National Conference in Islamic Finance (NCiF) 2007

Diminishing Musharakah: An Analysis of Structures

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PRESENTATION OUTLINE

- Introduction
- The Concept of Diminishing Musharakah
- The Six Structures of Diminishing Musharakah
- The Advantages and Uniqueness
- The Disadvantages
- Issues in Diminishing Musharakah
- Conclusion

INTRODUCTION

Types of Shariah-compliant Partnership

- **Musharakah (Shariah-compliant partnership)**
  - **Al-Thabitah Al-Mustamirrah (Fixed Continous)**
  - **Al-Thabitah Al-Muntahiyah (Fixed Ending)**
  - **Al-Mutanaqisah (Diminishing)**
  - **Al-Mutaghayyirah (Changing)**

INTRODUCTION

- Why Diminishing Musharakah?
  - The concept is globally acceptable by the Shariah scholars (First International Conference on Islamic Banking, Dubai, 1979).
  - The equity financing was proposed by most of the Islamic economists.
  - Creating the uniqueness of Islamic banking industry.
  - Reflecting the spirit of Shariah – quoting Tariq Hameed.
  - Products innovation and differentiation
  - The problem of continuous partnership (not a practicable phenomenon)
  - The exit mechanism for the financer (systematic liquidation mechanism)
  - Also suitable of waqf project

MALAYSIAN SCENARIO

To the date this article was written, the author did not notice any Islamic products offered by the Malaysian IFIs based on DM except as the following points:

- Kuwait Finance House – Musharakah Mutanaqisah Home Financing-i
- Citibank – Home Partner-i
- Asian Financ Bank – Asset Purchase and Home Financing

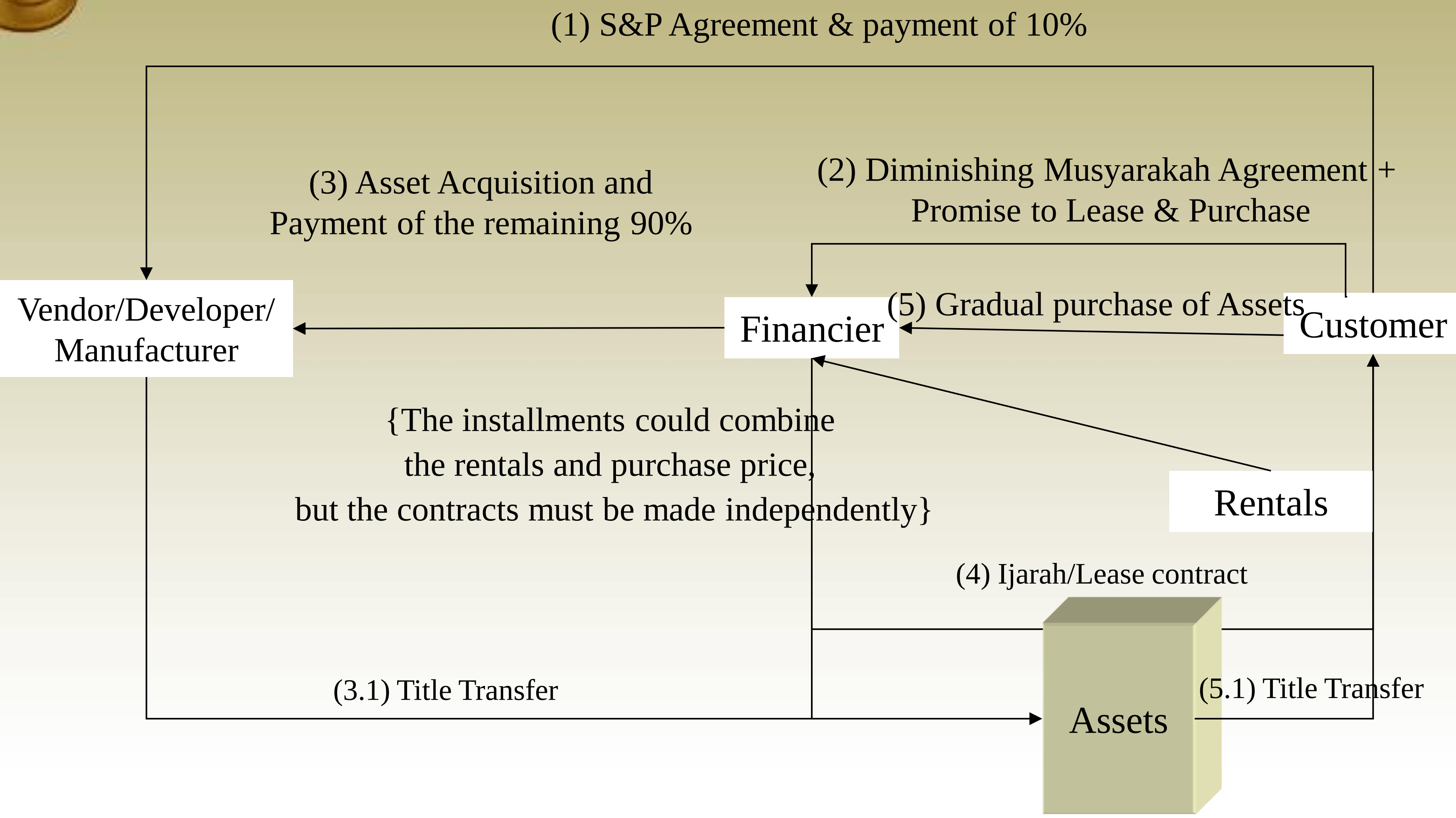
Having said all the above listed products and institutions, this list is not exhaustive. There are more IFIs that have planned to introduce a number of products based on the contract of Diminishing Musharakah.

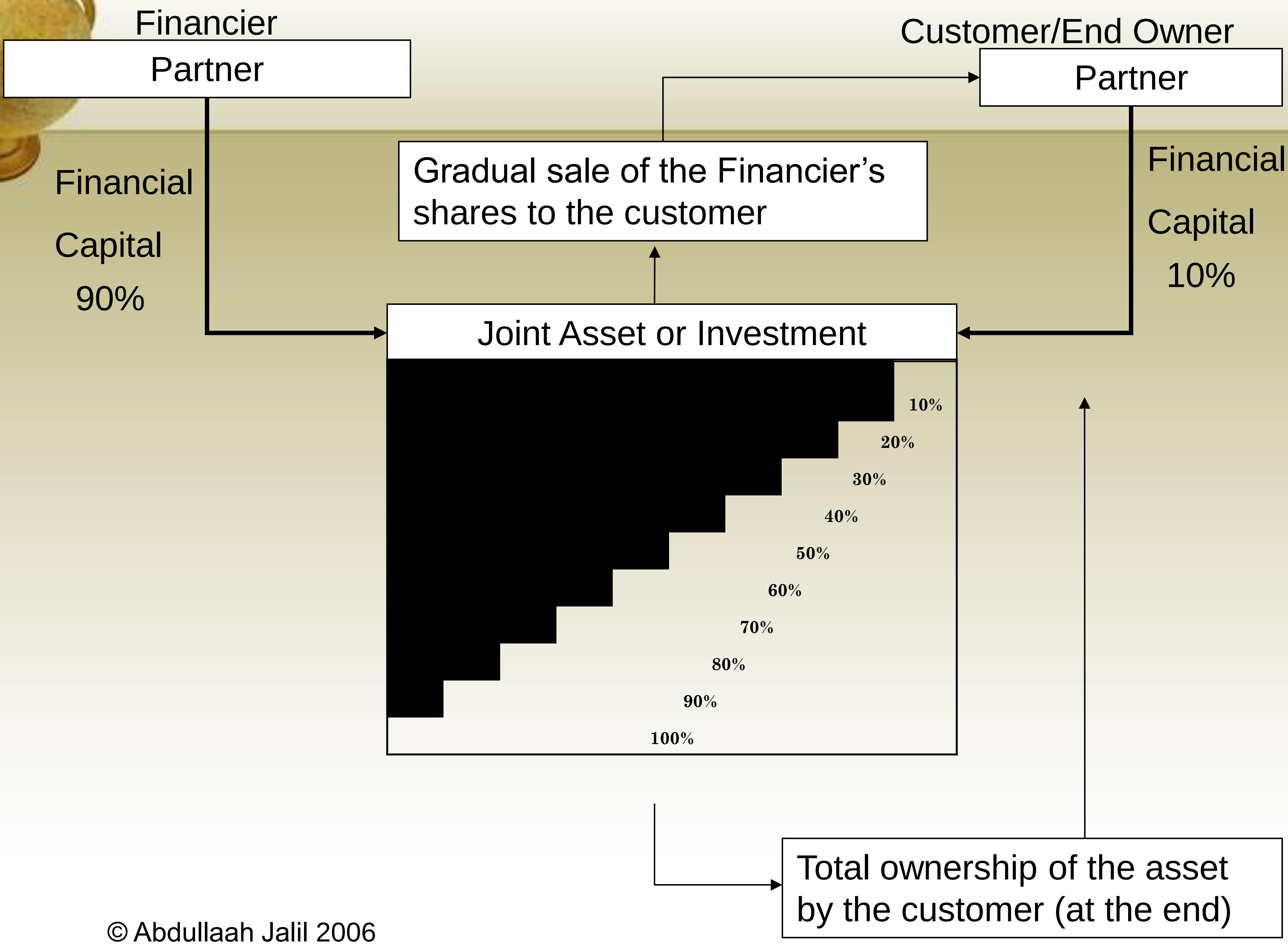
THE CONCEPT OF DIMINISHING MUSHARAKAH

- Definition:

  - Diminishing *Musharakah* is a partnership contract between two parties on a specific property where both parties has agreed that one of them will sell his portion to another party in installment or lump sum through an independent sale contract. In most situations, a lease contract to one of the partners or third party will take place where the rentals will be shared between both parties according to their portion. Eventually, one of the partners will own the *Musharakah* property in total.

THE NORMAL MODUS OPERANDI: DM + IJARAH

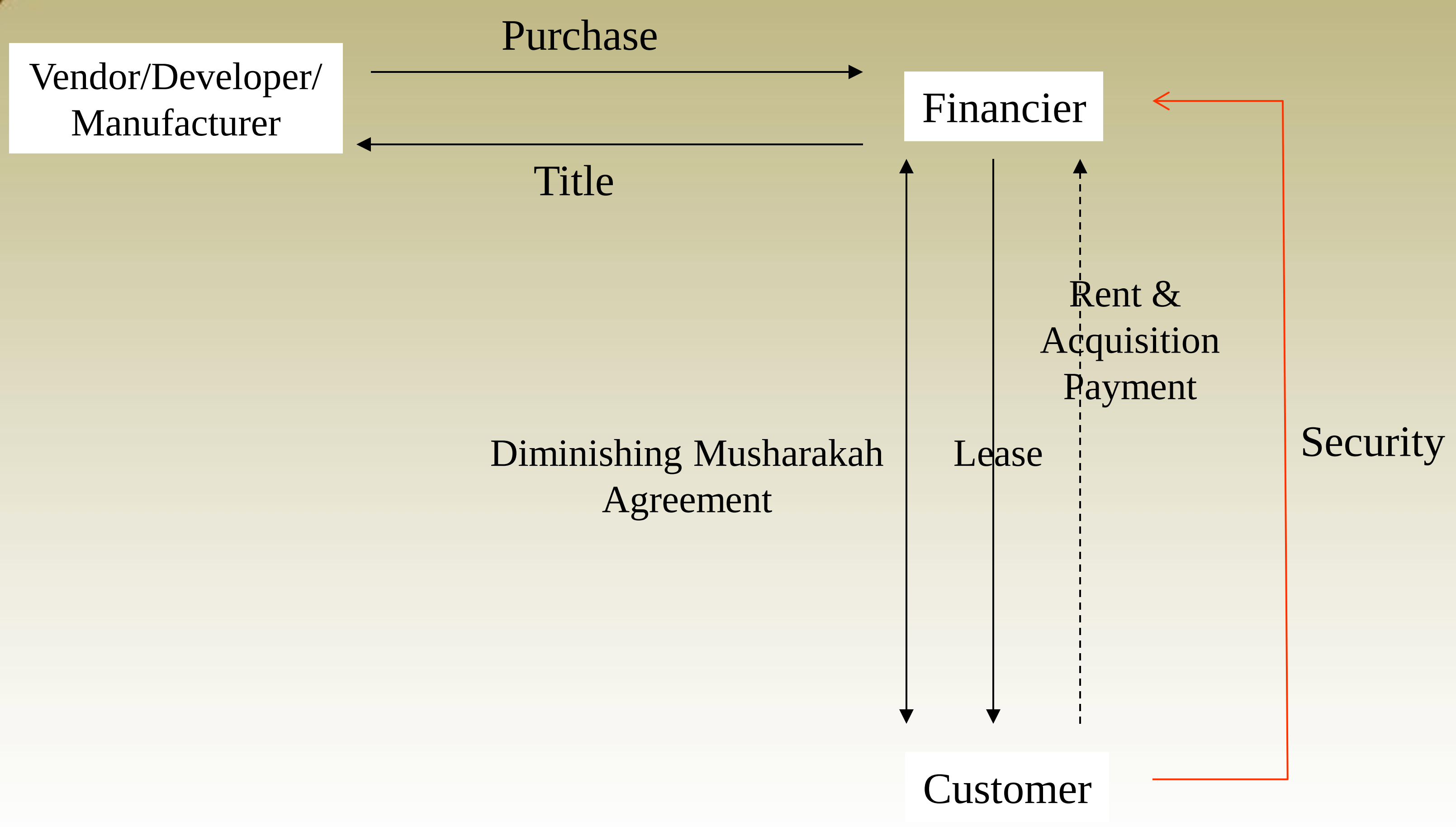



Financier
Partner
Customer/End Owner
Partner
Financial
Capital
90%
Gradual sale of the Financier's shares to the customer
Financial
Capital
10%
Joint Asset or Investment
10%
20%
30%
40%
50%
60%
70%
80%
90%
100%
Total ownership of the asset by the customer (at the end)

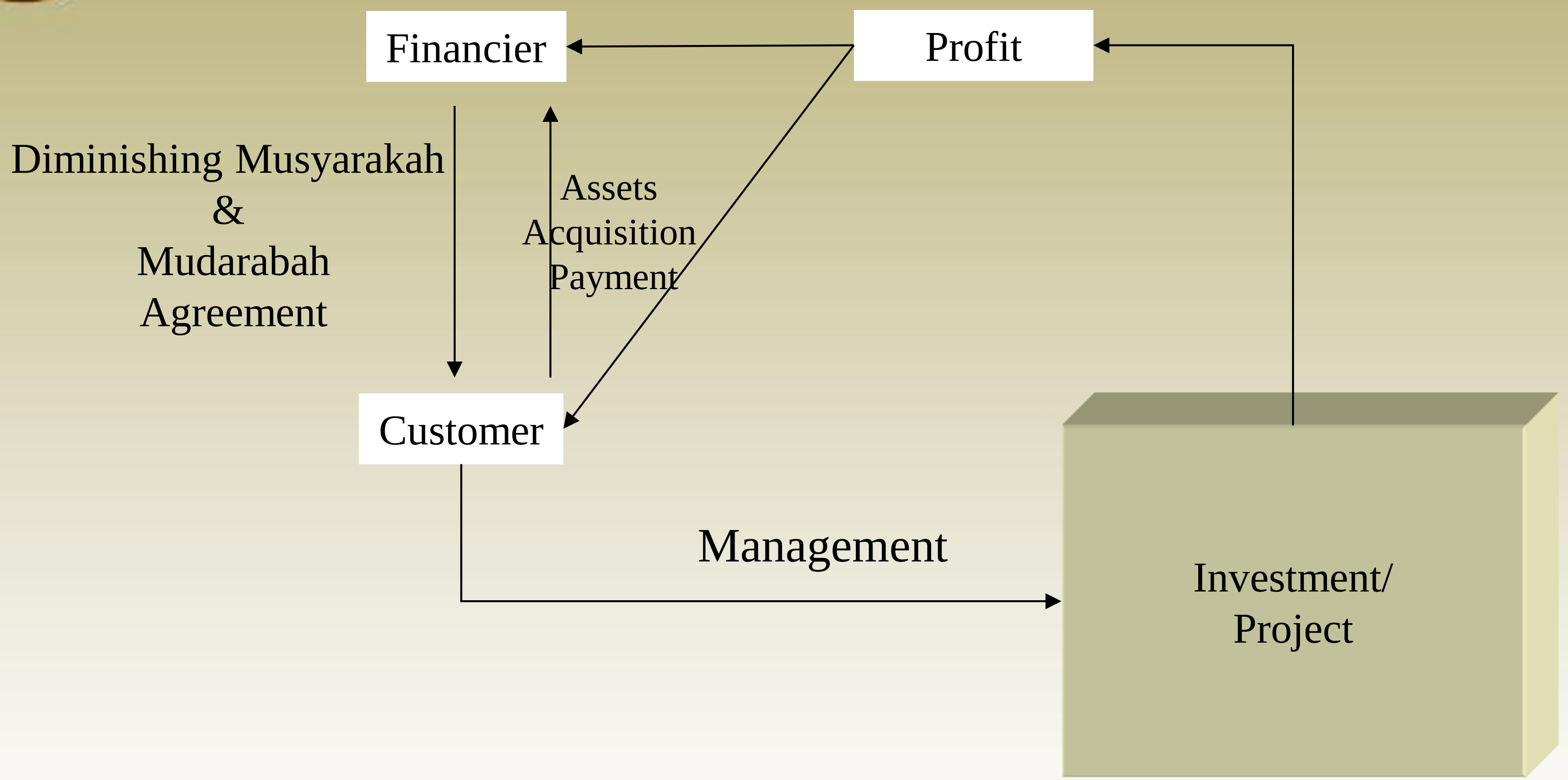
THE NORMAL MODUS OPERANDI

- First: The customer enters into the S&P Agreement and pay the 10% deposit for purchasing the house.
- Second: The customer approaches the bank and ask for Diminishing Musyarakah facility to acquire the asset. At the same time, he makes a promise to lease and purchase the asset.
- Third: The bank acquires the remaining balance.
- Fourth: The bank leases his portion to the customer (his partner).
- Fifth: The rentals will be distributed according to the Diminishing Musyarakah Agreement.
- Sixth: The customer will gradually own the asset by purchasing the bank's shares of the assets through a sale contract.
- {The installments could combine the rentals and purchase price, but the contract must be independent}

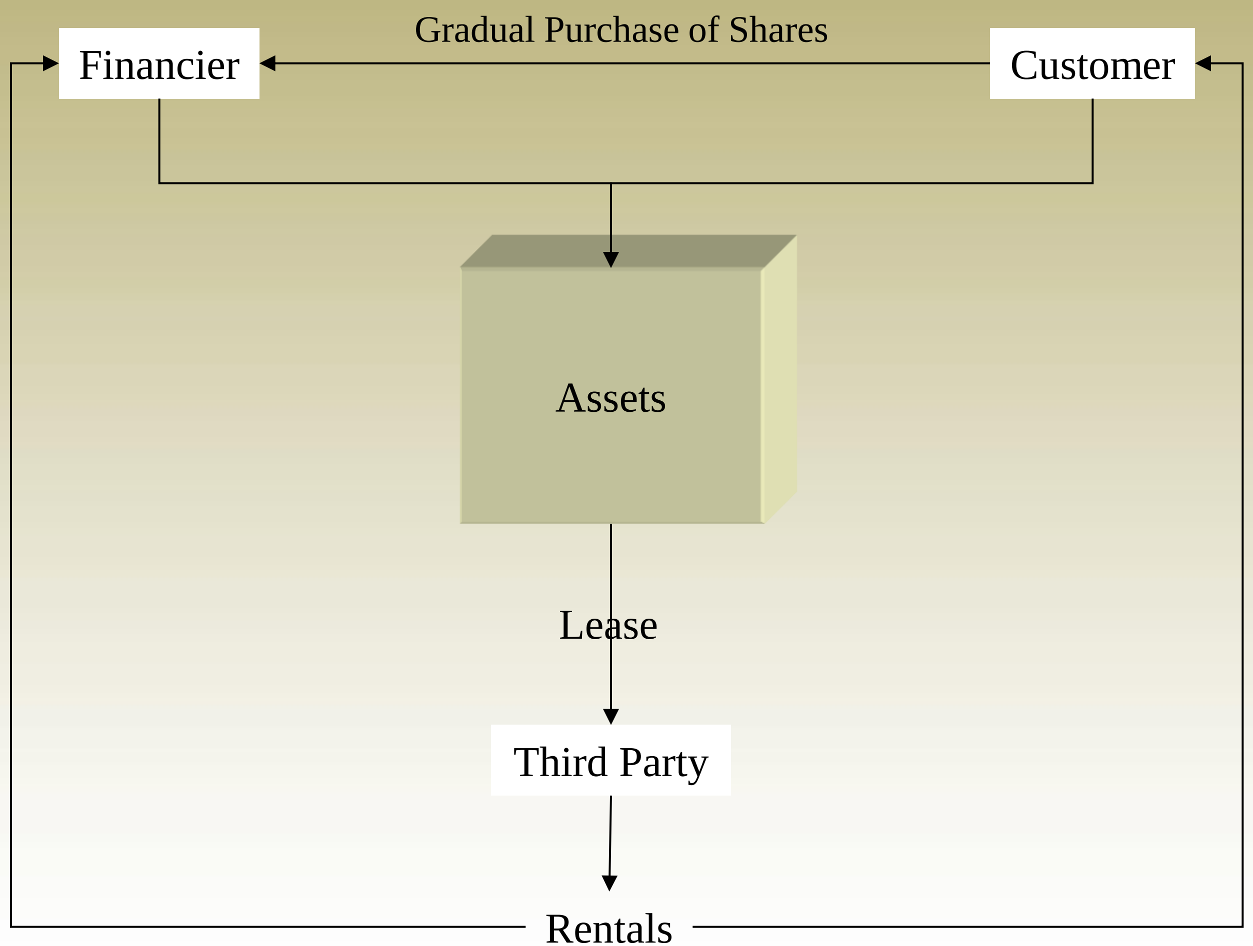
OTHER MODUS OPERANDI OF DM



OTHER MODUS OPERANDI OF DM



MODUS OPERANDI



THE CONCEPT OF DIMINISHING MUSHARAKAH

- Main Features
  - Joint ownership – joint capital contribution
  - Promise
  - Lease or Investment
  - Purchase of equity stakes
  - Combined contracts

- Lease
  - To a partner
  - To a third party

THE CONCEPT OF DIMINISHING MUSHARAKAH

- Methods of equity acquisition:
  - Setting aside a portion of profit
  - Sale of Musharakah shares/units in installments or lump sum
  - Sales could be on schedule or on voluntary basis

- Rentals:
  - Could be fixed or floating with benchmarking against a specific rate
  - Could be reviewed

- Rules of Profit & Loss:
  - According to the Musharakah contract
  - Loss:
    - shall be borne by each partner in accordance to his actual equity stake at the time of loss as one partner's equity decreases and the stake of other partner increases .
  - Profit:
    - Shall be shared according to the agreement at the time of contract conclusion.

THE CONCEPT OF DIMINISHING MUSHARAKAH

- Value added features:
  - Takaful protection of the assets.
  - A binding promise for purchase undertaking in the event of default.
  - Taking collateral/guarantee for compensation in the case of ignorance or misconduct or breach of contract.
  - Setting aside a portion of profit for reserves.
  - Feasibility study fee.
  - Third party guarantee of capital.

THE ADVANTAGES AND UNIQENESS

- A lot versions and can tailored to suit the market demand as well as risk profile. No standardization of DM.

- Income for the Financier:
  - Selling price of the shares
  - Rentals
    - The rentals as well as the selling prices could increase with the increase of the assets value.

- The time duration could be shorter compared to BBA.

- The rentals and selling prices of shares are not directly linked to the interest rate. They highly depend on the market value of the assets.

THE ADVANTAGES AND UNIQENESS

- Each partner should be responsible for the maintenance and insurance/takaful of his stake.
- The financer must assure the usage of assets must be Shariah-compliant. It is necessary to ensure the “halal” state of the rentals. (Shariah-compliance risk; Reputational risk)
- The sense of cooperation is there.
- A continuous process of bargaining.
- Theoretically, it could promote entrepreneurship.
- More competitive compared to the Musharakah and Mudarabah from the IFIs’ point of view.

THE DISADVANTAGES

- Diminishing musharakah requires long-term assets and most of the IFIs' assets are short-term deposits.
- More supervision and management are required.
- Difficult liquidation at the early stage.
- Default of partner
- Risk associated with the outcome of the projects or investment e.g. law suits (this is not an issue in house financing)

ISSUES IN DIMINISHING MUSHARAKAH

- Combinations of Several Contracts
  - The independence of each contract
- Binding promise
  - Mutually binding or one-sided binding;
  - On the customer or on the financier
- Tax treatment – stamp duty
- Selling of equity stakes must be at the current value and should not be fixed or at nominal value.
- Legal Documentation
  - Separated document or not
  - Registration of ownership

CONCLUSION AND RECOMMENDATIONS

- Diminishing Musharakah has the big potentials to be applied by the IFIs in developing more Islamic financial products. There are a number of DM versions in the global market and its flexibility as well as variability could be utilized to develop more competitive products.

- Risks inherent in Musharakah and Mudarabah has been mitigated in DM. However, the Shariah-compliant risks mitigation measures should be developed more to make DM more attractive.

- Diminishing Musharakah is a way for going global.

- A future study could analyze the differences between Murabahah, BBA, AITAB and DM for assets acquisition.

THANK YOU

Q & A Session

Allah Knows Best