



Why Islamic Banks Are Reluctant to Offer Musharakah Mutanaqisah for Home Financing: The Case of Maybank Islamic and Affin Islamic Bank

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Abstract: This paper focuses on the challenges faced by the Malaysian Islamic Banks in implementing Musharakah Mutanaqisah (MM) Home Financing. Even though the study is specifically on the Malaysian Islamic banks, but the issues and recommendations addressed in this study are also pertinent to other Islamic banks across the world since they are also offering it. Drawing upon in-depth semi-structured interviews with the senior officers in two leading Islamic banks in Malaysia, one is the bank which terminated its MM Home Financing products however the other one continues to offer it. Knowing the contradicting perspectives of both banks gives insight of the real challenges faced by them in offering MM for home financing which are advance rental and the system's incapability to capture the unique nature of MM, and at the same time to know the motivation of offering it i.e. product diversification and comprehensive risk mitigation. This paper concludes by making recommendations that may be adopted by Islamic banks and the regulators to facilitate the promotion of MM Home Financing. Notably, this paper offers empirical findings which are different from the previous literature.

Keywords: Musharakah Mutanaqisah, Islamic Bank, Reluctant, Reasons

JEL Codes: G20, Z12

Introduction

Musharakah Mutanaqisah is an alternative contract that can be offered under home financing and can replace Bai' Bithaman Ajil (BBA) as BBA is similar to fixed rate 'debt financing' or Murabahah (Asadov et al., 2018; Mydin Meera & Abdul Razak, 2005; Osmani & Abdullah, 2010; M. Ridwan & Shahrudin, 2013, Maulin, 2017; Subky et al., 2017). Yet, MM Home Financing is not used widely in the pra-

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ctice in Malaysia, Indonesia and Pakistan. These countries are still dominated by Murabahah Financing as MM is considered more complicated in its system and its calculation technique (Akram, Rafique & Alam, 2011; M. Ridwan & Shahrudin, 2013; Maulin, 2017; Rohmi, 2015; Subky et al., 2017). Thus, the issues that will be addressed in this paper are common in Islamic Finance industry across the globe.

In Malaysia, many Islamic banks have now shifted their focus from MM to Commodity Murabahah (CM) after phasing out BBA. The current situation shows that most products especially home financing ones, are granted under CM which could raise the concentration risk issue in the future. It is important to note that currently there are only five banks that still continue to offer MM Home Financing. Thus, it is essential to conduct a study to investigate the reasons behind Malaysian Islamic banks stopping promotion of MM Home Financing and to discover the factors that inspire a few of them to continue offering this type of financing.

The objectives of this study are to investigate the challenges faced by one of Islamic banks in implementing MM Home Financing and to investigate the factors leading to the continual offering of MM Home Financing on contrary. Thus, the research questions this paper seeks to answer are; What are the reasons for discontinuing MM Home Financing? and “What are the factors leading to continual offering of MM Home Financing?”

The present study significantly contributes to multiple fields. Firstly, this study enables banks to evaluate their position with regards to offering or discontinuing MM Home Financing. Secondly, the study’s findings will assist other researchers in investigating the challenges and reasons behind promotion of discontinuation of MM Home Financing. Thirdly, it would allow policy makers to address the challenges in offering MM Home Financing by implementing new guidelines. Lastly, it may act as a valuable source of reference for future studies in MM Home Financing as it is based on in-depth interviews with the experts of the field.

Problem Statement

MM Home Financing was introduced in 2007 as a better substitute for BBA. Bank Negara Malaysia (BNM) encourages the Islamic banks to offer MM as one of their home financing products. In 2012, seven banks were offering MM Home Financing (Lee, 2013). The figure increased to nine banks in 2013 (Muhamad, Abd Rahman, & Khalid, 2013). This however decreased in the later period with only five banks currently offering this kind of financing (Subky et al., 2017).

The current trend shows that many Islamic banks have stopped offering MM and are focusing on other types of products like CM. A study by Subky et al. (2017) stated that most Malaysian Islamic banks that were offering MM financing had stopped providing it and instead were offering other financing contracts such as CM, Ijarah Muntahiyah bit Tamlik (IMBT), and Istisna. The reasons for its discontinuation include advance rental and ownership risks for under construction properties in case the project is abandoned. The force majeure risk in completed property and refinance and remortgage issues constitute other reasons. Thus, it is vital to highlight the pros and cons in MM Home Financing so that the product can be improved, and more Islamic banks will re-offer MM Home Financing in the future.

Literature Review

This part examines the literature in three parts, namely the definition of MM, its advantages and disadvantages, and issues pertaining to MM Home Financing.

Definition of MM

On February 5, 2006, the Shariah Advisory Council (SAC) of BNM resolved that MM-based financing product is permissible as MM is a contract recognised under Islamic Muamalat. In implementing MM contract, it is permissible for the contracting parties to combine the two contracts of Musharakah and Ijarah in one document of agreement, as long as both contracts are concluded separately and are clearly not mixed. This serves to impose a pledge on the shares owned by the customer because the right of beneficial ownership is recognised by Shariah (Bank Negara Malaysia, n.d.).

According to Shuib, Borhan & Abu Bakar (2011), Asian Institute of Finance (2013), and Hanafi (2014), MM is a combination of three contracts, namely Musharakah, Ijarah, and Bai'. The Musharakah part of the contract is concluded between the bank and the customer in the capital contribution for the purchase of the housing property. Meanwhile, the Ijarah contract comes into the picture when the bank leases out its portion of the property to the customer. The Bai' contract is concluded when the customer buys the bank's portion of the property as the monthly instalments which consist of partly the gradual purchase price of the bank's portion and partly the rental. As explained by Azli et al. (2011), the modus operandi of MM is as follows:

1. The customer identifies the property and approaches the bank to obtain financing. The bank agrees to pay 90% of the property's price. The bank and the customer enter into Musharakah contract where the bank provides 90% capital and the customer provides 10% of the property's price. Consequent-

ly, the bank owns 90% beneficial ownership of the property and the customer owns the remaining 10%.

2. The bank leases its portion to the customer.
3. The customer pays monthly instalments (the instalment consists of partly the gradual purchase price of the bank's portion and partly the rental) to the bank
4. The bank's portion will gradually decrease, and the customer's portion will gradually increase. At the end of the financing tenure, the customer will own 100% of the property.
5. The bank will transfer the ownership of the property to the customer.

Advantages and Disadvantages of MM

MM was introduced as an initiative to replace the controversial BBA Home Financing. As explained by Azli et al. (2011), MM is a better alternative contract for home financing and is well accepted by the Muslim scholars worldwide compared to BBA. Hassan (2011) added that MM can be operated in a Shariah compliant way because it shuns interest. Asadov et al. (2018) stated that MM is a global product that may be applied in many types of financing that could be arranged as partnership. Zaidi and Mohammed (2018) propose the usage of cash waqf in MM model. However, implementing MM as a contract for home financing is not an easy task. Smolo and Hassan (2011) claimed that "MM looks like a perfect mode of finance literally, yet in practice, it is far from being perfect. All of the current practical problems faced by MM are man-made and caused by the current policies and regulations that can be amended or replaced."

Issues Pertaining to MM Home Financing

The issue of rental rates has always been raised in the application of MM Home Financing. Mydin Meera and Abdul Razak (2005) and Muhamad et al. (2013) highlighted the issue of banks charging customers profit rates which are benchmarked against the interest rate. The study done by Muhamad et al. (2013) also raised the issue of maintenance of asset; the legal contract does not state that ultimately, only one out of the two owners bears the cost of maintenance. Plus, Haneef, Kunhibava and Smolo (2011) argued about the issue of advance rental charged by the Islamic banks that needs to be returned to the customer if the property is abandoned. Notably, both parties are to share the loss according to their capital share.

The fourth issue in the application of MM as stated by Asmadi (2011) is waad, whereby purchase undertaking by the customer should be at the market value rat-

her than the floating price of the house as it will considerably affect the client. The research of Shofni (2012) also questioned the issue that why the customer, instead of the bank, is required to deliver the undertaking. The practice of the purchase undertaking is actually one sided and was supported by Subky et al. (2017).

There are various issues related to the current MM Home Financing offered by the Islamic banks. Hassan (2012a) tried to present a new model namely the Zubair Diminishing Balance Method (ZDBM). He claims that ZDBM is Shariah compliant and cheaper than usual MM Home Financing (Hassan, 2012b). However, it is found that ZDBM still remains as a theory upon which Islamic and conventional banks can practice in future.

Banks Offering MM Home Financing

The table below shows the list of Islamic banks offering MM Home Financing in 2014 and 2017. It can be seen that there is a declining trend from 2014 to 2017, from eight banks dropping to five banks in three years' time.

Table 1.
List of Malaysian Islamic Banks Offering MM Home Financing in 2014 and 2017

Bank	MM Home Financing	
	2014	2017
Affin Islamic Bank	Yes	Yes
Al Rajhi Bank	No	No
Bank Islam	No	No
Bank Muamalat	No	No
Bank Rakyat	No	No
CIMB Islamic Bank	No	No
Citibank Malaysia Berhad	Yes	No
Hong Leong Islamic Bank	No	No
HSBC Amanah	Yes	Yes
Kuwait Finance House	Yes	No
Maybank Islamic	Yes	No
Public Islamic Bank	Yes	Yes
RHB Islamic Bank	Yes	Yes
Standard Chartered Saadiq	Yes	Yes

Source: Mat Ali (2017) for year 2014 and Subky et al. (2017) for year 2017

Research Methodology

This paper employs a qualitative method, whereby library research focusing on related journal articles was done for the literature review and empirical study was performed through interviews with the banks. One of these banks does not offer MM Home Financing but the other one still offers it and has a robust MM framework since it's the pioneer and has been offering the product since 2007.

The interviews were conducted using a semi-structured method. The semi-structured interviews were conducted with questions prepared to capture the challenges faced by both the banks in promoting MM Home Financing. The face-to-face interviews lasted one to two hours per session and both interviews were conducted in English and Malay languages. In the interviewees, the bank that has stopped offering MM Home Financing was represented by its Head of New Product and Business Development who has 19 years experience in the field. From the other bank we interviewed it's Head of Shariah Department who has 12 years of experience in Islamic banking. The interviews were tape-recorded and transcribed.

Findings and Discussion

Factors Hindering the Implementation of MM in Home Financing

One of the respondent banks is the biggest Islamic bank in Malaysia has offered MM Home financing between year 2007 and 2016. Nevertheless, it offered MM home financing for completed construction only from 2012 and stopped offering MM Home Financing in 2016. The interview conducted with the bank revealed that the following are the real challenges that the bank faced and lead to termination of MM Home Financing.

Advance Rental and Ownership Risks for Under Construction Property in the Case of Defaulting Developers, and Force Majeure Risk in Completed Property

In 2011, BNM issued the Ijarah concept paper that discussed the advance rental and ownership risks. The bank highlighted that due to the new Ijarah concept paper, the bank had to return advance rental collected from the customers while the financing disbursed had to be forfeited in the case of an abandoned project. Unfortunately, this risk was too great, which ultimately led to the bank's decision to terminate MM Home Financing product for under construction properties in 2012, despite the product's stellar performance. The bank eventually terminated MM Home Financing for completed properties in 2016, taking into consideration the force majeure risk that could prevail.

Refinance and Remortgage Issues

MM is not applicable for refinance or remortgage as it involves the conversion from sale-based contract to a partnership contract. For example, a BBA Home Financing customer from another bank seeks to refinance with the bank, thus the bank will become a partner to the customer by buying the house from another bank and this scenario is possible. Conversely, in the case of a customer who seeks refinancing from the bank under BBA Financing to MM Home Financing, there will be confusion on matters pertaining to how the bank will buy the share from itself. There is no clear transaction in such a scenario. Remortgage also cannot be done because customers do not have partners and banks, thus, this is a confusing situation for the bank.

Comfortable with CM-based Products

In contrast, CM Home Financing addresses purchase, refinance, remortgage, and top-up financing. CM seems to present lots of possibilities with no limitation, so the bank decided to have CM as its core product. The bank's system has a comprehensive and complete platform for CM. There are more operational issues rather than Shariah related issues in CM, therefore, bank is comfortable to offer CM and has stopped offering both BBA and MM via phase out. Thus, the bank is now focusing on its financing products based on CM.

Factors Encouraging the Islamic Bank to Continue Offering MM Home Financing

In contrast to Malaysian Islamic Banks that have stopped offering MM Home Financing, there are others that continue to offer this product. This research explores the factors and reasons that are behind another bank's decision of continuing to offer this product. Some of these factors are as follows:

The Legality Issue and Controversy of Tawarruq Contract

The bank tries to minimise the use of Tawarruq in the financing offered by the bank as much as possible although the bank still uses Tawarruq for purposes other than the cash and liquidity management. The maximum capping that has been agreed for Tawarruq is 40%. In order to ensure the limit for Tawarruq is not transgressed, the bank has offered other Shariah contracts for their financing, including the MM Home Financing.

Hence, the Musharakah financing takes up approximately 20% of the bank's total financing portfolio, while approximately 22% to 23% is attributed to the Tawarruq portfolio. Furthermore, the BBA legacy customers make up the major

rity of the bank's financing portfolio. Although MM is the default contract used in home financing, the bank also offers CM-based home financing in the event that Musharakah is deemed unfit or the risk of the development is too high.

MM Home Financing Offered Conforms to the Ijarah Guidelines Issued by BNM

BNM issued the Ijarah guidelines that lay down the conditions that need to be fulfilled by the bank in issuing Ijarah contract to the customers. MM Home Financing also includes Ijarah as one of its underlying contracts when the bank leases out its portion to the customers. Most of the banks find it hard to comply with this requirement and choose to stop offering MM Home Financing. On contrary, these conditions were already included in the agreement for their MM Home Financing even before the guidelines for Ijarah were issued by BNM. Thus, the conditions prescribed in the guidelines issued by BNM do not in any way affect the existing MM Home Financing offered by the bank.

No Previous Case of Abandonment or Force Majeure Event

MM Home Financing is offered both to housing projects under construction and completed houses. Since the risk borne by the bank in offering MM Home Financing for house under construction is higher, the bank is more stringent and selective in choosing the developer before granting the customers this contract. The bank screens the track record of the developer thoroughly. If the customers propose to buy a house developed by reputable developers like Mah Sing, Sime Darby, and IJM, the bank offers them MM Home Financing. For less reputable developers, developers who develop on a smaller scale, and developers in remote areas, the bank offers other financing products.

Thus, with the precautionary measures taken by the bank, up until now, there has been no case of abandonment for MM Home financing or the projects under construction that have been granted by the bank. Besides, there has not been an issue of serious force majeure event in the past and the bank's risk in this event is also mitigated by the Takaful coverage.

Diversification of Financing Products

Learning from the year 2008's experience, when most of the bank's financing for purchase of houses was concluded via BBA's contract and suddenly, the legality of this contract was questioned, causing a distress for most of Islamic banks. Thus, the bank decided not to focus on certain Shariah contract in offering financing to

the customers. This was done to reduce the concentration risk that may be higher if no diversification is made in the financing products offered by the bank.

For home financing, the Shariah contracts which are offered include MM as well as Tawarruq. In the bank's overall financing portfolio, 20% are based on MM, 23% are based on Tawarruq, and the remaining is made up of the previous BBA's legacy and Al-Ijarah Thumma Al-Bai' (AITAB) i.e. the modes of financing with the highest proportion.

Comprehensive Risk Mitigation Plan

The issue of abandonment is a huge risk for the banks. In order to mitigate this risk, the bank has been working closely with the Ministry of Urban Wellbeing, Housing, and Local Government. A project that has stopped working for six months is deemed as an abandoned project by the ministry. The next stage is then to look for a replacement for the developer or to resume the project with the current developer under new terms. During this waiting period, the bank halts its advance rental collection and the collection only resumes upon the revival of the project. In the case where customers do not wish to wait for the revival of the project and instead wish to exit the Musharakah contract, the customer shall compensate the bank and the bank will return the advanced rental collected.

Recommendations

The above findings and discussions reflect that there is room for further implementation of MM-based financing products. This paper offers several recommendations that can be adopted by the Islamic banks and regulators in order to enhance the performance of Islamic banking products as well as innovate in the future.

Firstly, the current legal framework for the operation of MM Home Financing product needs to be improved through amendments to existing laws or the enactment of a new statute to govern its operation. Therefore, constant improvement and amendment to the legal framework will guarantee the development of Islamic finance, particularly for the equity financing, whereby it may be necessary to establish different legal and regulative structures for the operation of Islamic finance. Different treatment and consideration must be given to legal Islamic structures on various issues such as ownership, consequences of default, and to the asset in the event of an abandoned project. Increasing transparency by product disclosure is also important to ensure customers' awareness and confidence in the products they subscribe to. Henceforth, enhancement in legal framework in Malaysia is nee-

ded to ease the implementation of MM Home Financing in the Islamic banks. BNM as the regulator should pay attention to this aspect.

Moreover, there is a need for further research focusing on legal framework of MM Home Financing aiming to determine whether there is a real need for a new act for the operation or simple amendments in the current legal framework would be sufficient for its operation. The skilled talent pool is a valuable asset in supporting the development of Islamic finance. They are closely committed to the spirit of Shariah and are adept to uphold justice for the economic development, mainly for the Muslims as a whole, in order to accommodate the new legal framework of MM Home Financing. As a result, it is hoped that the application of MM Home Financing would become an incentive for further dependence to equity financing in Islamic finance, particularly in Malaysia (Hanafi, 2014).

Based on the findings, both banks did not use rental rate as their pricing mechanism in MM Home Financing; they applied the Islamic Base Rate (IBR) that still uses conventional interest rate as its benchmark. Therefore, a benchmark to determine the rental rate in MM Home Financing should be introduced to avoid Islamic banks using the interest rate as the rental rate which creates misinterpretation in the public. A research has been performed regarding the use of a rental index or house price index in determining the rental to be charged for each specified Ijarah contract period. The model is a practical alternative to the conventional floating rate financing since the rental rate can be adjusted if there is any fluctuation in the economy. As it is more flexible, the Islamic banks will not be too worried about variances in the economic conditions (Mydin Meera and Abdul Razak, 2005).

Moreover, an independent institution with authority needs to be established to set rate and update the periodic rental rate for every area. It is hoped that the pricing of home financing would be able to capture the true value of the property, while being fair, equitable, sustainable, and resilient to economic exposures. At the same time, it would remain competitive with the conventional banking as the rates are comparable, without relying on and being benchmarked against the interest rates. (Yusof, Mahfudz, Arif, & Ahmad, 2016)

From the interview, it was found that MM Home Financing is offered to both the housing projects under construction and the completed houses. As the risk taken by the bank in offering MM Home Financing for houses under construction is higher, the bank is stricter and more careful in choosing the house developer before giving the customers the contract. The process begins with the bank screening the

track record of the developer. Remarkably, with the precautionary measures taken by the bank, up until now, there has not been any abandonment for MM Home Financing in the projects under construction that have been granted by the bank. There is also no issue of serious force majeure event in the past and the bank's risk in such an event is also mitigated by the Takaful coverage. Therefore, the strict screening of developers should be followed as a guide by other Islamic banks as one of the methods to mitigate the risk in MM Home Financing.

Fourthly, tawarruq has evolved as a dominant concept in Malaysian Islamic banks. Nevertheless, the extensive use of Tawarruq in Islamic financial institutions has led to numerous arguments from both Shariah scholars and Muslim economists. The fact that Tawarruq is designed to simply imitate the characteristics of conventional products challenges the claims of Islamic finance proponents that Islamic financial institutions offer a genuine alternative to conventional finance. Concentration risks towards one Islamic contract will grow, and the question at the outset is that whether banks will take the time to develop other contracts instead of just building the CM product structure.

When BBA was introduced, no other product was developed in the market and the situation is now similar with CM. Nevertheless, there are opportunities for the development of other Islamic contracts. Maybe once the thinking to understand the transactional and Shariah risks of the new products emerges, the market would accept the idea that Shariah-compliant banking can be a different way of banking.

In the case of the bank that continues to offer MM Home Financing, the bank still uses Tawarruq for purposes other than the cash and liquidity management, yet it tries to minimise the use of Tawarruq in the financing offered by the bank as much as possible. The maximum capping that has been implemented by the bank for Tawarruq contract is 40% from all Shariah contracts used by the bank in its activities. In order to ensure that the limit for Tawarruq is not transgressed, the bank also offers other Shariah contracts for its financing, including the MM Home Financing.

Lastly, MM is a universal product that may be applied in many types of financing that could be arranged as partnership. For certain types of financing products such as personal financing and credit cards, CM appears as the most ideal structure. However, for working capital, Islamic banks may consider a profit-sharing structure such as Mudarabah and Musharakah although the risks associated with this kind of structure could be relatively higher. Undeniably, Islamic banks are en-

couraged to consider this profit-sharing structure for their financing products as it is deemed as the most acceptable form by a majority of Shariah scholars.

Nonetheless, it is vital for Islamic banks to be equipped with appropriate risk mitigation mechanisms, backed by risk officers with the right expertise. Besides, practising the MM contract in its true Shariah spirit, the use of MM contract should be extended to automobile and trade financing where rent or profit could be easily identified, and the value of the asset is more certain (Asadov et al., 2018).

Furthermore, one effective way for the future development of the MM model is that the banks can participate in joint venture with the developers. However, in reality, the banking industry is too regulated to venture into other equity products, especially via joint venture. Equity contracts and partnerships are better suited in an environment that is not bound by any kind of banking regulation. Banks do not want to put themselves at risk, therefore, eventually fall in practices which are similar to conventional banks (Kevin & Hassanudin, 2017).

Islamic bank is a Shariah-oriented business entity and is expected to be guided by the philosophies of Islamic business. The management or policy makers of the banks will use the philosophies in the process of constructing corporate objectives and policies, and the philosophies act as an indicator as to whether the specific Islamic bank is upholding true Islamic principles or not. Thus, the representatives of Islamic banks should know these philosophies. Islamic banking is a subdivision of the overall Islamic economic system. It must strive for a just, fair, and balanced society as prescribed by the objectives of Shariah (Maqasid al-Shariah). However, not many representatives of Islamic banks know and understand these philosophies and objectives (Muhamad et al., 2013). This is because most of them are from the conventional banks which are the parent banks of the subsidiary Islamic banks.

Conclusion

This paper examined the application of the MM Home Financing product as practised by two Islamic banks in Malaysia. It further highlighted numerous issues and challenges faced during this implementation. Notably, this research found a gap between the literature review and empirical findings on the issues of MM Home Financing; the reasons for the biggest Islamic bank in Malaysia to stop offering MM were its other operational aspects such as refinance issue and marketing reasons. However, one similar issue was found in the literature review and empirical findings, namely the issue of advance rental that needs to be returned to the customer

if the house is abandoned. Thus, this research contributed significantly with its empirical findings compared to other previous studies.

It is hoped that this research will provide new insights to further promote MM Home Financing in Malaysian Islamic banks in specific, and globally in general. More Islamic banks are urged to adopt MM Home Financing to benefit the clients and to ensure its conformity with the Shariah principles. However, few legal rules related to Islamic banking contracts, ownership, pricing mechanism, and other aspects need to be modified to implement MM effectively.

Moreover, it is hoped that there would be continuous attempts to improve the facility in the future, and eventually, the reliance on equity financing would increase due to the inherent benefits associated with it and to avoid concentration risks on CM. Even though MM has its own shortcomings, the advantages of MM are greater. The Shariah-based mode of finance is accepted internationally and is compatible with the underlying ethical basis of Shariah financing i.e. the benefit of the society as a whole.

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