

Diminishing Musharaka: A Mode of Financing in Interest Free Banks

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Abstract

The present day situation is undeniably pre-eminently dominated by economic considerations. A deep analysis shows that not only the national policies of the Government but also International politics appear to be exclusively governed by considerations of economic interest. The multinational Corporations, Financings bodies and International Banking Institutions if though do not, virtually, control the policies of the entire world; however, do the same in third world countries. There is no denial to the fact that the cornerstone of free market economy is Interest which is deeply percolated in the ins and outs of the current economic system and that is core disordering of the World economy. Contrary to this, Islam confers a guided economy, having restricted earning tools and more refined and specific patterns and procedures of financing deals in order to maintain the smoothness and order in the life system. Shariah's Teachings are transparent and perfect containing the basic principles and pros and cons of each and every action/phenomenon that take place in human life. Since almost all the activities revolve around economy for which Islam has provided complete guidelines regarding financial transactions and business deals in the form of Musharaka, Ijara and Mudarabah. The present study has focused on the Investigation of in vogue Diminishing Musharaka in Interest free banks and find out the loopholes which still exist in the in-practice Interest free banking and to propose the remedial measures to fill the gaps with appropriate shariah substitutes.

Keywords: Riba: the Interest, Safaqah: the deal or Transaction, Al-ghunm: Gain/ profit, Haram: Impermissible

The conformity of any commercial activity, business deals or mode of financing can only be decided in the light of shariah teachings. As such, the basic principles governing all contracts, business deals, transactions and modes of financing and investment have been expressly laid down in the Quran and Sunnah. The foremost principle mentioned in the Holy Qur'an as the most important component of all mutual dealings is the principle of *Taradi* (تراضي) means free mutual consent of the parties.¹ The Sunnah has also dealt with the basic requirement of all contracts and transactions. Anything that influences the free consent of the parties is totally restricted in Shariah and leads the contract towards void status. The parties must have certain know-how about the deal and must have ample awareness of what they are going to do.

One of the most important features that should be considered that the transaction must be free from *Gharar* which means a conditions or situations where there is uncertainty, might be uncertainty of price or uncertainty of commodity. Allah's Messenger Muhammad Peace be Upon Him has prohibited from the sale of flying birds before it is hunted². Similarly the transaction will also be free from Usury (*Riba*) involvement of any form may be that is any type of increase against nothing but time.³ Same way the profit must be linked with risk bearing(⁴). Normally these principles do not exist in the transactions of conventional Banks that leads the whole businesses void and Haram.

According to Muhammad Omer Farooq;

“The Conventional system based on Interest, neither profit and loss nor risk is shared by the contracting Parties.”⁵

The activities of Interest free banks are entirely of different nature. Interest free banks adopted the modes that are totally based on the Islamic Transactions (اسلامی بیوعات).⁶ In modern Interest free banks these are known as Islamic Modes of Financing because almost all the Islamic Banks use them as a Financing means and tools in order to maximize the profit within the boundaries of Shariah.

Islamic Modes of Financing

In Pakistan, Islamic Modes of Financing were introduced in 1984 with the promulgation of banking and financial services through amendment of Laws Ordinance 1984. This was a significant legislative step in the direction of Shariah based modes of Financing. Further an institutional framework for the establishment of Mudarabah engaged exclusively in activities consistent with the shariah. After the passage of a phase of years, these modes were approved by the State Bank of Pakistan.

Real and Ideal Instruments

Mufti Taqi Usmani, a well-known shariah scholar and expert in Islamic Finance states;

“The Real and Ideal instruments of Financing in Shariah are Musharakah and Mudarabah.”⁷

Indeed if these instruments are used by the Interest free banks with their real and basic shapes and forms, the fruits will be enjoyed by the laymen. One of the common reservations rose by the people that there seems no such special difference between these two sectors that is conventional banks and Islamic banks because in both cases the public

has to bear the burden. The reason behind this is the lacking of real and ideal instruments of financing that is Mudarabah and Musharaka. The real spirit of Islamic financing is to use the above mentioned modes for financing but due to a number of reasons the Interest free banks hesitate to adopt it in full pattern. The most common and basic factor of not opting these modes for financing by the Islamic banks is the lacking of honesty and sincerity among the people. The money that the bank finance out is actually the money of hundreds of depositors and it is the liability of Bank to finance the trusted money to other people or projects with full care and has to mitigate the risk of loss. A dozen of Interest Free Banks are working in Pakistan and in different Islamic countries. These banks have adopted the modes of financing which are normally the Murabaha, Ijara, Istisnah, Salam etc. and one of the most commonly used for house financing is the Diminishing Musharakah.

Why Musharaka Is differ from Diminishing Musharaka

Musharaka is common word used in Islamic fiqha's books. Its dictionary meaning is 'to share'⁸. In business terms it is joint enterprise of two or more than two persons or organization where all the parties share their profit or loss on agreed terms and conditions of the joint venture. Musharaka is one of the positive and productive substitutes for financing, free of interest and other Shariah restrictions. It has a great impact on production and distribution and playing a very vital role in enhancing the economic activities of banks in order to maximize the profit which is one of the key objectives.

This is what about the Musharaka but there are other terms used in Business world in general and specifically in Interest Free Banks that is new form, Diminishing Musharaka. These terms is little bit different and came to exist in near past. The concept of Diminishing Musharaka refers to the joint venture where the client and financing body, which is normally bank or financial institutions get agreed to sub divide the share of financier into smaller units and the client will purchase these units periodically one by one until and unless he purchased the entire units. Then the client will become the whole sole owner of enterprise.⁹

This scheme of financing commonly practiced in Interest Free banking Sector is Diminishing Musharaka through which generally houses are financed. Therefore, it is sometimes referred to as "home finance".

Procedural Stages of Diminishing Musharaka

It is one of the modes of financing and has the following three procedural stages.

- a. In the very first stage, both the parties i-e the Bank and the client, of the Agreement get together and by mutually consent after agreed terms and conditions any property or house is purchased. The bank's role is to finance the client; therefore, the share of the bank is generally high comparatively to the client's share in the property. For example the property is purchased and the share of the bank is 60- 90% and the remaining portion i-e 40- 10% by the client.
- b. The second stage is transferring of bank's share to the client in such a way that all the share of the banks is further divided into smaller units and then the client gradually purchase these units one by one. By this way after passing of time the client's share in the property increases and the banks share is gradually decreases. To make it very simple, let's consider the above example the share of the bank is of eighty percent is broken into eighty units and the clients purchase these eighty units.
- c. The share of the bank in the property is rented out to the client. The client pays to the bank as rental against the utilization of bank's share in the property and this activity is performed through separate contract of Ijara. The rental paid to the bank is directly proportional to its share as the share of the bank decreases, the rental charges payable by client also decreases till the time come that all the share of the bank transferred to the client and he/she becomes the only owner of the property.

Core Components

After the brief discussion of procedural stages of Diminishing Musharaka, come to know the following three components play a vital role in the entire process of it.

- i. Partnership by ownership
- ii. Leasing of partner's share (In leasable assets)
- iii. Sale

The role of the cited above components are quite clear. The partnership came into existence when the property was purchased by the bank and client jointly. The share of the bank is hired by the client against specified rate of rental as Ijara contract and finally the client purchased the Bank's share as normal sale. In simple words it can be stated that diminishing Musharaka is actually the combination of the Partnership, Ijara and normal sale as discussed above.

Juristic Analysis

It has been discussed in detail that Diminishing Musharaka refers to the joint venture where the client and financing body, which is

normally bank or financial institutions get agreed to sub divide the share of financier into smaller units and the client will purchase these units periodically one by one until and unless he/she purchases the entire units. Then the client will become the sole owner of enterprise. In Islamic jurisprudence the word Diminishing Musharaka in the sense aforementioned does not exist for the reason that it is actually the combination of three different transactions which are partnership by ownership, leasing of partner share and at very last purchasing take place.

The important thing about these three transactions is legal status that in the light of shariah none of the above transaction is impermissible but still there is a need to highlight the Shariah's status of combination of all three in one arrangement. The shariah ruling in this regard is transparent and clear. If there are more than one transaction and all are arranged in such a way that each one is interlinked and conditional to other. Such arrangement is unlawful and prohibited and leads the Agreement void. On the contrary to this if each transaction is totally independent and does not have made any dependency on others then this is legal and permissible in the light of shariah.¹⁰

Diminishing Musharaka is a good example of the above statement because almost three different transactions take place in different time phases but there is no binding of one with other and all are independent.

Diminishing Musharaka: Not the Conditional Sale (صفتان في الصفقة)

It might give the impression that the act of undertaking to buy the assets in the mentioned pattern is almost same to craft condition in a sale, for the reason that all parties connected to this agreement are well aware from very beginning that the bank will sale its share to client and he/she will purchase it. Consequently, these two transactions should be considered as conditional on each other.¹¹

The answer to this query is that there is a lot difference between these two formats i-e one sided undertaking to purchase assets and to craft one separate transaction, a condition for the soundness of the other transaction. The sense and actual meaning of making one transaction as a condition for the other transaction is that the first transaction will be concluded when the second transaction comes to an end. For example: Zaid says to Ali that he will sell his car to him on one condition that he will confer him his home on rent. In this state of affairs, the contract of sale cannot be concluded before the completion of contract of house hiring. Such type of agreement is not legal and is prohibited by shariah because of uncertainty factor enters in it.¹² In diminishing Musharaka,

one sided undertaking of client to purchase the bank's share is not the bindings or requisite for conclusion of first transaction i-e deal of partnership to purchase the property.

Hence, in this situation it cannot be said that the property that the Bank and client are purchasing in partnership, the validity of this sale is contingent/conditional on the client fulfilling his/her promise to purchase the shares of the Bank. In fact, this sale will be complete and would have all the effects of a valid sale whether the client fulfills his/her undertaking or not. On the other hand, by any reason if the client fails to overcome his/her undertaking of purchasing the bank's share, then firstly he/she will be forced to perform the activities according to the undertaking and secondly he/she will have to bear the loss suffered due to his/her violation of not fulfilling his/her commitment but the initial sale of the property will not be considered as void. In other words, by only making an undertaking, the bad element of uncertainty does not arise. Therefore, this method is permissible. This explanation illustrates that this method of financing that is adopted at Interest Free Banks for home finance does not go against the principles of the Shariah. The documents presented by them are properly matching with the laws mentioned in Shariah Standards and there is no involvement of any such features that lead the entire transaction from the limits and boundaries of permissibility to impermissibility or in simple words that make the transaction Haram and void.

Remedial Measures

In fact in the present day world, the Islamic Banking Industry has very rapid growth in the financial market and the deposits of these Islamic Banks keep on increasing day by day and mostly the people from business sector show their interest in and switching from conventional banks towards the Islamic ones.¹³ The Islamic Banking system is running under the supervision of Shariah experts and one of the key factor of its success is asset based financing. As a result of each transaction of any product, the economic activity came into being that contributes a lot in order to confer the employment opportunities to the market, indirectly causing positive impact on the country's economy.

In spite of all, that this sector has very pleasant effect on world financial market and public inclination is increasing day by day but there are number of challenges faced by Interest Free Banks. In order to compete with conventional banking system and to become the influential sector of the market, there is dire a need felt for the Islamic Banks to adopt the latest, innovative and modern means and tools for strengthening its roots of existence.

Following are some of the remedial measures for accomplishing the said objective, which should be considered on emergency basis:

1. As the Diminishing Musharaka is the combination of three different transactions which are permissible but the documented practice of Interest free Banks show the wrong impression that these are interdependent. There is a need to make it clear.
2. There is a need for the awareness program that educates the public in a better way about the clear difference between conventional banking system and Islamic Banking system. The Islamic Banking does not mean that the bank will not charge anything against any transaction. The Islamic Banks must confer the free loan (Qarz-e-Hasana) to the poor people on any aspect for their betterment. Such type of confusion exists in the public and these misconceptions must be eradicated for capturing the financial market.
3. The Interest Free Banks are supposed to make the bridge between the management/ decision makers and the business community. As this relation become stronger, the impact of Islamic Banking will move towards the common people, consequently the goodwill will be increased and the products offered will get the sustainable status in the market.
4. The Islamic Banks should present such products that meet the needs of the people of different fields like health sector, education sector, agriculture sector etc, not specific to the one sector or one class like Diminishing Musharaka focuses on Housing Sector.
5. One of the hurdles the Islamic Banks face is lack of trained staff who at least know the basic knowledge of Shariah teachings about the financial matters and problems. For this purpose, there is a dire need to establish training centers, colleges or universities that entirely focus on Islamic Economics Education.
6. The Interest Free Banks may open some programs with collaboration of management universities which help the students to get expertise according to the need of the banks. The students may get the required competencies through different workshops and seminars.
7. The Islamic Banks have to use the conventional banking bench mark i.e. IBOR Inter Banks Offered Rate, which is considered one of the loop hole of the system. There is a need to research on it and initiate the steps for maintaining separate bench mark for Islamic banking industry. Different economists and religious scholars should offer their services in this regard.
8. The need is felt for separate board comprises of high experts economically and religiously that watch and observe the Islamic Financial Institutions, their interactions with tax authorities,

State Bank, capital market, finance ministry and facilitate them accordingly.

9. There is also a need to consider the objections of Islamic Scholars on in-practice Islamic Banking System. If there is any validity, the management should do the changes accordingly. In case, the objections are not valid, then there should be a proper means of discussion in order to resolve the misconceptions and confusions of the objectors.
10. The Interest Free Banks or the conventional banks having Islamic Banking windows must review the procedure of implementation quarterly, biannually or annually to know the extent of conformity with Shariah Streamlines.

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