Current Practices of Islamic Home Financing: A Case of *Musharakah Mutanaqisah* in Malaysia

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Abstract: Islamic mortgage as being the housing finance tool of Islamic banking and finance offers a home ownership for those who seek for *halal* alternative. There are indeed various type of instruments used as an underlying contract for Islamic mortgage, which comprise of debt based financing (*murabaha, istisna', ijarah, bay'bithaman ajil*) and equity based financing (*musharakah mutanaqisah*). As the debt based products of Islamic mortgage are criticised for mimicking the conventional counterparts, the introduction of equity product of home financing based on *musharakah mutanaqisah* (MM home financing) is deemed to become a better alternative, which capable of fulfilling the true spirit of *Shari'ah* and overcome the shortcomings of debt based products. As MM has been introduced to replace BBA, there are many issues surrounding its implementation. This study, therefore, aims to obtain a clear understanding of MM home financing practises and to analyse legal framework and its adequacy in governing the implementation of MM home financing. In achieving the aims, this study employed the interviews with 19 individuals who are actively involved in the implementation of MM home financing in Malaysia including Islamic bankers, Islamic economists, *Shari'ah* advisor and regulator. The interview finding revealed that despite MM current operation, Malaysian legal system is in fact, not duly in place to accommodate the true implementation of MM equity financing which is regarded as relatively a new home financing product.

Keywords: Islamic home financing, *musharakah mutanaqisah,* legal framework.

1. Introduction

In the early inception of Islamic Banking and Finance (IBF) in Malaysia in 1983, the availability of Islamic mortgage is only dominated by a single instrument or product known as *Bay Bithaman Ajil* (BBA) home financing or sale with deferred price. It is basically designed on the basis of debt based financing with the element of *bay' inah* contract, which the amount of financing facility could be paid by the customers to the banks on a deferred payment basis agreed by both parties throughout the tenure of the financing and it is normally on the fixed payment monthly instalment.

Until presence, there are various issues associated with the implementation of BBA home financing. Such issues include BBA global acceptability from *Shari'ah* point of view, prohibition of *gharar* for the case of financing an uncompleted property, rebate, price and the issue of form against substance which mimicking conventional housing loan. These issues indirectly urge the government, particularly the Central bank of Malaysia to encourage a new mode of Islamic home financing which is more equitable and reflect to the spirit of *Shari'ah*.

This view is supported by Razak *et al.* (2008) who claim that since BBA in Malaysia receives many criticisms from various perspectives, there may be low intention to use BBA as a mode to finance a house among the public in future. The situation deteriorates due to the fact that through debt based financing, Islamic banks tend to choose risk avoidance strategy which causes the removal of morality from the banking business (Rosly and Bakar, 2003), and ultimately, the interest of home buyers are neglected.

The ideal model of Islamic banking is pivotal to ensure the sustainability of the system as a whole. As such, the reformation of the application of Islamic banking and finance is urgently needed.

However, new reforms do not translate into a complete and total abrupt discontinuation of the current practice. Siddiqui (2005:201) suggests a gradual move towards a better system of Islamic banking that is capable of eliminating interests in real sense which is also in line with the spirit of *Shari'ah*. Rosly and Bakar, (2003) and Anwar, (2003) have maintained that Islamic banking should operate with a social orientation in their businesses, which does not necessarily means charity, but are responsive to ethical and become real trader particularly in exercising *murabahah* and BBA concept.

Siddiqui (2005) further proposed necessary strategies to be adopted in order to promote the optimal profit and sharing approach. More importantly, the government should encourage Islamic banks to increase their profit and loss sharing assets by a small percentage every year. The small percentage of 3% to 5% is deemed sufficient for a move.

Therefore, based on the earlier discussion, MM can be made an alternative to replace the current BBA for Islamic home financing (Rosly, 1999; Meera and Razak, 2005; Taib *et al.*, 2008; Razak *et al.*, 2008; Kader and Leong, 2009). Besides capable of complying and fulfilling all the requirements for *Shari'ah* contract, MM is also able to promote the true spirit of Islam in providing justice to the house buyers.

Since MM home financing is relatively new in the market, the product experiences many issues surrounding its implementation which influenced its inherent capability of becoming a better Islamic home financing product. Therefore, the objective of this paper are: to develop a clear understanding of MM practises from the Islamic banks and experts in Islamic home financing; and to critically analyse legal framework governing the implementation of MM.

2. Method

In achieving the aims, this study employed the interviews with 19 individuals who are actively involved in the implementation of MM home financing in Malaysia. The aim of the interview is to develop a clear insight of practices from these industry players who are involved directly in the implementation of MM home financing particularly on the governing law for the implementation of MM home financing; and whether the existing law is exhaustive enough in governing MM home financing.

The interviews were conducted in Kuala Lumpur, Malaysia, involving the regulator, bankers, legal experts, *Shari'ah* advisors and Islamic economists. The participants are considered as all important individuals in their organizations, which make them key persons and experts in their respective areas.

3. Result and Discussion

i. *Operating Mechanism of Islamic Home Financing Based on MM*

The analysed data have established that most of the interviewees perceive MM as a new product of home financing that combines several contracts namely *musharakah*, *ijarah* and sale contracts, which are determined and shaped by certain *modus operandi*.

In relation to the *modus operandi*, the interviewees described that in an actual operation, the customer pays a certain amount of deposit to the developer, and later he approaches the bank for home financing. MM home financing takes place when the bank approves the customers' home financing application and the former pays the remaining price of the house to the developer. This creates a partnership between the bank and the customer. According to this partnership, the former owns 90 percent of the shares while the latter owns 10 percent of the shares of the house. During this stage, the parties enter into a partnership agreement in order to legalise the process.

As the practical explanations provided by the interviewees, since the intention of the customer is to stay in and eventually own the house at the end of the financing period, a leasing arrangement then is made whereby the bank gradually, leases out their portion of the house to the customer and he pays a monthly rental, which constitutes a profit to the bank. The third stage is the sale contract, whereby MM is structured as reducing balance or diminishing partnership. This means that the banks' shares in the partnership will be reduced throughout the partnership and that is by virtue of customer undertaking to gradually purchase the banks' shares in the property throughout the financing tenure.

As can be seen, the leasing contract and sale contract indeed take place concurrently whereby the monthly instalment typically divided into two portions: one portion goes to the rental and; another portion goes towards the purchase of the banks' shares. Finally, at the end of the financing period, the customer would become a full and sole owner of the house and by that time the lease will end, because lease can only occur when the bank still owns certain portion of the house for which the bank charges rental to the customer.

In examining the structure or the form of MM home financing, therefore, particularly having several *Shari'ah* contracts are combined and translated into practice to provide one particular home financing contract to the customer is a clear indication of unique features of this product. It is this particular nature, which makes MM home financing absolutely different than BBA home financing. In other words, the *modus operandi* explained above successfully proves that MM is not a typical BBA, whereby the latter is perceived as *inah* contract which merely involve the sale and buy back transaction. Based on this ground, it is mainly the reason most of the interviewees viewed that the implementation of MM home financing is because of the attempt to move away from BBA home financing that is dotted with various controversial issues.

Although the implementation of MM home financing clearly indicates a move away from BBA, it does not necessarily mean of phasing completely out from debt based financing. The main reason obviously can be seen from the name of the product itself and the principles of contracts applicable in it. Albeit the word *musharakah* is defined as partnership, which is equity instrument in nature, the word *mutanaqisah* on the other hand, connotes the meaning of diminishing which is designed to be perfected by two distinct debt-like instruments namely 'leasing' and 'sale contracts'. As such, MM home financing is indeed not a pure equity contract, but rather it is a combination of debt and equity contracts.

Although the contracts involved are not purely equity financing, the requirement for the product to observe the unique features of each contract applicable, should be given paramount consideration. For instance, how far the terms of partnership principles are strictly adhered to in order to reflect its equity financing part and how far the terms and conditions for *ijarah* and sale are kept to in the implementation of this home financing product. Failing to strictly observe these requirements may lead to various issues and problems regarding the implementation of this product particularly from *Shari'ah* perspective.

In other words, the principles relating to partnership in the MM contract should at least be observed in order to warrant 'equity implications' between the contracting parties. Realising the principles of partnership or equity part of the whole financing is very important which is often considered to be the preferred Islamic mode of financing because it adheres most closely to the principle of profit and loss sharing. To reiterate, profit and loss sharing concept has considerable implications at the macroeconomic level, as such arrangement will play an important role in greater economic development particularly for the Muslims.

Apart from that, equity financing is also perceived to reflect *maqasid Shari'ah* which promotes justice for all the stakeholders. According to *maqasid* approach, the primary aim of the *maqasid Shari'ah* is to secure benefit and repel harm or injury. Therefore, the products should be engineered in the way that it complies with the *Shari'ah* objective. Therefore, Islamic banks are expected to provide the service and offer the products that can repel the harms commonly found in the conventional interest based financial products. The Islamic banking product will not reflect the spirit of *Shari'ah* if these harms cannot be eliminated and cause injustice to the parties, which is the main principle is and should be considered in product development and survival.

Following this argument, the practice of MM in Malaysia should therefore be capable to repel the harm as commonly practiced in conventional banking system. For instance, Chapra (2011) and one of the interviewees view that if a default or failure of repayment caused by the customers is due to strained circumstances, Islam recommends not just rescheduling, but even remission if necessary. In the case of auctioned property, the bank should to a certain extent, take a risk of loss, if any, according to their proportionate shares. Hence, if this element of equity financing can be fulfilled in the MM product, it will lead to an increased demand for Islamic product. Yet, in the reliance on equity and profit and loss sharing on the basis of its inherent advantages over other financial alternatives and therefore create a healthy balance between debt based and equity based financing for the prosperity of the economy and society, as the economy with highly reliance on debt will cause a high risky economy that links to the global crisis.

ii. Legal Framework and the Adequacy of Current Law Governing the Application of MM Home Financing in Malaysia

Based on the findings and the provided information in the interview analysis, this section discusses the legal framework on how MM home financing is legally operated in Malaysia and whether the current state of legal framework is adequate to govern its operation. The preceding data analysis revealed that the MM home financing in Malaysia is conceptually based on Islamic principles, but its legal operation is based on conventional principles of laws with the spirit of debt financing being dominant.

It is further revealed that there are mixed responses on the adequacy of current laws to govern the operation of this product. Some of the interviewees held that current law is adequate. However, further amendments maybe necessary to improve the whole legal structure to achieve a true meaning of equity financing. On the other hand, as indicated above, some of the interviewees held that the current state of law is completely inadequate requiring new law to be enacted for the MM home financing to take effect.

It is apparent in the previous section that the *modus operandi* of this home financing product is based on several *Shari'ah* contracts. The application of hybrid contract of equity and debt instruments namely partnership, *ijarah* and sale to form the entire process of home financing is inevitably a successful translation of *Shari'ah* concept of *muamalah* into a reality. As such, based on this premise, it is no doubt that a majority of the interviewees held that MM home financing is conceptually based on Islamic principles.

Unfortunately, in terms of its legal operation, most of the interviewees viewed that legal operation of MM home financing is based on conventional principles of law with the spirit of debt financing is still prevailing. It is argued that this is the result of the current state of legal framework in Malaysia governing the banking system as a whole, which is conventional in nature. The fact of having dual banking system, in which Islamic banking exist side by side with the conventional counterpart, may to certain extent reflect the spirit of debt financing in this product. Moreover, the Malaysian legal system is in fact, not duly in place to accommodate the equity financing which is regarded as relatively a new home financing product. Although there is a specific statute regulating the establishment and the operation of Islamic banks in Malaysia, which is the Islamic Banking Act, it remains as the only regulatory body without specifying any statement of substantive law to be applied in cases of a dispute.

This indirectly creates a real challenge for the practitioner in Islamic banking system, when preparing legal documentation for Islamic banking contracts particularly in the case of MM home financing contract. They may have to ensure that the documentation must be *Shari'ah* compliant and is accord with other civil laws which are Malaysian law generally, and also enforceable before the court of law. In particular, with regard to civil laws, the practice of this new home financing product employs additional legal safeguards such as 'trust', 'caveat' and 'charge' in order to protect the banks' interests.

While discussing the application of certain legal safeguards to the banks, it is also worth mentioning that although from the *Shari'ah* perspective the co-purchase of the house by the customer and the bank is actually accorded ownership partially to the bank, these additional legal safeguards are utilised to defend the right for the bank in the context of Malaysian land law. In other words, while the basic concepts used in this product are based on *shirkah*, *ijarah* and sale, these legal instruments are employed to further safeguard the rights of the banks particularly. Without employing these statutory legal safeguards, the interests of the contracting parties remain contractual in nature, with no statutory certainty in which the banks feel vulnerable. Based on this ground, it can be argued that due to the need to address the current structure of the legal framework to become enforceable before the court of law resulting in MM home financing being viewed as operationally conventional.

On the issue of an adequacy of current legal framework in governing the operation of MM home financing, there are various responses from the interviewees. To reiterate, some of the interviewees with professional banking background held that current state of legal framework is adequate for the operation of this home financing product. However, they agreed that further improvements or amendments to the current legal structure may be needed in order to improve the whole legal process in relation to MM home financing product, with the objective of providing certainty or recognition to their approaches and dealing with the current state of MM home financing. On the other hand, some interviewees with the *Shari'ah* advisory or non-practitioners background viewed that current legal framework is completely inadequate to govern the operation of this new financing product. This argument based on fact that MM contract is indeed a unique equity financing with unique features that requires specific statute to govern its operation which can be capable of giving true spirit of equity financing.

The divergence of the opinions on this issue indirectly demonstrates the nature of the potential problem. However, it is certain that in absence of this proper and specific statute, operation of MM home financing with the legal structure based on conventional finance, the spirit of debt financing remains prevalent in the construct and operation of MM. Turning to the practitioners' perspective, since the bankers are familiar with the conventional system with its established rules and policies, for them the operation appears to be much easier in practice. Following this argument, the current state of legal framework which is conventional in nature is perceived to certain extent to be adequate for MM with merely some modifications to suit the current conventional system in order to justify the operation of this new Islamic home financing product.

It is also worth mentioning that albeit different responses on this issue voiced, all of the interviewees shared the common views that 'something need to be done' for the betterment of the current legal framework for the operation of this home financing product irrespective if it involves the amendments to existing laws or enactment of a new statute to govern its operation. Hence, consistent improvement and amendment to the legal framework will ensure the development of Islamic finance particularly for the equity financing, whereby it might be necessary to establish different legal and regulative structures for the operation of Islamic finance. In other words, different treatment and consideration must be given to legal nature of Islamic structures on various issues, such as owner liability, the consequences of default and what happens in the event of loss or destruction of the assets.

It should also be noted that it is a need for further research exclusively on legal framework of MM home financing focusing on whether there is a real need for a new statute for the operation or mere amendments on the current legal framework would be sufficient for its operation. To accommodate this, qualified pool of talent remains the valuable asset in order to support the development of Islamic finance being closely attached to the spirit of *Shari'ah* and capable to uphold justice for the economic development particularly for the Muslims as a whole. Thus, it is hoped that the implementation of MM home financing would become an impetus for further reliance to equity financing in Islamic finance particularly in Malaysia.

4. Conclusion

The findings from the analysis concluded that the implementation of MM involved the combination of various *Shari'ah* contracts namely *musharakah*, *ijarah* and sale. Besides, the analysis also concluded that albeit MM is conceptually based on *Shari'ah* contracts, its implementation are based on conventional system with the element of debt based financing being dominant. This happens due to certain legal safeguards which were available to the banks were actually conventional in nature such as, caveat, trust and charge. Those safeguards which were used to protect the interest of the bank particularly were derived from the civil laws, making it based on debt based financing.

To conclude, through meticulous analysis and discussion, this study shows that MM home financing in Malaysia is relatively a new product of home financing with the element of equity financing. Since this is the first ever product of equity financing for retail market, there are a lot of issues and problems ranging from the provision to the conceptual nature of the facility. However, in light of the current support by the policy makers in marketing Islamic financial products, it is hoped that there would be continuous attempt to improve the facility in future, and eventually the reliance on equity financing would increase due to inherent benefits associated with it, which is consistent with the underlying ethical basis of *Shari'ah* financing for the benefit of the society as a whole.

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