthly income. Conventional home mortgages are, of course, interest-based and

• Shariah Department, The Bank of Khyber, Islamic Banking Group, Peshawar, Pakistan.

•• Assistant Professor, Shaykh Zayed Islamic Centre, University of Peshawar.

forbidden in Islam. Accordingly, Islamic financial institutions have introduced a number of *Shāri'ah* compliant modes for home ownership, the dominant of which is Diminishing *Mushārah* or *Mushārah Mutanāqisah* contract. Diminishing *Mushārah* is widely practiced in Pakistan and the Middle East market of Islamic banks. Presently, the Islamic banks of Pakistan using Diminishing *Mushārah* as a major product of financing especially in house financing sector. Islamic Banking Bulletin of the State bank of Pakistan (SBP) shows that Islamic Banks in Pakistan has invested 67.9 billion (Pak Rupees) in Diminishing *Mushārah* Product which is 32 percent of the total financing of Islamic banking industry in Pakistan¹, which reflect the interest of banks in the products as well as customer attraction towards Diminishing *Mushārah*. While in Malaysia, only four banks have been practicing *Mushārah Mutanāqis'ah* Home Financing which are RHB Islamic Bank, Kuwait Finance House (Malaysia), Maybank and Citi Bank Malaysia with its Islamic banking windows. In RHB Islamic bank, MM home financing is called as equity home financing. Other Islamic banks also trying to convert portfolio of house financing to Diminishing *Mushārah* from other products gradually.²

Some *Shāri'ah* scholars have disapproved Diminishing *Mushārah* on some Jurisprudential point of view. They have some serious concerns about the viability of the product from *Shāri'ah* point of view.³

The aim of this paper is to discuss the Diminishing *Mushārah*, observations on Diminishing *Mushārah* from *Shāri'ah* point of view and then to analyze the reservations in the light of *Shāri'ah*.

II. Concept of Diminishing *Mushārahah*:

Diminishing *Mushārahah* is a contract in which two or more partners participate either in a joint ownership of a property or an equipment or in a joint commercial enterprise. The share of the one of the partners is further divided into a number of units while the other partner will purchase the units of the share of the first partner one by one periodically, thus increasing his share till all the units are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.⁴

The Accounting, Auditing Organization of Islamic Financial Institutions (AAOIFI) *Sharāh* Standard No. 12 defines *Mushārahah Mutanāqisah* as:

*“A partnership in which one of the two partners promises to gradually buy the other partner’s stake until he owns the entire project”.*⁵

House financing through Diminishing *Mushārahah* is composed of the following transactions:

1. Creation of a Joint ownership.
2. Giving the share of one partner to another.
3. Promise of one partner to purchase the units of share of the other.
4. Actual purchase of the units at different stages.
5. Adjustment of the rental money according to the remaining share of the other partner in the property.

The first step in the above arrangement is to create a joint ownership in the property. While the second part of the arrangement is that the financier leases out his share in the house to his client and

charges rent from him. This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party, its permissibility is a point of difference among the Muslim jurists. Imam Abu Hanifah and Imam Zufar are of the view that the undivided share cannot be leased out to a third party, while Imam Malik, Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. However, if the property is leased to the partner himself, all of them are unanimous on the validity of *Ijarah*.⁶

The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share is related to land and building, the sale of both is allowed according to all the Islamic schools of thought. Similarly, if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists.⁷ However, it should be kept in mind that at the time of the purchase of each unit, sale must be affected by the exchange of offer and acceptance at that particular date.

It will be preferable that the purchase of different units by the client is affected on the basis of the market value of the house as prevalent on the date of purchase of that unit. However, it is also permissible that a particular price is agreed in the promise of purchase signed by the client. Rental of the property shall be adjusted according to the remaining shares of the financier in the property.

III. Practical Steps of House Financing under Diminishing *Mushārah*

The product of Diminishing *Mushārah* is used for house financing in almost all Islamic banks in Pakistan. The Bank of Khyber (BoK) (Islamic banking Group) also uses the same for house financing to facilitate its customer. Here we quote the practical phases related to house financing scheme under diminishing *Mushārah* from the manual of Bank of Khyber.⁸

Step 1. A Diminishing *Mushārah* account to be created with Islamic Banking Branch of BoK and the client (co-owner) shall pay his share of investment in full or amount less advance. Bank will also deposit its share of investment in the same account. Disbursement upto purchase price is to be made to the vendor at the time of purchase of a house and the balance amount to be utilized for other direct expenses.

Step 2. Joint ownership to be created by virtue of *Mushārah* Agreement (*Shirkat-ul-Milk*). Client shall also provide undertaking that he will mortgage the house in favor of the bank after its transfer in his name.

Step 3. Demand Promissory (DP) Note for the value of shares of the Bank in the House.

Step 4. *Ijārah* Agreement to be executed on the date of transfer/possession of property by the client as co-owner.

Step 5. BoK's share to be divided into units and to be given to the client on rent.

Step 6. Client promises to purchase bank's units over the period of facility as approved.

Step 7. Post dated cheques, one for each year for the amount including annual shares to be purchased and annual rent.

Step 8. Mortgage deed shall be prepared and property shall be mortgaged within seven days or as soon as possible after property is transferred in the name of client (co-owner). Registered Deed of Irrevocable General Power of Attorney in favor of BoK.

Step 9. NOC (post mortgage legal opinion) from BoK's approved legal advisor.

Step 10. NOC from Credit Administration Department.

Step 11. Payment by the co-owner to the bank for the purchase of shares shall be considered as sale of shares and bank will record the sale of shares in its system and a receipt will be provided to the customer.

IV. Analysis of *Shariah* Observations on House Financing Scheme under Diminishing *Musharakah*:

IV.i Combination of Contracts in One Single Contract:

Some *Shari'ah* scholars pointed out that Diminishing *Musharakah* is an unfamiliar term for Islamic Jurisprudence. It is not a simple or one contract but basically it is a bunch of contracts with in the contract which is prohibited by *Shari'ah* as narrated by Abu *Hurairah* (R.A):

”نهى رسول الله صلى الله عليه وسلم عن بيعتين في بيعة“

Forbade the Messenger of Allah peace be upon him from two transactions within one Transaction.⁹

They also argue that Diminishing *Musharakah* is a conditional transaction as it is a combination of three transactions i.e. Partnership, lease agreement and sale purchase agreement. All these three transactions are conditional with each other and come into existence with the sequence which make all the three transactions conditional with each other and *Shari'ah* does not allow conditional transaction as narrated by Amr ibn Shoaib (R.A):

أن رسول الله صلى الله عليه وسلم نهى عن سلف وبيع وشرطين في بيع

The Messenger of Allah peace be upon him forbade the loan and sale and the two conditions in a sale.¹⁰

Given the *Shari'ah* prohibition of the combination of two agreements in one transaction and the prohibition of the conditional transaction, they are of the view that diminishing *Musharakah* of Islamic bank is not permissible from *Shari'ah* point of view as it is conditional as well as combination of contracts into one contract.¹¹

If all these transactions have been combined by making each one of them a condition to the other, then this is not allowed in *Shari'ah*, because there is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another. However, if there is unilateral promise by one party which is not part of the agreement then transaction will not become null and void from *Shari'ah* point of view.¹²

In the present practice of Diminishing *Musharakah*, instead of making two transactions conditional to each other, there is one sided promise from the client, which is not part of the transaction. The client promises to take share of the financier on lease and pay the agreed rent,

and secondly, to purchase different units of the share of the financier of the house at different stages.

IV.ii Floating Rentals:

Some contemporary scholars like Mufti Muhammad Taqi Usmani from Pakistan and Dr. Abu Umar Faruq Ahmad have allowed in long-term leases, to tie up the rental amount with a variable benchmark which is so well-known and well-defined that it does not leave room for any dispute.¹³ For example, in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of the same increased amount. Similarly, it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore, if there is an increase of 5 percent in the rate of inflation, it will result in an increase of 5 percent in the rent as well. This floating rent is objectionable according to some *Shari'ah* scholars like Mufti Ahmad Mumtaz, a prominent Scholar and Mufti from Karachi. They argue that the variations of the rate of interest being unknown, the rental tied up with the rate of interest will imply *jahalah* (ambiguity) and *gharar* (uncertainty) which is not permissible in *Shari'ah*. It is one of the basic requirements of *Shari'ah* that the consideration in every contract must be known to the parties when they enter into it. The consideration in a transaction of lease is the rent charged from the lessee, and therefore, it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the future rate of interest which is unknown, the amount of rent will remain unknown as well. This is the *jahalah* (ambiguity) or *gharar* (uncertainty) which renders the transaction invalid.¹⁴

In response to this objection, Usmani¹⁵ says that the *jahālah* has been prohibited for two reasons. One, it may lead to dispute between the parties. This reason is not applicable here, because both parties have agreed with mutual consent upon a well-defined benchmark that will serve as a criterion for determining the rent, and whatever amount is determined based on this benchmark will be acceptable to both parties. Therefore, there is no question of any dispute between them.

The second reason for the prohibition of *jahālah* is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest in a particular period zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a specific range. For example, it may be provided in the base contract that the rental amount after a given period will be changed according to the change in the rate of interest, but it will in no case be higher than 15 percent or lower than 5 percent of the previous monthly rent. It will mean that if the increase in the rate of interest is more than 15 percent, the rent will be increased only up to 15 percent. Conversely, if the decrease in the rate of interest is more than 5 percent, the rent will not be decreased to more than 5 percent.¹⁶

This is further supported by Al-Zuhāyli¹⁷ who writes that a sale without determining the price is defective and invalid. One cannot agree to buy or rent something without knowing the price one must pay. Further according to him, the sale must not include any of the six important shortcomings. These are: uncertainty or ignorance (*al-jahala*),

coercion/force, time restriction, uncertain specification (*gharar al-wasf*), harm (*al-darar*), and corrupting conditions (*al-shurāt al-mufsidah*).

IV.iii Wa'ad (Unilateral Promise to Purchase Units/Shares):

An additional instrument of *wa'ad* is usually entrenched in two forms. First, the customer undertakes to pay the monthly payment until the end of Diminishing *Musharakah*. Second, the customer irrevocably undertakes to purchase the bank's share.

In contemporary juristic opinions, *wa'ad* becomes legally binding if it is made conditional upon the fulfillment of an obligation and the promise has already incurred expense on the basis of such a promise with the following conditions:

- (a) It should be one-sided promise.
- (b) The promise must have caused the promisee to incur some liabilities.
- (c) If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. Mere promise itself should not be taken as the concluded sale.
- (d) If the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller. The actual damages will include the actual monetary loss suffered by him, but will not include the opportunity cost.¹⁸

IV.iv Event of Default:

In terms of compensation (*ta'widh*) for late payment, some scholars view penalties for late payment of rentals as not permissible; while contemporary scholars have given an alternate to avoid willful default from customers. They are of the view that the financier/lessor may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes including advancing interest-free loans

to the needy persons.¹⁹ The amount payable for charitable purposes by the lessee may vary according to the period of default and may be calculated at per cent, per annum basis. The agreement of the lease may contain the following clause for this purpose:

“The Lessee hereby undertakes that, if he fails to pay rent at its due date, he shall pay an amount calculated at ...percent/per annum. to the charity fund maintained by the Lessor which will be used by the Lessor exclusively for charitable purposes approved by the *Shari'ah* and shall in no case form part of the income of the Lessor”.

This amount shall be given in the charity by the financial institution and shall not take any benefit from this fund.

V. Conclusion:

This paper pointed out some practical issues in Diminishing *Musharakah* particularly Sharia issues which are contradictory among the present day jurists. It is recommended that Islamic *Fiqh* Academy *Jeddah* or AAOIFI to develop consensus among the jurists and make this product more acceptable to all *Shari'ah* scholars from different school of thoughts. We also urge that more Islamic banks may come forward and adopt Diminishing *Musharaka* home financing to provide benefits to the clients and also to keep it more compliant to the *shari'ah* principles. The *Shari'ah* prescribed conditions must be observed and strictly monitored through *Shari'ah* Audit and Compliance in DM; otherwise, it would not be other than the shadow of interest based loans.

Notes and References:

- ¹ Islamic Banking Bulletin (December, 2011) State Bank of Pakistan, table 4, p. 10, Islamic Banking Division.
- ² Bank Negara Malaysia, www.bnm.gov.my, retrieved on July 10, 2012.
- ³ Mumtaz, Ahmed (2011) *Ghar Sodi Bankari Ilmi Jaiza*, p.52, Karachi: Mari Por, Hawks Bay Road. And, Rifaqa (2011) *Murawwaja Islami Bankari*, p. 127, Karachi: Binori Town.
- ⁴ Usmani, M. T (1998) *An Introduction to Islamic Finance*, p.71, Karachi: Idaratul Ma'arif.
- ⁵ AAOIFI (2008) *'Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, p.78, Manama: AAOIFI.
- ⁶ Ibn Qudamah al maqdisi (1993), *Al-Mughni*, vol. 6, p. 137, Beirut: Darul Kutub.
- ⁷ Usmani, M. I. A (2004) *Meezan Bank guide to Islamic Banking*, p. 43, Karachi: Darul Ishaat.
- ⁸ Manual of the Bank of Khyber for Diminishing Musharaka, pp. 26-30.
- ⁹ Al tirmizi, Muhammad Ibn Esa (2005) *Sunan al-Tirmizi*, p. 533, Beirut: Darul Kutub.
- ¹⁰ Nasai, Ahmed ibn Shoaib (2003) *Al Sunan Al kubra*, Hadees No. 6018, Beirut: Darul Kutub.
- ¹¹ Rifaqa (2011), p. 134.
- ¹² Mahmood, Mufti (1997) *Fatawa Mahmoodiya*, vol 4, p. 224, Karachi: Qadimi Kutab Khana.
- ¹³ Ahmad, Abu Umar Faruq (2011) *Shariah Parameters of Musharakah Mutanaqisah in Islamic Finance: The Experience of Australian Institutions Offering Islamic Financial Services*, *Isra International Journal of Islamic Finance*, vol 3 (2), p.27.
- ¹⁴ Mumtaz, Ahmed (2011), p. 55.
- ¹⁵ Usmani, M. T. (1998), p. 244.
- ¹⁶ *Ibid*, p. 44.
- ¹⁷ Al-Zuhayli, Wahaba (2003) *Islamic Jurisprudence and Its Proofs*, p. 33, 56, Beirut: Dar al-Fikr.
- ¹⁸ *Resolutions and Recommendations of Islamic Fiqh Academy, Resolution no. 2 and 3, Fifth Conference of the Islamic Fiqh Academy held in Kuwait, 1409 AH. See the academy's Journal No. 5 (2), p. 1599.*
- ¹⁹ Usmani, M. T. (1998), p. 44.