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# Musharakah Mutanakisah (MM) Financing: Experience of Islamic Banks

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## Abstract:

This study aims to analyze the concepts and practices of Musharakah Mutanakisah (MM) by Islamic banks. The findings revealed that the MM is a hybrid contract that combines three independent contracts namely: partnership, leasing and sale. MM could be used it for financing asset acquisition as well as for other types of partnership. Hence, MM has been successfully implemented by Islamic banks in Islamic and non-Islamic countries for house financing.

**Key words:** Islamic banks, Leasing and sale, Musharakah Mutanakisah (MM), Partnership.

**JEL Classification Codes:** G21, G24, F65.

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## Introduction :

The Islamic finance industry has witnessed a rapid growth in many parts of the world, the increasing demand for Sharia -compliant products and services to meet the needs of both Muslims and non-Muslims have contributed to its prosperity. Various products have been developed based on the principles of legitimate finance.

One of new Islamic contracts is Musharakah Mutanaqisah or (Diminishing Partnership) (MM) considered as an innovation in Islamic financial industry (Ahroum & et al, 2017). In a Musharakah Mutanaqisah (MM), an Islamic bank may finance a client by partially owning the purchased asset, whereby the client gradually purchases the shares of the Islamic bank through periodic payments and leading to a full ownership by solely the client and used to describe those joint business enterprises (Alkhan, 2020).

Musharakah Mutanaqisah (MM) is unique, using rental rate than to benchmarking conventional rate is crucial in pricing the contract (Hanudin & et al, 2014). Thus, Musharakah Mutanaqisah (MM) has been successfully implemented by Islamic banks in Muslim and non- Muslim countries for various financing purposes and commonly used for home financing.

**Research problem:** In recent years Islamic banking and finance have made the product innovation in many economies, in this regard, the product development is essential to achieve its full potential and fulfill the need of investors. In the light of the above discussion, we are trying to answer the following question:

To what extent the Musharakah Mutanqisah (MM) financing is provided by Islamic banks?

The following sub-queries may therefore be raised:

- What is Musharakah Mutanqisah (MM)?
- What are the advantages of the implementation of MM by Islamic banks?
- What are the successful experiences of implementation of MM by Islamic banks?

## Research objectives:

- Developing a better understanding of MM as new financing product.
- Drawing attention to the role of this tool in contributing in solving many problems of Islamic financing market.
- Presenting successful experiences of MM practiced by Islamic banks.

**Research importance:** In the rapidly changing of the financial environment Islamic finance the need for financial innovation is crucial for Islamic banking to outperforming competitors and meet the request of investors using the sharia principles

**Research methodology:** This study relies on the use of descriptive analytical approach by presenting the various concepts related to MM and data analyzing its existing practices by Islamic banks.

## 1. Musharakah Mutanakisah (MM): How it Works?

### 1. 1. The concept of Musharaka Mutanaquisah (MM):

The formal acceptance of the concept of Musharaka Mutanaquisah (MM) or Diminishing Musharakah was only announced by OIC's International Fiqh Academy at its 15th Session held in Muscat Oman in 2004 ( Asadov A. & et al, 2018).

Musharakah Mutanaquisah (MM) comes from the Arabic word "She-Ra-Ka" that refers to as joint, binds be part of,. Meanwhile, Mutanaquisah which derived from the word "Na-Qa-Sa" means reduce, decrease, or decline (Shahwan & et al, 2013). Musharakah Mutanaquisah (MM) is a financing type that is based on decreasing partnership concept based and loss sharing. In this context one of the parties undertakes that s/he will purchase the shares of the other party. (Dinc, 2017). The AAOIFI defined the Musharakah Mutanaquisah (MM) or Diminishing Musharakah as follows:

"Diminishing Musharakah is a form of partnership 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. It is necessary that this buying and selling

should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other" (AAOFFI Shariah Standard, 2017). From AAOIFI definition, it implies that MM is a hybrid contract that combines three independent contracts Musharakah (joint venture), ijarah (lease), and bay (sale). In addition, it also stated unilateral promise as it comes from the buyer side to buy bank's portion (Syafa'atur Rahman & al, 2018) So that, the mention of Musharakah Mutanaqisah is a form of cooperation between two or more parties for ownership of an item or asset collaboration will diminish the proprietorship right one party while the other party increase this form of cooperation ended with the transfer of the rights of one party to the other party (Abdul, 2019).

## 1. 2. Rules of Musharakah Mutanaqisah (MM):

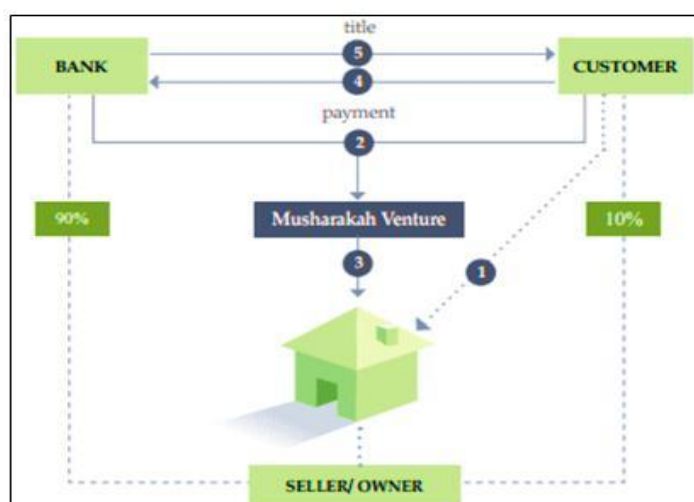
MM involves a financial institution obtaining an equity share in an asset or business as opposed to a conventional loan. Some basic rules of MM are below:

- Profits are shared as per the agreement of the partners, whereas Losses must be shared in proportion to the respective capital contributions;
- Silent partners must take a share of profits in direct proportion to their initial investment (Abu Umar Faruq, 2011);
- The Sharia advisory board must have the right to monitor the contract;
- The contract of partnership and the contract of sale should be done separately, and not collectively;
- A binding promise can be taken from one partner to purchase the share of the other partner gradually ( Asadov & et al, 2015).

## 1. 3. Mechanism of Musharakah Mutanaqisah (MM):

The MM or decreasing partnership represents a joint venture between the bank and the customer (i.e. bank 90% and the customer 10 %), where they buy the house (or any other asset) together. Once acquired, the house is leased to the customer who pays the rent to the bank for using its shares in the house. Together with the rent, the customer will pay additional amount in order to redeem the shares of the bank. Consequently, the bank's shares will decrease while the customer's shares will increase until the house is fully owned 100% by the customer ( Smolo, 2007). Figure1 below summarizes the steps involved in structuring MM house financing.

### Mechanism of Musharakah Mutanaquisah (MM)



Source: ISRA (2010), Managing default in Musharakah Mutanaquisah, p 5

- 1- Customer selects the house or the project for the financing.
- 2- Bank, once application is approved, enters into a Musharakah arrangement with customer with specific ration.
- 3- Customer leases bank's shares in the project under the concept Ijara .
- 4- Customer will use his portion from the lease rental amount to buy gradually the bank's share.
- 5-The partnership will be end up with the customer owning of the project; the title will be transferred to the customer.

To summarize the gist of the discussion above the process of MM includes three contracts, set up a joint venture, leasing shares of the bank to the customer, selling bank's share to the customer.

## 2. Musharakah Mutanaqisah (MM) with a rental rate:

The rental issue is very important as its utilization in MM home financing could replace interest rate as a benchmark (Audia & et al, 2018). The MM uses a formula by banks to calculate the monthly payment but MM and it is calculated as follow (Ching Lung, 2013):

The rental rate is,  $x = X/P$

Where:

$X$  = Monthly rental payment

$P$  = Total value of the asset

The formula of MM as follows:

$$M = x (1+x)^n B / (1+x)^n - 1$$

Where:

$M$  = periodically payment to the bank (include the additional amount of rental)

$x$  = Rental rate periodically

$n$  = Number of periods

$B$  = Initial bank share

The customer makes periodic payment to the Bank which includes the additional amount of rent that will be used to redeem the Bank's share gradually.

Example is if the rental is 2000.00 DA but the customer pays 2500.00 DA, 500.00 DA is the additional amount that can be used to redeem the bank's share until the customer owns 100% of the asset.

The formula that is used to find the additional amount is as follows:

$$A = \frac{x[p - (1+x)^n \cdot C_0]}{(1+x)^n - 1}$$

Where:

A = Additional amount that customer needed to pay in order to increase its ownership.

X = Rental rate

P = Total value of the asset

C<sub>0</sub> = Contribution of the customer to purchase of the asset.

n = Number of period all formulas taken from ( Ching Lung, 2013).

## Example of MM calculation:

Price of house = 200 000.00 DA

Initial contribution of customer (10%) = 20 000.00 DA

Initial contribution of financier (90%) = 180 000.00 DA

Monthly rent = 1000.00 DA

Number of years = 20 year (240 months)

In order to redeem the financier's share within 12 years the customer has to pay on top of monthly rental of 1000.00 DA as calculated below:

$$X = \frac{\text{monthly rental}}{\text{House price}}$$

$$X = \frac{1000.00}{200\,000.00}$$

Here, the rental rate is x=0.5% per month and the additional monthly amount is needed:

$$X = \frac{0.005[200,000 - (1+0.005)^{240} \cdot 20,000]}{(1.005)^{240} - 1}$$

$$X = 289.58 \text{ DA}$$

There the additional amount the customer has to pay is 289.58 DA.



Therefore, the total monthly payment:  $1000.00\text{DA} + 289.58\text{DA} = 2597.41\text{DA}$  for 12 year ( Kameel & et al, 2009).

The rental is most suited for use in Islamic finance since it is measured from the true usufruct of the asset, unlike interest charges that are apparently not tied to the asset's usufruct. Hence, the rental rate can differ among houses within a same row of houses or among different floors within a condominium block but interest rates are generally independent from such factors (Ahamed Kameel & Dzuljastri, 2009). However, the current practice to determine the rental in MM home financing product is based on the conventional benchmark such as KLIBOR and LIBOR (Redzuan & et al, 2018). Nevertheless, there are some alternatives to benchmark being proposed to reflect the market value such as using the market rental yield and the Islamic Interbank Benchmark Rate (IIBR) (Yustiardi & et al, 2019).

### 3. Advantage Musharakah Mutanaquisah (MM):

MM is a better alternative contract for home financing and is well accepted by the Muslim scholars worldwide, it is a global product that may be applied in many types of financing that could be arranged as partnership (Nurul & Rusni, 2019). In MM the value of house always reflects the market, and the rental is determined by the market rental values or at a price agreed at the time of acquisition and can be adjusted at the end of each subcontract period. Thus, the bank can manage better the liquidity risks (Mydin - Meera & Abdul Razak, 2009).

Since Islamic banks share risk and profit with customers and will benefit from their financial wellbeing, they will act as true partners. This partnership based on real economic factors strengthens the link between real and financial markets and reduces adverse influences of one on the other (Asadov & Ibrahim, 2018).

Furthermore, financing through an MM contract can prevent inflation since this type of contract does not create credit in the economy. Therefore, in the event of inflation, it avoids new money creation as in fractional reserve banking. By avoiding

money creation and operating under a profit-and-loss sharing setting, the MM can bring about a harmonious balance between the monetary sector and the real economy and thereby is likely to contribute towards the achievement of the maqasid al-Sharia (Bahari, Hatizal, & Doktoralina, 2019).

In addition to home ownership, all business ventures manufacturing, service, agriculture and trading enterprises can be financed on the basis of MM and the poverty can be reduced as well as by providing interest free loans to small and the enterprises (SMEs) trough MM (Selim, 2018).

## 4. Successful Experiences of Musharakah Mutanaquisah (MM) practiced by Islamic banks

### 4. 1. Pakistan

In Pakistan, Islamic banking operations, in terms of full-fledge Islamic banks, were started in 2002. At present, there are total 34 domestic private, government and foreign banks are operating in Pakistan (Talat & et al, 2018).

The Islamic banks of Pakistan are currently using MM as a major financing product; especially in the house financing sector Meezan Bank Limited (MBL) developed scheme a called "Easy home" that was the first Islamic home financing facility financing (Smolo & Hassan, 2011).

The below table illustrate the different provided by the state bank of Pakistan over the period 2012-2020

**Financing Mix of Islamic Banks in Pakistan (Percentage Share)**

	2012	2013	2014	2015	2016	2017	2018	2019	sept-2020
<b>Murabaha</b>	39,7	40,6	30,1	24,5	15,8	13,2	13,6	12,9	13,3
<b>Ijarah</b>	9,3	7,7	7,7	6,6	6,8	6,4	6,2	5,7	5,3
<b>Musaharakah</b>	0,8	6,7	11	14	15,6	22,0	19,9	19,8	23,5
<b>Mudarabah</b>	0,2	0,2	0,1	0	0	0	0	0	0
<b>Musharakah Mutanaquisah</b>	36,2	30,8	32,6	31,7	34,7	30,7	33,3	34,1	34,5

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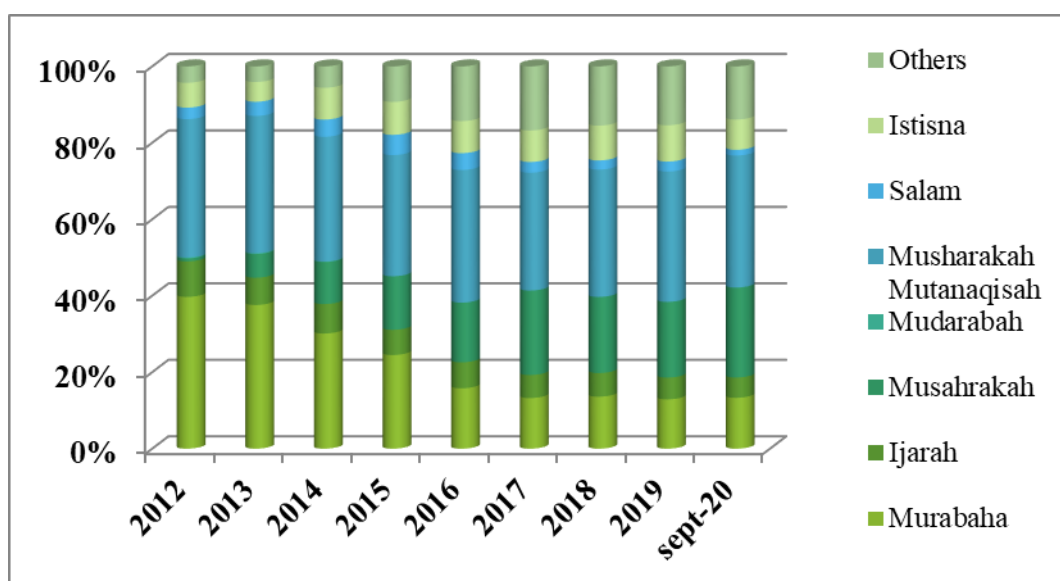
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<b>Salam</b>	3	4	4,5	5,3	4,4	2,8	2,4	2,6	1,5
<b>Istisna</b>	6,5	5,6	8,3	8,6	8,4	8,2	9,1	9,5	7,9
<b>Others</b>	4,3	4,4	5,6	9,3	14,3	16,7	15,5	15,4	13,9
<b>Total</b>	100	100	100	100	100	100	100	100	100

Source: State Bank of Pakistan during the period (2012– sept20).

In the year of 2012 and 2013 the share of Murabaha financing was the highest 36.2% and 38.8% respectively. On the other hand, the MM financing there is an increase in the share from 30.1% in 2014 to 15.8% in 2016 (see Table 1). Again, MM is the highest in overall financing of Islamic banking with a share of 34.1%, followed by Musharaka 19.8% and Murabaha 12.9% in 2019, and by the end of September, 2020 in terms of mode wise financing, MM remained the largest share in overall financing of Islamic banking industry with a share of 34.5% ( State Bank of Pakistan, 2020).

## The evolution of MM financing among other financing product



Source: Self –elaborated by the authors.

From the figure above) is also showing the MM financing increase rapidly since 2012. In other hand, a decline trend in using Murabaha financing over the period 2014 to September 2020, Islamic banks in Pakistan move away the Murabaha financing and replace it by MM financing and there is continuously increase in using MM financing all over the period 2012- sept 2020.

From the available literature the shift in the financing trend that because MM is the most efficient in terms of cost incurred by a client. In other words, MM is relatively the most affordable mode of financing. In addition to that, the duration of financing could be substantially shorter (Smolo & Hassan, 2011). Furthermore, this represents an efficient mechanism of reducing profit misreporting risk (Elfakir & et al, 2020). Murabaha and Ijarah were only devices for protection against interest and are offered for overnight period only, and these are not the ideal Islamic banking products, this can be described as major cause of this paradigm shift from Murabaha and Ijarah financing to profit and loss sharing instruments such as MM. In the practices in Pakistan, the rent or the profit share is assessed in Karachi Inter Bank Offer Rates, which is also known as KIBOR (Dinc, 2017).

## 4.2. Malaysia:

MM started gaining popularity in Malaysia and globally by applying practices that are more closely related to the Shariah Law (Mohd Thas Thaker & Loke Ke Wei, 2017).

In Malaysia particularly, the MM was resolved by Shari'ah Advisory Council, Bank Negara Malaysia on 5th February 2006 The advert of the application of MM in this country is consistent with the historical development of Islamic banking in Malaysia (Abdul Rahman & et al, 2013) According to the General guidelines issued by the Bank Negara Malaysia),

There are two kinds of contracts used by MM for the purpose of asset acquisition and for venturing in profit generating business activities and they must be governed by

shirked al-milk (joint ownership two or more persons) and shirked al-aqd (joint commercial enterprise) (Asadov A. & et al, 2018).

There is a bigger rooms for the MM based financing contract to be further implemented by the banks because currently only nine banks has implemented MM 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 (Muhamad & et al, 2013).

## House financing contracts used by Islamic banks in Malaysia



Source: Muneeza & et al (2020), House financing: contracts used by Islamic banks for finished properties in Malaysia, P173.

We notice from the previous figure that MM is the second product for home financing after Murabaha financing in Malaysia the reason why has gained popularity is because of the fact that via the Bursa Suq Al Sila platform, it is easy, swift, reliable, profitable, cheaper, convenient and has zero risk to do this type of transaction at the comfort of the office (Muneeza & et al, 2020). However, financing property using Musharakah Mutanaqisah is considered to have less risk than other financings (Juliyanti & Wibowo, 2021). Moreover, it may also have a role that prevents economic crises based on mortgage (Dinc, 2017).

In Malaysia provide financing through MM using base financing rate which is the same as base lending rate from conventional financing system instead of rental rate. This is allowed by the Sharia scholars at this moment until an alternative is found (Abdul Razak & Tazwar, 2018).

## 4. 3. Canada, UK

Thousands of homes for Muslim population in Canada for last three to four decades, and it is expected that all such institutions will play even greater role in interest free financing in the days to come Qurtuba Housing, ISNA Housing Co-operative Limited (IHC) and Ansar Co-operative Housing Corporation Limited (ACHC), all based in Canada, operate as Cooperative housing on the basis of MM principle and have shown remarkable success in interest free financing (Selim M., 2018)

Islamic finance is expanding in the UK with Islamic mortgage worth £164 million with average annual growth rate of 68.1 per cent, showing its great potential HSBC Bank is another example of successful implementation of MM modes of finance. Under this model, HSBC buys a property jointly with its customer and it will be held by a third party (in this case, HSBC Trust Company) who will hold it on trust for both of them. During the financing term, the client will pay monthly Amanah Home Finance payments to acquire shares in the property. This will cause the client's share to increase while the bank's shares will decrease in the same proportion. During the same period, the client will pay the property leased to him/her by the bank. At the end of the term, once all payments are made, the bank will transfer the property into the client's name (Smolo, 2007). Contemporary MM agreements link rental rate to some known interest rate index such as the London Inter-bank Offered Rate (LIBOR) in the UK (Asadov A. & et al, 2018).

Hence, the application of this tool alongside with Sharia principles of risk and profit sharing plays a functional role in deriving benefit and enhancing effectiveness, raises their performance and attracts more investments in the international market.

## 6. Conclusion:

Musharakah Mutanaqisah (MM) or Diminishing Musharakah is a combination of three independent contracts namely: partnership (Musharakah) contract, leasing (Ijarah) and sale (Bay) based on loss and risk sharing. MM is the best mode of finance

for house financing and could be applied for other types of partnership. As its use in MM home financing, the rental issue is very significant that could replace interest rate as the benchmark.

MM is universal product, the cases presented in this paper can give credibility to the viability of The MM. It has been successfully implemented in many Muslim countries such as Pakistan and Malaysia and non- Muslim countries Canada, UK, In addition to home ownership, all business ventures manufacturing, service, agriculture and trading enterprises can be financed by MM. Thus, we can contribute in solving many problems such as the crises of house in many countries and reduce poverty. Therefore, is recommended that Islamic banks expand their supply of this product which should be in line with Sharia principles to meet the need of the customer. However, adopting and developing a real benchmarking of rental rate in MM, is considered to be essential tasks for the achievement the content of Islamic finance and to provide a real alternative to the conventional financial structure which is based on interest.

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