



The Practice of Musharakah Mutanaqisah at Malaysian Islamic Banks: An Empirical Review



By:



Prof Dr Zulkarnain
Muhamad Sori



Prof Dr Shamsheer
Mohamad



Alam Asadov

The strong demand for Shariah-compliant products and services from both Muslims and non-Muslims around the globe has contributed to the phenomenal growth of the Islamic finance industry for the last few decades. The cumulative growth rate of global Islamic finance assets was recorded at 17.3% per annum between 2009 and 2014. Proponents of Islamic finance postulate that the link to real economic factors with risk-sharing attributes, competitive returns with their conventional counterpart and the ability to share profit and loss (PLS) and buffer financial crisis are reasons for this rapid growth.

Among many permissible Islamic finance products, Musharakah or the partnership contract was put forward as a true representation of the PLS concept in the late 1970s. However, due to challenges to fully implement this type of contract in practice, practitioners have improvised a more practical version of the partnership contract termed Musharakah Mutanaqisah (MM) (or Diminishing Partnership). Currently, Musharakah Mutanaqisah is applied in home financing by Islamic banks and proposed as a replacement for Bai Bithaman Ajil and Bay al Inah in Malaysia. Despite the increasing popularity of MM in home financing in the Malaysian Islamic banking industry, there are issues in the way the Islamic banks operate and report this mode of home financing in their annual reports. This is possibly due to convergence in practice as current MM products by Islamic banks closely resemble conventional home financing practices except for some contractual terms, thereby lacking the true spirit of the contract (Lung, 2013). Specifically, this lack of spirit is reflected through the use of interest-based benchmarks and absence of profit and loss sharing elements in the contract, as well as avoidance of any type of ownership risk (or expenses) by the bank and even reporting this transaction in their financial documents in a way that does not reflect the true nature of the contract.

A Brief Overview of the Musharakah Mutanaqisah (MM) Contract

The MM contract uses concepts of Musharakah (partnership), al-Bay (sale) and Ijarah (lease). In general, the partnership is operationalized as follows: It begins with two parties (i.e. the financier and the customer) purchasing a certain asset (e.g. a house) as partners. After the purchase, one of the parties (usually the customer) rents the portion of the asset that belongs to the other via a periodical payment (i.e. rent). In addition to the rent, a sale price is paid periodically (based on an agreed ratio), representing a purchase of the other partner's (usually the bank's) share of the property.

Any losses in value and maintenance expenses of the underlying asset in the contract are supposed to be shared in proportion to the partners' shares in the asset, which is consistent with the principles of Musharakah. In addition to sharing profit or loss from the asset with the financier, the customer gradually acquires the partner's share in the asset by making extra payments over the financier's profit share in every period. With every subsequent payment, the profit part of the installment decreases as the financier's share of ownership of

the asset decreases. The partnership ends when the customer makes the last payment to the financier that covers both its profit and an amount equal to the financier's remaining share of the asset.

The permissibility of the MM contract in Shariah is conditional upon the following principles (Osmani & Abdullah, 2010):

The goods must be present. The property which is not present at the time of transaction or pledged already, is not allowed to be used as collateral in a transaction.

The proportion of the profit must be specified, and the profit will be in proportion and not by amount of money. Both the financier and the customer must share the profit and loss of the property. Though the profit is distributed according to a pre-agreed ratio, the loss should be shared according to the proportion of each partner's share in the ownership.

The Shariah advisory board must have the right to monitor the contract on a continuous basis.

The contract of partnership and the contract of sale should be done separately, and not collectively. Contracts underlying MM partnership could be combined in one package but should not be binding on each other. This means that partnership (Musharakah), sale (Bay) and lease (Ijarah) contracts should be separated from each other.

A binding promise can be taken from one partner to purchase the share of the other partner gradually.

“The MM contract uses concepts of Musharakah (partnership), al-Bay (sale) and Ijarah (lease)”

None of the parties have the right to acquire the other's share at cost price. The price paid should be either the market price or the price agreed at the time of the sale.

over the last decade, MM financing has become the preferred alternative for home financing in the local market.



ISLAMIC HOME FINANCING

23% Bai Bithaman Ajil

30% Musharakah

38% Murabaha

RM150b

No partner should be forced to bear the entire cost of the insurance or other general expenses. Such expenses should be borne according to the share of each partner in the partnership.

Finally, there should not be any stipulation preventing either party from withdrawing his contribution from the partnership.

Based on the Bank Negara Malaysia (BNM) guidelines, the Musharakah Mutanaqisah contract can be used for the purpose of asset acquisition, which is governed by principles of shirkat al-milk (joint ownership of a property by two or more persons), and for venturing in profit generating business activities governed by principles of shirkat al-aqd (joint commercial enterprise).

To provide more insights to the Musharakah Mutanaqisah home financing by the Malaysian Islamic banks, published financial statements of Islamic banks and MM documents from two full-fledged Islamic banks were reviewed, followed by structured interviews with regulators and academics. The following sections present a brief summary of the relevant information gathered from both the documents and interviews.

Background Information on Islamic Home Financing

In summary, the financial statements of all Islamic banks showed that the home financing by IBs amounted to RM151 billion (approximately USD37.04 billion; exchange rate of RM1=USD0.25) for the financial year ending in 2015. In terms of volume of home financing, Murabaha contracts accounted for 38% of the overall home financing (rank first), followed by Musharakah (30%) and Bai Bithaman Ajil (23%). Since its introduction

Relevant Standards for Reporting Musharakah Mutanaqisah Financing

MM financing is a contract of partnership to jointly own an asset between a customer and an IB. Subsequent to the acquisition of the asset, the bank leases its share in the asset to the customer at a certain lease payment. Based on the nature of the transaction in practice, few accounting treatments, namely (i) revenue recognition; (ii) initial recognition of the financial asset; (iii) assessment of financial assets' impairment are documented based on guidelines by MFRS 15 (Revenue from Contract with Customers), MFRS 117 (Lease), and MFRS 139 (Financial Instruments: Recognition and Measurement)¹.

Accounting Treatment for Revenue Recognition

Regardless of the type of Islamic financing, it is necessary to document the banks' profit based on certain set standards. But, there is no set "Islamic" standard for profit estimation and reporting in MM contract. Consequently, the Islamic banks apply the conventional banking effective interest rate method (except that there is no compounding of interest in overdue situations).

Since MM financing involves a lease contract, the IB's ownership in the asset will be leased to the customer. Islamic banks have to split the monthly lease payments (i.e. minimum lease payments) into two portions, namely the profit portion (finance charge) and payment of principal (i.e. reduction of the outstanding liability). Though the IBs claimed that the bank portions are leased to the customer, the documents showed that IBs did not follow the leasing standard requirements (MFRS 117). The leasing standard requires separate disclosure under different title. In practice, IBs document MM in the same group as other type of financing under MFRS 139

¹ With effect from 01st January 2018, MFRS 9 will supersede MFRS 139. Reporting of equity instruments would be affected due to failure to comply with the 'Solely Payment of Principles and Interest' test as required by the standard. As a result, the regulators are looking for the best solution for this dilemma. Based on our other research, we recommend that the reporting of equity based instruments should be done through 'Fair Value Through Profit and Loss' by having a separate item labeled as Investment in Musyarakah.

that is the 'Financing, Advances and Other Financing' classification².

Review of financial statements reveals that nine out of sixteen (56%) IBs offered MM financing to their customers and all of them declared that their revenue recognition was based on the 'effective profit rate method'. It was observed that the IBs that offered MM financing, offered it as "a joint ownership of the MM asset with their customer, and subsequently lease their equity or share of the asset on the basis of ijarah".

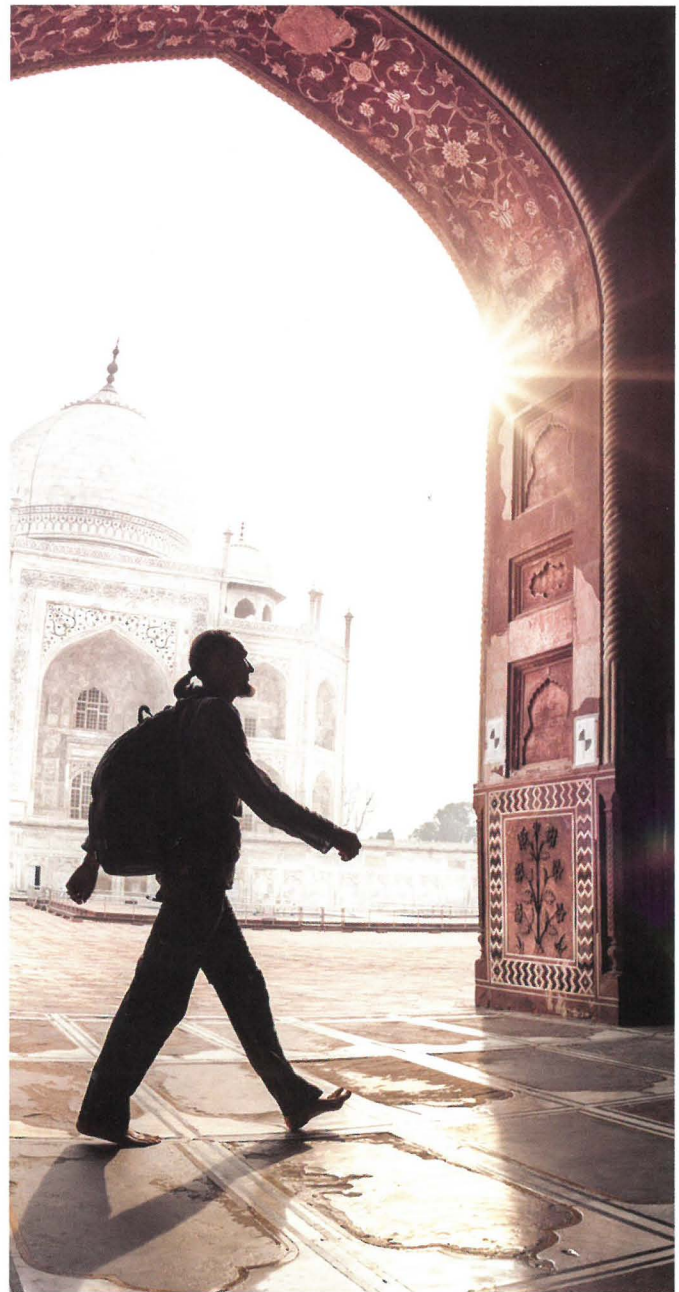
The above finding raises ambiguities regarding the way MM financing contracts are operated as lease (Ijarah) contract in practice. In context of MM home financing, Ijarah usually refers to lease and separate sale (bay) transaction. Since financing Ijarah combines both lease and sale contract together, IBs use Effective Profit Rate Method (EPRM) to split the periodic payment made by the customer into payment of principal and profit of financing. The use of an Ijarah contract also eliminates the musharakah features of the financing product and the transaction is documented as a common debt-based instrument.

Recognition of Financial Assets

In MM financing, the IB enters into an agreement to jointly own an asset (or a house) and makes capital available to the partnership. The bank owns a sum of equity in the asset or the portion of the bank's ownership of the underlying asset. The initial step is to calculate the fair value of the asset, where the amounts of any preliminary expenses (such as a feasibility study or legal documentation charges) that bring the asset into working condition can be capitalized in the value of the asset (Paragraph 43, MFRS 139). It is important to note that FAS 4 of AAOIFI disallows capitalization of these cost elements unless agreed by both partners. Indeed, as mentioned earlier, IBs lease their ownership in the asset (equity/share of the asset) to the customer subsequent to its acquisition under the MM financing. Thus, it is normal practice for IBs not to recognize the leased asset in their book and the customer would normally recognize the value of the asset in their book (if they are a business entity) due to consideration of the 'substance over form' principle. This is further evidenced by registration of ownership under the customer's title as a beneficial owner with the land office and relevant authorities, and the IB will only claim ownership rights in the event that the customer defaults on the lease payment.

It is important to note that through the use of an Ijarah contract, IBs circumvent various Shariah issues in MM financing. Issues such as shared Takaful expenses, continuous periodic fair value assessment and distribution of price variation as a result of price increase or decrease in fair value assessment, and the asset's fair value due to early termination of the MM financing contract, are no longer relevant in MM financing.

The findings reveal that all nine IBs complied with MFRS 132 and MFRS 139 and disclosed their MM financing



under the classification of 'Financing, Advances and Other Financing'. The implication of this practice is that the asset is not subjected to a depreciation and impairment test. Furthermore, it is evident that periodical fair value assessment and distribution of variation of the asset's value (either upward or downward) were not considered in practice. However, in practice, IBs periodically assess the impairment status of their 'Financing, Advances and Other Financing', where uncollectible financing would be written off from the account. Institutions that adopted the AAOIFI financial reporting regime reported this transaction differently, where, IBs recognized MM transaction as Ijarah assets in their book and subsequently provide the relevant estimate of depreciation and impairment of the asset.

Disclosure Requirements

The objective of MFRS 7 is to provide relevant information to users on the significance of financial instruments to the financial position, performance and cash flow of the respective IBs.

² Due to the Shariah compliance requirement of Islamic banking business, the term 'Financing, Advances and Other Financing' is used as a variation of the original classification of 'Loan and Advances' as stipulated in MFRS 139.



“MM financing is a contract of partnership to jointly own an asset between a customer and an IB.”

the asset at its fair value and this may result in variations from the actual projection of liabilities. However, the current practice shows that the IBs lease their ownership rights of MM financing under the Ijarah contract. And, the gradual transfer of the MM asset's ownership over the tenure of the contract is just a myth. There is no accounting record for the gradual transfer of ownership.

The beneficial ownership of the asset is transferred at the beginning of the contract and the IB only claims rights to the asset in the event that the customer fails to make the minimum lease payments. Indeed, the periodical payment of the account would only result in reduction of the customer's outstanding value of the MM financing.

Since the MM contract is documented as an Ijarah contract, the accounting treatment for MM financing is inconsistent with those recommended by Shariah Scholars in the literature. The IBs did not report their share in MM assets and subsequent periodical fair value measurement and other related information. Since IBs recognized their revenue based on the 'effective profit rate method', it is pertinent for regulators to view this matter seriously and provide an objective solution. Perhaps relevant laws should be amended to allow joint ownership of MM assets and use of actual operating Ijarah for calculation of IB's profit. Finally, it is not fair to call a financial arrangement MM financing if it is in essence another Ijarah transaction and the reporting is done using common debt-based instruments under the guidance of MFRS 139. ■

Although the MM financing is claimed as a joint ownership with profit and risk sharing features, the use of the Ijarah contract eliminates the unique features of MM financing. Based on the 'substance over form' principle, the substance of the transaction (or economic reality) indicates that the MM asset is under customer custody and they would be held responsible for the state of the asset. Furthermore, the MM asset is registered with the authorities under the name of the customer and the asset is charged (as collateral) to the bank. From the government's perspective, it is clear that the IB is not a registered owner of the asset except for their claim to the MM asset that is being charged as collateral. Above all, IBs in Malaysia use accounting standards on financial instruments to account and report the MM financing.

Conclusion

In practice, MM home financing is a close replica of the conventional home financing. The payment schedule of MM financing is calculated based on the effective profit rate method and the amount invested in the MM asset is disclosed as 'Financing, Advances and Other Financing'. In MM financing there is supposed to be a gradual transfer of