

## Review

# Middle east bank and their challenge operation in Malaysia: A case study on Kuwait finance house Malaysia Berhad

Mohd Sollehudin bin Shuib<sup>1\*</sup>, Ahmad Azam bin Sulaiman@Mohamad<sup>2</sup> and Mohammad Taqiuddin bin Mohamad<sup>2</sup>

<sup>1</sup>College of Business, Universiti Utara Malaysia, 06010 Sintok, Kedah, Malaysia

<sup>2</sup>Academy of Islamic Studies, University of Malaya, 50603 Kuala Lumpur, Malaysia.

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This research attempts to understand the history of first foreign Islamic bank that operate in Malaysia. The bank was Kuwait Finance House Malaysia Berhad (KFHMB). The focus is on how KFHMB implement musharakah mutanaqisah concept for home financing product. This paper will discuss on how this syariah concept run on Islamic home financing product, their advantages, issues and challenges that was face by KFHMB. This research also focuses on determining Musharakah Mutanaqisah itself. This research shows that home financing through musharakah mutanaqisah is a new product in Malaysia, offered from 2005 by KFHMB. Musharakah Mutanaqisah was a hybrid contract and created by some element like ijarah, al-bay', musharakah. This research also shows that this respondent banks offer the product with their own style in certain part in the same time related with Malaysia buying and selling house tradition. This situation affected institutions from different background and how they run their product. This study also proposes how KFHMB solve the issues and challenges from product offering.

**Key word:** Islamic banking, Kuwait finance house Malaysia Berhad, musharakah mutanaqisah, home financing.

## INTRODUCTION

Malaysia new progress on Islamic banking industry shows that Musharakah Mutanaqisah (diminishing Musharakah) becomes a new innovation for syariah concept that was used to create a product. This equity base concept is a better hypothesis than before like BBA (Fazila, 2003). It is because of partnership concept and also Musharakah Mutanaqisah is a hybrid contract. History shows that Ansar Islamic Cooperative Housing Corporation (ICHC) in Toronto, Canada became the first institution to use this concept for their home financing product (1980 to 1981) (Ansar Housing, 2009). KFH also become among the bank that used this concept in Middle East and in Malaysia (2005). Firstly, academic paper is discussed on this concept by Mohd (1991). Malaysia

banking industry was offer their product at the start of 2005 by KFHMB and followed by RHB Islamic Berhad. MIB star their Musharakah Mutanaqisah product on early 2008. Hypothesis shows that Musharakah Mutanaqisah financing concept is better than the concept that was used before.

In Malaysia, BBA became among the famous concept that was used by Islamic Banking Industry to create and offer their product. BBA was the most used concept in Malaysia Islamic banking industry from 2002 till now. This trend actually the same as before. Just now, they have a big issues and probem on BBA concept. Saiful Azhar says BBA is not accepted because of BBA dont take risk (Saiful, 2005). The big issue of BBA when Malaysian civil court decides is that BBA is a not permitted contract. Therefore, Islamic banker and syariah scholar must create a new contract and innovation to make sure this industry is always relevant. For this, the study

\*Corresponding author. E-mail: [sollehudin@uum.edu.my](mailto:sollehudin@uum.edu.my).

must understand and always be alert with a new progress in banking and finance industry.

### Research problem statement

Home is important for our lives. Every family must have their own house (Awang, 2004). In Malaysia, people can buy house or build depends on where you are or who are you. Most common style now, urban people buy it then village people built it slowly. The tradition of buying and selling house in Malaysia involved buyer, developer and bank as financier. Tradition show that buyer make a transaction with developer first, then go to bank for their financing. But Islamic concept of financing like BBA, Murabahah (Anwar, 2003) and Istisna tell their bank or financier as a must to buy the house from developer first before selling it to customer. So it becomes a clash of transaction. So this paper will explore how the bank makes this situation legally permissible by Syariah concept that was used. It was a complicated process and need a big courage. So it is important to understand this situation.

This paper will focus on how the bank (KFHMB) implement Musharakah Mutanaqisah concept for their home financing product.

KFHMB is a local foreign bank. So their background is different with any local Malaysia bank. Different background will affect their culture or operation style in offering product. This is because; foreign bank was affected from their mazhab, their scholar background. Remember that KFH Syariah advsory board does not recognise floating rate and other contract like BBA and `Inah. This paper will explore how KFHMB with their own style implement Musharakah Mutanaqisah concept for their home financing product.

This will make more interesting because KFHMB is Middle East Bank with Malaysia culture and tradition on property trade. This paper will be discussed on Musharakah Mutanaqisah concept itself, their element, Syariah and their resolutin on it. As a hybrid concept, they are more than one element in this contract. So it's important to understand how this concept was run as a contract. This is because, Islamic law of contract prohibited from making two transaction in a single contract (bay'atan fi al-bay'ah). This paper will also explore the modus operandi KFHMB and MIB from their home financing product and how those will run this concept for under construction property or house. However, the status for early payment of Sedangk house is not yet complete.

From product perspective, it will be discussed on their advantages, challenges and solutions. This paper also tries to discuss about how profit is determined in Musharakah Mutanaqisah (MM) concept, because

Musharakah Mutanaqisah is based on rental, and at the same time, Islamic banking benchmark profit is based on BFR.

### DEFINITION

Musharakah Mutanaqisah is a form of partnership (Mydin and Dzuljastri, 2009) in which one of the partner's promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him/one party (Nasir, 2010). The transaction starts with the formation of partnership, after which buying and selling of the equity take place between the two partners. It is therefore necessary that this buying and selling should not be stipulated in the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract should be entered into as a condition for concluding the other. Mutanaqisah Musharakah contract is permissible from Islamic law of contract even if the contract involves a number of agreements in a document. With the conditions of these, contracts are separately Aqd even in one document. To see the necessity and validity of the contract Musharakah Mutanaqisah, this study can refer back to the verse from Surah al-Ma'idah paragraph 1.

The contracts involved in Musharakah Mutanaqisah also identified into three, namely: Musharakah, Ijarah and al-bay'.

Postulates a requirement of the three contracts have been much mentioned in previous discussions of Islamic scholars who made the Qur'an and Sunnah as the primary references source of Islamic law (Weeramantry, 2001).

### FINANCING BASED ON MUSHARAKAH MUTANAQISAH CONTRACT

Islamic financial institution has submitted a proposal to offer property financing product based on the concept of Musharakah Mutanaqisah. Basically, the modus operandi of the property financing product based on Musharakah Mutanaqisah is as follows:

- i) The customer who wants to buy a property approaches the bank for financing.
- ii) The bank and customer enter into Musharakah agreement to jointly purchase the property based on an agreed share depending on the amount of financing requested (for example, 90:10).
- iii) The deposit already paid by the customer will be deemed as his initial share contribution.
- iv) The customer will rent the bank's shares of the jointly acquired property through Ijarah agreement; and

v) The instalment by the customer will be used to buy the shares of the bank gradually until the entire bank's share is owned by the customer.

Musharakah Mutanaqisah means a contract of partnership between financier and customer to own an asset in which one of the partners give the right to the other partner to buy his equity share of the asset either by one lump sum payment or several payments based on agreed conditions.

### Resolution

The Council in (Malaysian Shariah Advisory Council) its 56th meeting held on 6th February 2006/7th. Muharram 1427 resolved that the financing product structured based on Musharakah Mutanaqisah contract is permissible. This is because the Musharakah Mutanaqisah is a contract recognized in Islamic muamalat. In implementing Musharakah Mutanaqisah contract, it is permissible for the contracting parties to:

- i) Combine the two contracts of Musharakah and Ijarah in one document of agreement, as long as both contracts are concluded separately and clearly not mixed between each other; and
- ii) Impose a pledge on the shares owned by the customer because the right of beneficial ownership is recognized by Shariah.

### FINANCING THROUGH MUSHARAKAH MUTANAQISAH IN KUWAIT FINANCE HOUSE (MALAYSIA) BERHAD (KFHMB)

#### History of Kuwait finance house (Malaysia) Berhad (KFHMB)

Kuwait finance house (KFHMB) has been widening its wings to Malaysia in 2005. KFHMB establishment in Malaysia is part of the agenda to expand sharia banking based activities. In Malaysia, KFHMB is known as Kuwait finance house (Malaysia) Berhad or short KFHMB. KFHMB operations in the country are based in Etiqa Tower, Jalan Pinang, Kuala Lumpur. Based on the chronology of its establishment in Malaysia, KFHMB history began when Bank Negara Malaysia (BNM) has announced to offer and issue licenses to three foreign Islamic banks to operate in Malaysia. Announcement was made in September 2003. KFHMB not only allow this opportunity but also apply to establish branches in Malaysia.

In May 2004, BNM has approved the application of KFHMB to become the first foreign Islamic bank in Malaysia. A year later, Ministry of Finance has been

awarded licenses to KFHMB to launch its activities in Malaysia. In August 2005, KFHMB began operations in Malaysia with the opening of its first branch in Kuala Lumpur. KFHMB is also the first Islamic bank licensed distributor by the securities commission in February 2006.

Establishment KFHMB officially launched on February 17, 2006 by the Prime Minister of Malaysia at that time, namely Dato 'Seri Abdullah Haji Ahmad Badawi

### Musharakah Mutanaqisah home financing product at KFHMB

Financing transactions in KFHMB through Musharakah Mutanaqisah contract involving three parties, namely:

KFHMB as i) financier and partner, ii) partners consisting of customers and iii) the supplier of goods or the Company Property Developers (Housing Development). Three parties here mean that all those involved in the financing contract is Musharakah Mutanaqisah in KFHMB has a close relationship even though traditional purchase homes in their relationship separate buyers (customers) with developers and customers with the bank. Such a relationship can see the effects of functions in the event of default-EOD (such as failure of the developer to complete the house) (Figure 1).

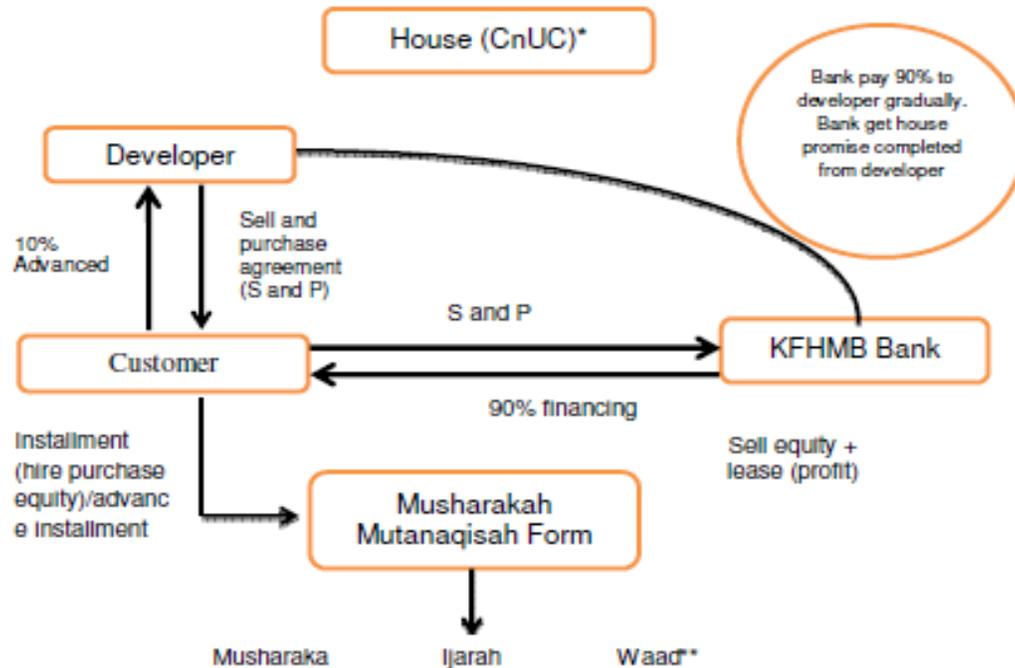
i) Customers who wish to obtain financing in Musharakah Mutanaqisah will identify homes that they want to buy. Once satisfied with the home specifications, customers need to get Sale and Purchase Agreement or Purchase Receipt Booking Form or from the developer as evidence for submission to the bank when applying for financing.

ii) Sale and Purchase Agreement must not only be in the name of customers, but customers need to meet KFHMB prior to Sale and Purchase Agreement also state later KFHMB as buyers together.

iii) Customers will find the next KFHMB to apply for home financing that by submitting the required documents. KFHMB offers financing products for both categories of home, whether the house is still not ready or have not been completed (under construction) or already completed (completed construction).

iv) After discussion with approval, bank customers will sign the agreement document as agreed to sign a contract Musharakah Mutanaqisah products through Musharakah Mutanaqisah Financing-i. Customers will start paying the next installment in accordance with the stipulated period as 30 years from the date as temetrai in the agreement.

v) In concept Musharakah Mutanaqisah, KFHMB and customers are like share capital required in buying a house with the ratio of the partnership agreed as 90:10 or 80:20. The ratio of banks is usually greater than the ratio



**Figure 1.** Operation of Musharakah Mutanaqisah home financing product at KFHMB.

\*C- Completed construction. UC- under construction, \*\* Waad Mulzim = customer promises to purchase bank equity (house). Source: Based on interviews made with the bank officials (10 March 2009).

of customer-owned, but in the case of 90:10 for example, 90 are owned by the partnership KFHMB while 10 are owned by sharing ratio to customers who bought the house.

vi) Customers will eventually occupy the house (if the house property is completed) and make lease payments in accordance with current lease rates. Rental payments were usually aggregated in one monthly installment payments customers made. This is because the monthly installment is KFHMB customers to include payments and rent payments for the purchase of equity owned KFHMB on the house.

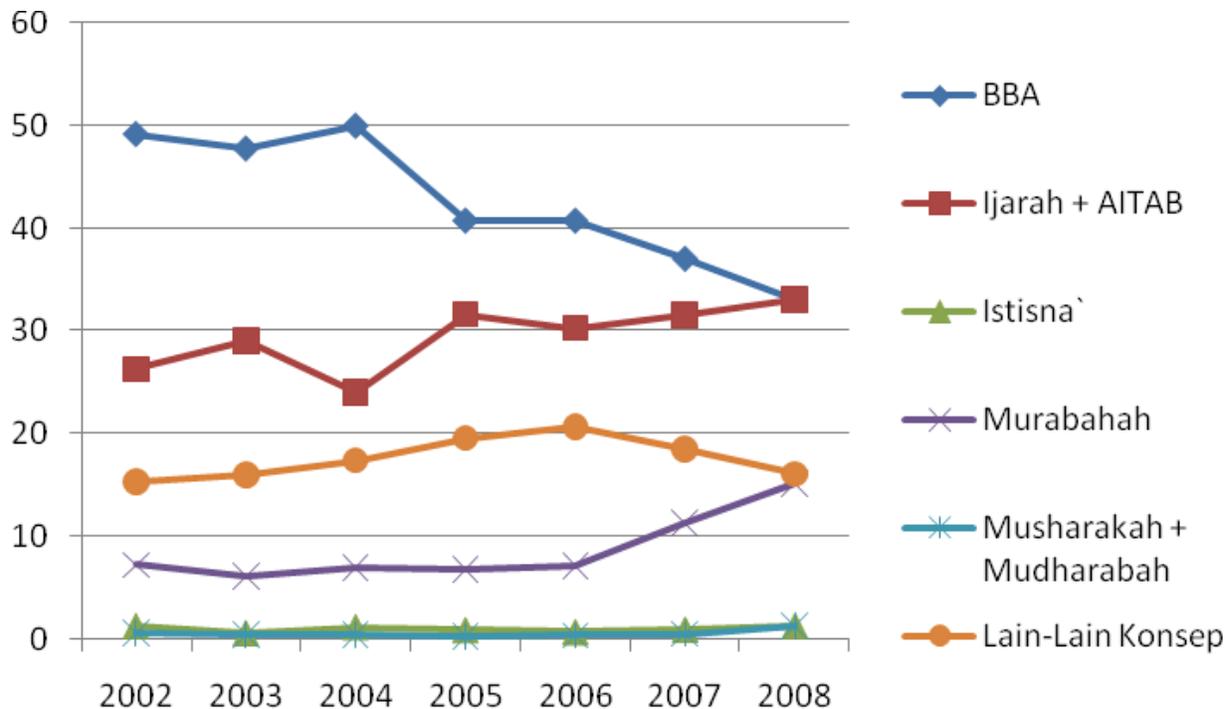
vii) The purpose of the purchase by the customer ekuti KFHMB gradual process is referred to as customers or take equity ownership of banks to redeem the house gradually until the occurrence of the perfect home equity transfers from KFHMB to customers. Tenure is in accordance with customer options agreement made during the same 30, 20 or 15 years. The duration also depends on the buyer's background as individual buyers of Malaysians maximum period are 30 years. While for individual non-citizens is 20 years maximum.

viii) After due and proper payment of installments made to customers, then the transfer will be completed between KFHMB and customers. So with this, complete financing to buy houses in Musharakah Mutanaqisah will be practiced by KFHMB.

Financing for homes is still under construction, the initial payment of the home when the customer is not ready is counted as an advance rental payment (advance rental) based on the concept Ijarah mausufah fi zimmah. After the house was completed and occupants' (customers), advance rental payments collected shall be calculated as the rent for the first month after the house was occupied. This is also the rent in fully bank profits. In this financing, promises to be completed will house the bank obtained directly from the developer and not from customers (Shahar and Fazli, 2009).

### Advantages of product financing based on Musharakah Mutanaqisah at KFHMB

Kuwait Finance House products through Musharakah Mutanaqisah Financing-i has offered special features significant than other Islamic banks in the country. This is because foreign banks KFHMB is more accurate or more from the Middle Tangah who is also the second largest Islamic bank in the world. So what's on offer in Malaysia is also largely based on the practice of KFH in Kuwait itself. Among the advantages offered by this product KFHMB is the aspect of partnership applied. The first advantage in product financing as Musharakah Mutanaqisah offered KFHMB as banks that will equally



**Figure 2.** Illustration position of financing based on syariah concepts.  
Source: Bank Negara Malaysia (Annual Report and Mac Statistical Bulletin).

share profits or losses that occur in the housing finance products in Musharakah Mutanaqisah are based on the terms and limits agreed with. In the case of houses that are still not ready (property under construction), for example, when developers in the event of failure to complete the house purchased, the bank will provide full cooperation in resolving the problem. KFHM methods used at this time are to restore the full advance payment in addition to rental customers fully independent from binding with the bank. At the same time, the remaining matters involved KFHM and developers only. This is altogether different with the products before financing was primarily based on the BBA.

The second advantage is in KFHM supply facilities through cash financing products to customers Musharakah Mutanaqisah-i this. Facilities can be obtained with cash through selling shares to customers of the home shared with the bank. Customers can sell the Setaka which they have. This is not a mediator of their exit from the contract, but customers are still occupants and they rent the house. This facility may be needed by customers at times when the unexpected accident such as requiring expenditure, requiring surgery that costs may be higher or when work is removed. KFHM facilities provided is very interesting in Meastikan their products can compete in the market. The third advantage offered by this product is KFHM facilities make early settlement (early settlement). This mediator customer who have

surplus money and want to resolve the remaining financing fees can do so at any time. Terms are to give notice of a month earlier. No indicators defined and customers only need to pay only Pokak. Hence, the question arises does not automatically give rebates or not because customers were indeed get rebates by early settlement made. This is because products based on this concept of Musharakah Mutanaqisah do not have the selling price. The question arises only grant rebates for products which have the selling price (Figure 2).

#### **Issues and challenges in financing operations based on Musharakah Mutanaqisah at KFHM**

There are several issues that arise in financing housing in Musharakah Mutanaqisah in KFHM. The first issue is related to absence rate ceiling for financing products in KFHM. The second issue is related to problems in the contract of guarantee capital financing in Musharakah Mutanaqisah. In addition there are several challenges faced in product offerings this KFHM, most notably to convince the developer contracted with a 3rd party banks and customers. The second challenge is related to action when a bank fails (event of default-EOD) customers or developers of such delays occur in installment payments by customers, clients continue to fail in making installment

payments and the third housing developer fails to complete the house according to period and subsequently disappeared (financing for homes still under construction or not yet built).

The first issue related to the absence of a ceiling rate (cap rate) profit for the product in house financing KFHMB. Even KFHMB products all have ceiling rates. This raised a question mark because usually products of Islamic banking in Malaysia have a ceiling rate of profit, especially products that refer to a floating rate of profit. This is because the floating rate is 100% depends on the basis of Islamic financing rate (base rate finance-BFR) while BFR is also influenced by the overnight rate and the cost of funds involving the elements specified by Bank Negara Malaysia (BNM). For authors absence rate ceiling for this product may cause floating proportional emergence Gharar.

In addition the Islamic banking system at this time still does not have its own benchmark in determining the rate of profit and still rely on conventional benchmark. Hence how KFHMB not put any ceiling rate for the product. According to them, the reason given is putting a ceiling rate of profit seems to make a product that has two prices. This act is not required by results of Syariah Advisory Council KFH based in Kuwait. The second issue is related to problems in the contract of guarantee capital financing in Musharakah Mutanaqisah. This issue arises because the contract allowed the contractual Musharakah not guarantees the capital of another partner or the other. Such guarantees may raise the issue laptop. According to Mr Masri Mohd Fazli, issue guarantee capital should not arise if the sale of equity to the original law partner is not based on a fixed rate determined at the beginning of the contract (fixed value determined at the beginning of contract). According to the majority of jurists' opinion must be based on sales of equity market price. But in this issue, it is not practical and in operation and very difficult to follow the market for the purchase of equity in each month must refer the market price and the house must be assessed on the equity to be sold each time. But a few scholars' allow the purchase of equity on the basis of the values given in the initial contract. Rasionalnya is to protect the customers affected by ripples from the increased price of the property market will cause the value of equity (share value) will also increase and menjadi expensive. Next there are several challenges faced in the KFHMB offering financing products in this Musharakah Mutanaqisah.

The first challenge is to convince developers that hold contracts of Musharakah Mutanaqisah three parties. In this case KFHMB will ensure that the developer promised that the black and white house still under construction can be completed. Promise must be given to KFHMB. This developer is not a mediator separated by buying practices such as regular home where the contract is made separately, such as customers and developers,

customers and banks, and thus, involves developers and banks with many sides, but such contracts involve two parties only. KFHMB strive to ensure that the contract pembiayaan housing Musharakah Mutanaqisah really involves three parties that is developers, customers (buyers) and banks. This is to ensure that developers play better and to ensure the welfare of customers (buyers) is maintained. The KFHMB insist in this case where the contract financing Musharakah Mutanaqisah will not proceed if the developer does not want to act as third parties. KFHMB second challenge as a bank financier in question is related to EOD. Failure problems can be divided into three customers that fail to make installment payments during the period specified, the customer fails to exceed 6 months without any response and the developer fails to complete the third house by the desired customers. The problem is that customers failed to make installment payments during the period specified, KFHMB such as Islamic banks will impose other penalties of 1% of the number of installments that should be paid that month. Penalties with result will be entered into the welfare fund and not for use in the calculation of their profits KFHMB is issued for customers who fail to make full payment installments after six consecutive months.

KFHMB as banks that provide financing has four alternative solutions. First, KFHMB will take over the house and rent it out to a third party. KFHMB will take over second homes and rent to others first while waiting for new home buyers to have it. Third, KFHMB will restructure the financing re-evaluate the price of the house and offers to customers to buy again. KFHMB fourth option is to issue notice to the customer, if it does not get proper response from customers, KFHMB will take approach to bring the case to court.

Usually after getting a court order, KFHMB will be auctioning the properties. Results from the auction will be used to pay debt financing customers that are still remaining. If there is a surplus, the money will be given back to customers. If the auction results are not sufficient to accommodate the remaining debt financing customers, then customers will be ordered to pay the balance of financing available to KFHMB. The third challenge is related to failure of the developer in preparing a house still under construction. Issues for developers who fled or failed to complete the home is financed, KFHMB has its own approach to solve this problem. Thus, KFHMB will hold discussions between customers and give them two options either refund the installments (rent deposit) of customers fully or the second KFHMB will get permission to develop their own home until the house is ready to be inhabited customers. This will make your customers not to worry if their house fails disiapkan developer. This advantage only applies to categories in home construction or not yet built (Shahar et al., 2009).

## CONCLUSION

In the overall description and analysis made, the purchase method authors find in homes in Malaysia are still using traditional methods that customers need to meet before the developers get financing from banks. However, the contract will be matched with the Islamic method of purchase of these traditions. These include the use of the concept Musharakah Mutanaqisah in Islamic financing products. As a result, several questions arise that require clarification of this concept related applications.

Authors also found that the approach used by the MIB KFHMB and offers products for financing housing Musharakah Mutanaqisah is mold itself must comply with other guidelines in accordance with sharia and flow like a traditional method of selling in Malaysia. Approach to both the bank offers advantages in products, face issues and challenges that arise is also different. Various words in here and there is the same approach and there is also a different approach in the supply and settlement. This is due to the influence of the background between banks of different strategies and approaches of its own.

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