AN EXPLORATORY STUDY INTO THE EFFICACY AND IMPLEMENTATION FEASIBILITY OF VEHICLE FINANCING USING THE CONCEPT OF *MUSHĀRAKAH MUTANĀQIṢAH*

BY

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ABSTRACT

There is a growing interest among the researchers in Islamic finance and banking, specifically, after the world economy downturn. One of those areas which have not yet been covered by them is the application of vehicle financing under the pretext of musharakah mutanaqisah particularly in Malaysia in which this study attempts to explore. The study uses the qualitative method by which the researcher interviewed eight informants who are bankers and experts in the field of Islamic banking and finance on legal constraints, Shariah argumentation, and product accessibility and feasibility. The findings of the study reveal base on the informants' responses that, vehicle financing can be workable using the concept proposed by the study on long run as people getting acquainted with it in Malaysia or in other Muslim countries. Only two informants were of the opinion that, the concept cannot take a root in Malaysian soil or in any other places, supporting their argument that people would not accept or understand it even if introduced. One of informants said, the problem with the concept in Malaysia is because it is at its infant stage. In conclusion, the researcher suggests a plethora of studies to be conducted in this area for her knowledge that there is not enough research works in vehicle financing with musharakah mutanaqisah so as to open people's horizon in understanding the issue more and more.

ملخص البحث

ازداد اهتمام الباحثين في مجال الصيرفة والتمويل الإسلامي، وعلى الأخص، بعد انحطاط اقتصاد العالم. ومن تلكم المناطق التي اهتموا بها و لم تتم تغطيتها بعد هي قضية تطبيق تمويل السيارات بعقد المشاركة المتناقصة خصوصا في الديار الماليزية التي حاول هذا البحث اكتشافها. استخدمت هذه الدراسة المنهج النوعي بأن قامت الباحثة بإجراء المقابلات مع ثمانية أشخاص ذوي خبرات طويلة في مجال الصيرفة والتمويل الإسلامي بخصوص العوائق والحجج الشرعية، ووصول هذه المنتجات. وعلى هذا، أظهرت نتائج الدراسة حسب استجوابات المقابلين بإمكانية تطبيق تمويل السيارات باستخدام آلية المشاركة المتناقصة إلى أمد بعيد حتى يتعرف الناس عليها في الديار الماليزية أو في البلدان الإسلامية الأخرى تدريجيا. وقد أجاب شخصان فقط بعدم إمكانية تطبيق تمويل السيارات بآلية المشاركة المتناقصة داعمين حججهم بعدم فهم الناس ذلك. وفي الختام اقترحت الباحثة إجراء عدد كبير من الدراسات في هذا المجال لمعرفتها بقلة البحوث في تمويل السيارات باستخدام المشاركة المتناقصة، وذلك لفتح أفق الناس في فهمه أكثر فأكثر.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards if scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the Master degree in Islamic Banking and Finance.

…………………………………….
Younes Soualhi
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards if scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the Master degree in Islamic Banking and Finance.

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Dzuljastri Abdul Razak
Examiner

This dissertation was submitted to the Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Islamic Banking and Finance.

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Dean, Institute of Islamic Banking and Finance (II*i*BF)

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Thalia Rohaina Binti Abdul Latiff

Signature: ………………………………. Date: …………………………….

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Affirmed by Thalia Rohaina binti Abdul Latiff

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Signature Date

I dedicate the thesis to my beautiful Mother Che Wan binti Mohd Yusof, my four beautiful children, Abdul 'Arif Haikal bin Abdul Ghani Shukhri, Sarah Nur Hannah binti Abdul Ghani Shukhri, Alya Laila Isadora binti Ahmad Saniy and Ahmad Zamzamiy Yusof bin Ahmad Saniy for their understanding and support and not forgetting to my loving late father Abdul Latiff bin Abdul Hamid.

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CHAPTER ONE

INTRODUCTION

BACKGROUND OF THE STUDY

A cursory survey of *Shari'ah*-compliant vehicle financing products used by financial institutions and the general *Shari'ah* concept that is utilized was carried out in the author's previous endeavour. The said survey indicates that, by and large, the most popular mode of effecting Islamic vehicle financing, in Malaysia, is via the concept of *Al-Ijarah Thumma Al-Bay'* or AITAB. Interestingly, this mode of *Shari'ah*-compliant financing (AITAB) is not practiced among selected financial institutions outside of Malaysia. Instead, among these institutions, vehicle financing employs the concept of *murabahah* or *ijarah*.

AITAB essentially involves a leasing arrangement (*ijarah*) that ends with a sale. The financing process entails the following steps. The customer identifies the vehicle of choice. The customer then engages the bank to seek financing. Bank purchases the selected vehicle from the manufacturer/distributor/dealer. Bank as owner of the vehicle then leases the vehicle to the customer according to agreed terms and conditions (including rental amount and lease period). At the same time, the bank makes a unilateral promise to sell the vehicle to the customer at the end of the lease period, for a nominal price. The customer can return the vehicle at any time prior to exercising the option to buy and thus terminating the agreement; customer is not obliged to pay all the rentals. At the end of the lease period, after all rental payments have been made, the customer has the option to purchase the vehicle at a nominal price.

The *murabahah* model, popular in GCC countries, comprises the following basic steps. The bank places its representative at various car dealerships and showrooms. The customer visits such a vehicle warehouse/showroom and identifies the desired vehicle. The customer then approaches the bank's representative located at that showroom/dealership, to seek financing. The bank will then purchase the identified vehicle from the dealer on cash basis. The bank proceeds to sell the said vehicle to the customer on deferred payment terms.

The *ijarah* model is particularly suitable for when the customer is a corporation or institution in need of financing of a fleet of vehicles. This model has the following key features. The bank purchases the vehicles and leases them to the customer over an agreed protracted period. Lease payments are made periodically over the lease period. The customer may exit the lease at any time by returning the vehicles (in reasonable condition) to the bank and paying the bank a pre-determined fee. The customer has the option to purchase the leased vehicle at any time throughout the lease period. At the end of the lease period, the customer has the option of either returning the vehicles or purchasing them.

However, there is now a growing interest in *musharakah* as a financing instrument, albeit initially among non-shariah academics and now increasingly by shariah scholars and regulators. This view is rooted in the premise that debt instruments like the BBA and murabahah are deemed shariah non-compliant by certain scholars such as Siddiqi (Siddiqi, 1983) and Chapra (Chapra, 1985) as they are of the view that the interest-based system must be replaced with profit sharing instruments "if the objectives of socio economic justice" are to be realized (Ayub, 2007). Indeed, Nejatullah Siddiqi, one of the foremost critics of debt financing and a proponent of equity financing declared that, "I would prefer that bai' muajjal be removed from the permissible methods altogether" (Siddiqi, 1983). He argued that the bai' muajjal has close "proximity" with conventional loans and invoked the legal maxim, "Anything leading to anything prohibited stands prohibited" (Siddiqi, 1983). Chapra has been more subtle and noted that it is beyond dispute that "the criterion for determining the permissibility or otherwise of any method of financing is that the financier cannot avert the taking of risk if he wishes to derive an income" (Chapra, 1985). Both are proponents of the profit and loss sharing financing who argue that these vehicles, among others, are engines of growth (Aggarwal et al., 2000). Meanwhile Anwar alleged that "the difference between the sale price and the purchase price is time value of money that is equivalent to interest" and that "the profit added to the principal is nothing but riba" (Mohammed, 2003).

The rationale of these Muslim economists is that in financial transactions, Islam advocates risk sharing and in this respect Chapra argued that in order for one to enjoy income, one cannot evade risk taking and rekindled the "no-risk no-gain" concept (Chapra, 1985). Lately Rosly has also been expounding this idea and he alleged that there is an absence of risk sharing in BBA and that there is not only apparent resemblance but no significant difference between BBA and conventional loans (Rosly, 2008). He further questioned whether BBA would have an impact on the economy and that it is not worthy of the Quranic concept of al-bai' (Rosly, 2008).

However, it should be noted that these writers are actually Muslim economists and not shariah scholars. As for shariah scholars, they have allowed most "Islamic" debt financing instruments except tawarruq and bai al-'inah. The OIC Fiqh Academy, in its 7th session in Jeddah, decided that *"Deferred instalment sale is permissible even if the deferred price is more than the immediate price. In other words, deferred instalment sale is permissible, even if the seller decreases the immediate price and* *increases the deferred price"* (http://www.isra.my/fatwas/topics/commercial-banking/financing/ murabahah/item/284). In the case of tawarruq, the OIC Fiqh Academy has earlier permitted non-pre-arranged tawarruq (classical tawarruq) but later prohibited pre-arranged tawarruq. (Bank Negara Malaysia, 2006) Even in the case of bai al-'inah, The Shariah Advisory Council of both Bank Negara Malaysia and the Securities Commission has approved it, albeit with conditions (Bank Negara Malaysia, 2006 and Securities Commission, 2007). Indeed in the early years of Islamic banking, the use of debts instruments have been predominant but in the late nineties, contemporary jurists have made efforts to explain how equity instruments such as *musharakah* may be used for Islamic financing (Muhammad Taqi, 1999). Lately, more thorough discussions on *musharakah* by regulators (Bank Negara Malaysia, 2010) have been observed, possibly paving the way for its more widespread use. The writer is of the opinion that in the context of Islamic banking in Malaysia, the views of the shariah scholars have more weight than the economists.

On the other hand, the concept of *musharakah mutanaqisah* has been propounded in the seventies for house financing by cooperatives to their members (Quraishi, 1977) and to a certain extent, by Islamic financial institutions in the West in the eighties (Lariba website).

SUMMARY OF THE PROPOSED DISSERTATION

This dissertation will explore the implementation feasibility of a vehicle financing instrument structured based on the concept of *musharakah mutanaqisah*. The real world practicality of a number of key features of the product, namely, the equitable assuming of vehicle takaful costs by the financier, the use of non-interest based benchmarks for product pricing, flexible share purchases accorded to the customer and a sell-back feature, will be delved into. To ascertain the likelihood of this product reaching market successfully, possible legal constraints and regulatory issues will also be addressed. In addition, the dissertation also seeks endorsement as a mode of retail vehicle financing that better embodies *Shari'ah* values and tenets, by way of *Shari'ah*-based argumentation and reasoning.

Towards such ends, the dissertation will rely on a variety of research methods, tools and approaches such as questionnaire survey data, qualitative semi-structured and open-ended interviews with key stakeholders as well as gathering, review and analysis of documentary evidences and relevant literature.

PROBLEM STATEMENT

To the best knowledge of the author, there has not been notable or widespread application of the concept of *musharakah mutanaqisah* in the provision of vehicle financing. Thus, the use of such a framework to structure a vehicle financing instrument is, at this stage, exploratory in nature.

A standard version or form of the proposed *Musharakah Mutanaqisah* structure for vehicle financing was conceptualized based on a similar structure used for home and property financing, currently a *Shari'ah*-compliant approved product in Malaysia. This structure is based on the concept of diminishing partnership in ownership. The bank and the customer jointly acquire and own the vehicle. The bank leases the bank's share in ownership of the vehicle to the customer on the basis of a leasing agreement (*ijarah*), given that the customer is the sole user of the vehicle. In addition, the customer promises to acquire, periodically, the bank's share in ownership of the vehicle. Thus, the customer's periodic (monthly) payments to the bank comprise two components:

- Rental payment attributed to the bank's share in ownership of the vehicle (payment being for exclusive use of the vehicle by the customer)
- Purchase of share in ownership of the vehicle by the customer.

As the leasing period progresses, the share in ownership of the vehicle by the customer gradually increases, while the share in ownership of the vehicle by the bank decreases. At the end of the *ijarah*/lease term and upon payment of all *ijarah*/lease rentals, the customer would have acquired all of the bank's shares in ownership and the partnership will come to an end. The customer becomes the sole owner of the vehicle.

This structure essentially makes use of four Islamic nominate contracts or concepts – *musharakah* (*shirkah al-milk*), which refers to the concept of joint ownership between two or more persons in a particular asset or property, which may or may not generate earnings; *ijarah*, relating to the usufruct of a particular asset to another person in exchange for a rent claimed from him; *wa'ad*, which is a unilateral binding promise, applied to ensure that the customer would diligently purchase shares of ownership in the vehicle, as per the financing installment payment schedule, as well as providing recourse to the bank in the event of payment default; and *bay'*, representing the contract used for each purchase of the bank's share in ownership of the vehicle by the customer which takes place during each monthly installment payment.

Notwithstanding the fact that such an envisioned structure has received approval from various *Shari'ah* authorities (or at least in its application in home financing), a number of issues or concerns emanating from this structure could be articulated, described under the following headings – risks and liabilities of ownership, benchmark to conventional interest rates, and substantial resemblance to conventional financing.

The author has identified three areas which will be the focus of attention of this dissertation:

A. Legal Constraints and Regulatory Challenges

B. Shari'ah Argumentation in Claiming Product's Efficacy

C. Product Acceptability and Feasibility

Legal Constraints and Regulatory Challenges

While the *Shari'ah* permissibility of such a proposed product is imperative, another regulatory concern is the legal standing of such an instrument. In Malaysia, vehicle financing activities are governed by the Hire-Purchase (HP) Act 1967. The proposed financing structure has some notable differences with current vehicle hire-purchase practices, namely joint ownership of the vehicle and quasi-contractual gradual purchases of ownership shares by the customer. The legality of such a modus operandi, within the governance and legislative clout of the HP Act 1967, needs to be ascertained.

Shari'ah Argumentation in Claiming Product's Efficacy

Developing a *Shari'ah* compliant financial instrument should not be made void of due consideration of *Shari'ah* objectives. If anything, these objectives of the *Shari'ah*, or *maqasid al-Shari'ah*, should steer and guide product development. Pursued in such a manner, *Shari'ah* compliance would not be reduced to simply categorical or nomenclatural differentiation with the purely commercial aim of targeting a captive Muslim market.

Maqasid al-Shari'ah embodies the values and principles of the *Shari'ah*. In devising a financial instrument that claims to encompass such tenets of Islam, the following should be kept in mind (Chapra, 2000).

- While it is well-recognized that Islamic banks are for-profit organizations, such institutions should not be solely driven or oriented by profits. The concept of *maslahah* (public benefit), which sometimes connotes the same meaning as *maqasid al-Shari'ah*, implies that Islam stresses great importance on public interests rather than merely individual interests such as those of the financial institutions and their financial stakeholders (Dusuki and Abdullah, 2006).
- Scholars have cautioned against the abuse of the *Shari'ah*, often culminating in misleading application of various tools of Islamic jurisprudence (Abozaid and Dusuki, 2007). It must always be remembered that the *Shari'ah* is a source of guidance and reference and not merely a tool or device to seek commercial gain.
- The performance of Islamic banks should not be measured by only conventional yardsticks (Mohammed, 2006). The extent to which Islamic financial institutions contribute towards the realization of key values and principles of the *Shari'ah* should garner due attention from Islamic banks' management and stakeholders. In this regard, two important principles are those of fairness and distributive justice.
- It is imperative that in the structuring of a *Shari'ah* compliant financial instrument, the construction of a contractual arrangement that has the substance of an interest-bearing debt instrument is averted. An underlying interpretation of the prohibition of *riba*, arguably the *raison d'etre* of

Islamic banking and finance, is that debt is a kind of asset that cannot be subjected to growth (Kahf, 2006). Thus care must be exercised to ensure that any instrument constructed departs substantially from the essence of a debt instrument. In addition, there are certain "risks of Islamic financial contracts" that are an immediate outcome of the nature of those Islamic contracts. The carrying of these risks by the finance provider is intended by the prohibition of *riba* (Kahf, 2006).

An implicit claim made is that the previously discussed "product enhancements" would make such a vehicle financing offering closer in its embodiment of *Shari'ah* ideals and principles than other presently available vehicle financing instruments. Such a claim requires further deliberation, scrutiny and analysis. Relying on Islamic sources of knowledge, tools of Islamic jurisprudence and guided by an overall framework of *maqasid al-Shari'ah* (objectives of the *Shari'ah*), the author endeavours to provide grounds and argumentation in advocating that such product enhancements are indeed more "*Shari'ah*-based" than other currently available alternatives.

Product Acceptability and Feasibility

The proposed product structure differentiates itself from other present commercial offerings by advocating a number of "product enhancements", namely:

- Making the financier responsible for the logistical arrangements associated with vehicle takaful.
- Getting the financier to bear its equitable share of the financial costs of vehicle takaful.
- Relying on non-interest based benchmarks to determine product pricing or amounts due from the customer.

- Giving the customer the option to make share purchases in flexible amounts.
- Incorporating a sell-back feature in the financing scheme, thus according the customer a short-term cash financing facility.

A key concern is, how would relevant stakeholders view such product enhancements? While the author may conjecture that these products are desirable from a *Shari'ah* standpoint, its acceptability and commercial feasibility are essential if the product is to have any chance to be a reality. Will financiers be open to the idea of receiving payments from customers in variable amounts (thus making cash inflows less predictable and in turn, introducing additional risk elements)? Can objective, fair and practical benchmarks be developed to replace existing interest-based measures? Would customers value such product enhancements, to the extent that they may, in certain instances, be willing to pay a higher cost (relative to current product offerings)? Would regulators have no objections in such a manner of financing as it represents a radically different mode of consumer financing (and thus may introduce new and unique regulatory issues)? These are some key questions that have to be addressed.

JUSTIFICATION OF PROBLEM

Although musharakah has been used for house financing, its use in personal vehicle financing has not been observed. Should the musharakah principle be used, there could possibly be inherent risks and liabilities, including that of ownership.

When the contract of *ijarah* is used, the *Shari'ah* stipulates a number of rules that should govern the rights and responsibilities of the lessor and the lessee of a lease arrangement. A pertinent few are mentioned below:

- The lessor is responsible for the leased asset throughout the lease period. In the event of any defects occurring onto the leased asset, which impairs the intended use of the asset, the lessor is responsible for restoring the usufruct of the leased asset, the cost of which must be borne by the lessor. However, there are two exceptions to this rule:
    - The impairment is a result of willful misconduct by the lessee.
    - The impairment represents acceptable wear and tear resulting from normal use.
- The lessor may not exclude itself from any such aforementioned liability nor can the lessor transfer such liability to the lessee. However, the lessor may delegate the task of carrying out any necessary repairs, to the lessee, but at the lessor's cost.
- The lessor, in managing such aforementioned liabilities, may take permissible forms of insurance (*takaful*) and the expenses arising from it must be borne by the lessor. The lessor may take this into account implicitly when determining the rate of rental but once the lease contract is signed, no additional cost attributable to the *takaful* may be recouped from the lessee (AAOIFI, 2004, pp. 142-143).

During the normal course of using a vehicle, two general types of risks and liabilities exist:

- Risks and liabilities attributable to usage, such as fuel costs, toll and parking charges, road tax, and minor maintenance and repairs (engine oil change, tyres, battery change, etc.)

- Risks and liabilities associated with ownership, namely substantial damage or defect occurring on the vehicle as a result of an accident and other potential unforeseen events.

In the case of the former type, the responsibility to bear such risks and liabilities, and the resulting costs, should be that of the lessee. On the other hand, in the case of the latter type, such risks and liabilities, the *Shari'ah* stipulates, must be borne by the lessor. Such risks and liabilities are typically (or in some cases, it is mandatory) managed via the purchase of insurance coverage or through participation in a *takaful* scheme.

Hence, for a vehicle financing arrangement to be permissible in terms of the *Shari'ah*, the costs of receiving vehicle *takaful* coverage must be borne by the lessor.

In proposing a *musharakah mutanaqisah* structure for vehicle financing, a number of issues emerges.

- The idea that the lessor should bear the cost of *takaful* in a vehicle financing arrangement is foreign and goes against current practice. In both conventional vehicle hire-purchase agreements and *Shari'ah*-compliant vehicle financing, as presently practised in Malaysia, the logistical and financial responsibilities of insurance or *takaful* are those of the customer (lessee).
- Vehicle *takaful* is typically for durations of 6 months or one year, and are renewed periodically. Thus, the actual cost of *takaful* coverage cannot be ascertained ex-ante for the entire duration of the financing period. This implies possible variations in the rate of return to the financier, given that the cost of *takaful* will fluctuate and that the financier, as lessor, must bear this cost. Again, such a scenario presents unfamiliar circumstances to

financial institutions, whereby current vehicle financing products are generally fixed-return financing instruments.

- To add another dimension of complexity and unfamiliarity, the concept of *musharakah mutanaqisah* involves a joint ownership of the vehicle. Thus the responsibility for the vehicle must be jointly borne. The financier is leasing its share of the vehicle, not that of the entire vehicle, and this share will gradually decrease as the financing period progresses. In other words, the bank's share of responsibility to bear *takaful* costs will diminish over time whereas the same will increase for the customer.

The salient point of the preceding discussion is this – within the *Shari'ah* financial framework, in an *ijarah* arrangement, the financier (lessor) has to bear an equitable portion of risk (specifically, that which relates to ownership risk) in order to justify the returns it makes. The leased asset is only an *amanah* (trust) in the hands of the lessee, and the lessee cannot be made liable for losses or damages that occur not as a result of the lessee's negligence or misconduct. The complete transfer of risks and liabilities associated with the ownership of the leased asset to the lessee is unacceptable from the *Shari'ah* point of view (Obaidullah, 2005).

OBJECTIVES OF THE STUDY

The main objectives of the study are:

- To examine the feasibility of financing the purchase of motor vehicles using the principle of *musharakah mutanaqisah*.
- To explore the incorporation of takaful costs into the vehicle financing product structure via the concept of *musharakah mutanaqisah.*

- To investigate the pricing index of vehicle financing product using non-interest based benchmarks.

The following research questions are formulated based on these objectives

RESEARCH QUESTION

The questions posed by this study are in three fold

1- Is the purchase of vehicles feasible using the principle of *musharakah mutanaqisah?*.

2- Can takaful costs be incorporated into the vehicle financing product structure via the concept of *musharakah mutanaqisah?*.

3- Can the pricing index of vehicle financing product using non- interest based benchmarks be implemented in Malaysia for example with the principle of *musharakah mutanaqisah?*.

SCOPE AND LIMITATION OF THE STUDY

The scope of this study employed the concept of *musharakah mutanaqisah* or diminishing partnership in the provision of vehicle financing or the structuring or offering of a financial product to that effect. The *musharakah mutanaqisah* concept is increasingly being applied to home financing. The extension of such a concept onto vehicle financing is the primary subject matter of this dissertation.

Much of this dissertation is dependent upon access to data and providers of key information. While the author sought consultation from and solicited inputs from various relevant stakeholders, the author recognizes that it is possible that some data or information may not be available or accessible due to a variety of reasons. This constitutes one of the possible limitations of the study.