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يُؤْتِيهِمُ اللَّهُ مِنْ فَضْلِهِ يُغْنِيهِمْ

**CUSTOMERS VIEWS ON IIUM ASSET
FINANCING: A COMPARATIVE STUDY
OF AL-MUSHARAKAH AL-MUTANAQISAH
AND AL-BAY' BITHAMANIN AJIL**

BY

UMAR AHMED

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**A project paper submitted in partial fulfilment of
requirement for the degree of Master of Science in
Finance**

Kulliyyah of Economics and Management Sciences

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ABSTRACT


Murabahah has been used by Islamic banks worldwide. In South-East Asia, al-Bay Bithaman Ajil (BBA) contract is used for asset financing. The BBA is a Murabahah contract, based on buy – and- sell for deferred payment to finance assets. The application of BBA in Islamic banking has drawn a lot of criticism among Muslim scholars recently. As a result, some scholars and practioners have tried to explore appropriate alternatives to the BBA. Prominent among these alternatives is the Musharakah Mutanaqisah (MM) contract. The MM consists of a Shirkah (partnership) contract and Al-Ijarah (Rental) contract where the funding of the financier follows a diminishing principle. Scholars agreed on its permissibility and it is internationally acceptable. This study used a survey and compares these two contracts in terms of their pricing, religiosity, objectives of Shariah, customer satisfaction and choice. The study concludes that MM is a better alternative to BBA because, it is complies with the spirit of the Shari'ah, it is a just and fair mode of asset financing, it promotes the welfare of the people, it contributes positively to equitable distribution of wealth and income and more customers would prefer to use it.

الملخص


عد بيع المرابحة من أكثر صيغ التمويل شيوعاً وإستخداماً لدى المصارف الإسلامية في العالم ، وفي جنوب آسيا يستعمل البيع المؤجل أو ما يسمونه ببيع المرابحة للأمر بالشراء بشكل كبير في تمويل السلع والمعدات والآلات. وهذا العقد الذي هو أصلاً عقد مرابحة يتم فيه البيع والشراء بثمن مؤجل أو على أقساط. وقد أثار تطبيق هذا العقد ، أي البيع المؤجل وممارساته لدى المصارف الإسلامية جدلاً كبيراً بين علماء المسلمين. ولهذا السبب حاول بعض العلماء والمهنيين المختصين بإيجاد بدائل مناسبة لهذا البيع. ومن البدائل عقد المشاركة المتناقصة والذي يتكون أصلاً من عقدي الشركة والإجارة ويتناقص فيه سهم الممول في الشركة تدريجياً. ولقد نال عقد الشركة المتناقصة إقبالاً كبيراً على مستوى العالم وانتفق جمهور العلماء على جوازه. استخدمت هذه الدراسة طريقة البحث الميداني وقارنت بين عقدي المشاركة المتناقصة والبيع المؤجل من حيث تسعيرهما وشرعيتهما ومدى تحقيقهما لمقاصد الشريعة ومدى قناعة الزبائن واختيارهم لكل واحد منهما. وخلصت الدراسة إلى أن المشاركة المتناقصة بديل أفضل للبيع المؤجل، حيث أنها تتوافق من روح الشريعة الإسلامية وهي صيغى عادلة في تمويل السلع والمعدات والآلات ، كما أنها تراعي المصلحة العامة وتساهم بطريقة إيجابية في عدالة توزيع الثروة والدخل بين الناس ويفضل معظم زبائن المصارف الإسلامية التعامل وفقها.

APPROVAL PAGE

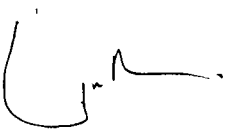
I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in the scope and quality, as a project paper for the degree of Master of Science in Finance.


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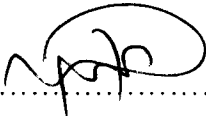
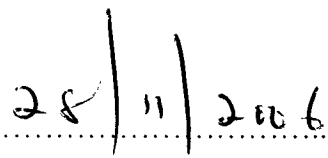
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.....
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DECLARATION

I hereby declare that this project paper 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.

Name: Umar Ahmed Umar

Signature.......... Date..........

This work is dedicated to my dear and beloved mother, Zam Zam Ramadhan Wani, and my father Ahmed Umar Mohammed, and my uncle Mustafa Omar Mohammed; who rendered me all the love, care and support for my education. May Allah's guidance and blessing be upon them in this world as well as in the hereafter.

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LIST OF ABBREVIATIONS

BBA	Al-Bay' Bithaman Ajil
MM	Al-Musharakah Mutanaqisah
BNM	Bank Negara Malaysia
CIIP	Council of Islamic Ideology Pakistan
ICHC	Islamic Cooperative Housing Corporation
AHL	Ansar Housing Limited
S.O.S	Shared Ownership Scheme
ABC	Arab Banking Corporation
KBI	Islamic Youth Cooperatives
IIUM	International Islamic University Malaysia
KENMS	Kulliyyah of Economics & Management Sciences
IRKHS	Kulliyyah of Islamic Revealed Knowledge and Human Sciences
KAED	Kulliyyah of Architecture & Environmental Design

CHAPTER ONE

INTRODUCTION

1.0 RESEARCH BACKGROUND

In the area of Islamic banking, especially in Malaysia, BBA is widely used for asset financing for customers and the payment is based on monthly installment for a specified duration. The Middle Eastern scholars disagree with the Al-Bay Bithamanin Ajil (BBA) contract, citing that its application is similar to the conventional loan (Meera and Abdul-Razak, 2005) which we shall soon explain. A new mode of BBA has recently been introduced, the variable-rate financing, to complement the existing fixed – rate BBA financing. The fixed-rate regime has resulted in a funding mismatch to the Islamic financial institutions because their long-term financing was funded by short-term bank deposits which give variable returns. As a result, banks had locked in their profit rates for a long term financing and any upward movement in the market rates; would make it difficult for banks to give satisfactory return to their depositors. This is because the constant income stream from the financing is tied to a fixed profit rate which is relatively lower when compared to a conventional floating rate loan. This causes depositors to switch fund from Islamic to conventional banks. Therefore, the variable rate financing is designed to mitigate the mismatch risk faced by the Islamic financial institutions by allowing them to vary the profit rate for the financing in order to raise the deposit rates. As a result, depositors will obtain satisfactory returns and would not switch their deposit to the conventional banking market (BNM Report, 2003).

Fixed-rate BBA provides several advantages. The price of the asset is determined upfront and fixed, the transaction is transparent, there is no element of uncertainty, the customers know exactly when the financing will end and there will be no compounding of arrears and outstanding charges. Last but not least unlike flexible-rate BBA, repayment is not subject to the bank lending rate.

The use of both fixed rate BBA and flexible rate BBA leave the financiers as well as the customers in uncertainty. According to Rosly, (2005), one way to do away with the problem of choice, is to apply the contract of Musharakah Mutanaqisah (MM). It helps clients to buy properties without resorting to interest-bearing or even deferred sale financing.

There are growing concerns that Islamic banking customers would be more dissatisfied with BBA mode of asset financing and many would prefer the conventional mode over the Islamic one. Due to such problems associated with BBA, among others, there is need for a widely acceptable mode of asset finance that would mitigate the problems associated with the current BBA and at the same time offer a viable alternative to the customers.

The Musharakah Mutanaqisah contract offers one of such alternative. It is a Shariah compliant mode of asset financing which is gradually gaining acceptance internationally. The Musharakah Mutanaqisah is now widely practiced in the Middle East, United States, Canada, United Kingdom, Australia (Meera and Abdul-Razak, 2005) and to some extends few institutions within Malaysia. MM consists of Musharakah (partnership) contract and an Ijarah (leasing) contract, where the equity of the financiers follows a diminishing balance method unlike BBA which based on buying-and-sell principle. Under BBA contract, a client requests bank to purchase a

property, according to certain specifications and then, after Bank has obtained the property, it resell to the client by Murabahah.

Musharakah Mutanaqisah (MM) is acceptable internationally as *Sharī'ah* compliant and it is inline with the objective of shariah as it allows people to own property with limited initial capital; hence it promotes the welfare of the people. It is also a just and fair mode of financing compared to the conventional loans and the BBA. It brings economic stability and assists equitable distribution of wealth. In addition, it avoids interest by using rental or house price index, it reduces the cost of financing, shortened the duration of payment, its pricing much lower compared to BBA hence the balance of financing at any point in time never exceeds the original price of the assets (Meera and Abdul-Razak, 2005).

Despite these benefits, some issues arise in relation to the implementation of MM, particularly in Malaysia. MM is suitable for real estate property financing but not for depreciating assets. The national land code also needs to be amended in order to allow the bank as a partner to register itself as the principal co-owner of the property. The tax regulation need to be amended to allow only rental charges contributing to profit be treated as income to the bank and should not be taxed.

1.1 STATEMENT OF THE PROBLEM

BBA and MM continue to be at the center of debate in relation to asset financing. The proponents of either contract continue to paint the rosy side of mode of financing, they favor. The adherents of the alternatives have given all kinds of labels and excuses, ranging from inefficiency, distributional inequalities to lack of Islamicity. However, most of the literature on BBA and MM contains theoretical arguments on the subject. Few have done survey on the issues at hand, especially regarding MM. This study, to

the best of my knowledge, is among the pioneering ones in the area. This paper attempts to investigate whether Musharakah Mutanaqisah can provide a better option over BBA.

1.2 OBJECTIVE OF THE STUDY

To examine the perception of IIUM staff on the relationship between BBA and MM.

The study wants to find out if:

- i) MM is cheaper compared to BBA.
- ii) MM is a Shari'ah Compliant than BBA.
- iii) MM promotes the wellbeing of society better than BBA.
- iv) Customers are more satisfied with MM rather than BBA.
- v) Customers would choose MM rather than BBA if they are given a choice.
- vi) Customers are aware that IIUM is using MM for home financing.
- vii) Customers are satisfied with IIUM asset financing.

1.3 RESEARCH METHODOLOGY

The research methodology of this study is based on primary data. Questionnaires were distributed to IIUM staff seeking their opinion on BBA and Musharakah Mutanaqisah modes of asset financing offered by the IIUM, Bank Islam and Bank Mu'amalat. The literatures surveyed consist of published Journals, books, unpublished articles and internet resources. The study uses descriptive statistics in analyzing data, drawing conclusion and making recommendation.

1.4 SIGNIFICANT OF THE STUDY

- a) The study will help assess the acceptance level whether, Musharakah Mutanaqisah concept can be an alternative to conventional interest and the BBA Home financing product.
- b) It is expected to inform us that Musharakah Mutanaqisah product could promote welfare of the society better as an alternative to Asset financing.
- c) The study will add to the existing stock of knowledge in the area of Islamization of economics.

1.5 THE SCOPE AND THE LIMITATION OF THE STUDY

- a) The research focused on knowing the views of IIUM staff regarding BBA and Musharakah Mutanaqisah. Two samples were surveyed. One sample related to the IIUM staff using Musharakah Mutanaqisah for home-financing offered by the university and the other relates to IIUM staff using BBA contract from bank Mua'malat or Islam home financing.
- b) The study compares advantages and disadvantages of both BBA and Musharakah Mutanaqisah
- c) Musharakah Mutanaqisah is not popular among the financiers as well as the clients in Malaysia and there is not much literature regarding Musharakah Mutanaqisah. This study fills the gap in a small way.
- d) Musharakah Mutanaqisah is only applied to the purchase of house although it can also be used for the purchase of machinery, automobile and other business ventures.

1.6 THE ORGANIZATION OF THE STUDY

This study consists of four chapters including the introduction. Chapter two provides the literature review. Chapter three discusses the methodology of the study and presents the findings. Chapter four contains the analysis, summery and conclusion of the study.

CHAPTER TWO

REVIEW OF THE LITERATURE

2.0 INTRODUCTION

This chapter examines the concepts of BBA and MM contracts and evaluates their advantages and disadvantages. The chapter looks at evolution of Murabahah financing, its nature, pricing, religiosity, social responsibility and its limitation. The chapter also discusses profit-loss sharing instruments as alternatives to asset financing; analyze its benefits and costs. At the end of the chapter, study builds a case that MM is a better alternative to BBA.

2.1 DEFINITION OF MURABAHAH

Murabahah, in its original Islamic connotation, is simply a sale. A 'sale' is defined in *Shari'ah* as an exchange of a thing of value by another thing of value with mutual consent. According to Khujah and Ghaddah (1997), Murabahah, is one of the types of a simple and pure sale. He categorized murabahah in to two forms that is Fiqh Murabahah and Murabahah financing.

2.1.1 Fiqh Murabahah Fiqh

Fiqh Murabahah is a sale where the seller mentioned his costs to the buyer and adds mark-up or profit. The profit is determined by mutual consent, either in lump sum or through an agreed ratio to be charged over the costs (Khuja, and Ghaddah, 1997). The contract involved two parties, the buyer and the seller and the payment may be at spot and may be on a subsequent date agreed upon by both the parties. Fiqh

Murabahah is valid only when the exact cost of a commodity can be ascertained. However, if the actual cost cannot be ascertained, then the contract is called Bay' Musawamah (sale based on bargaining). That is, without reference to the cost or to the ratio of profit or mark-up. The price of commodity in such a case would be determined in lump sum by mutual consent (Khuja and Ghaddah, 1997).

2.1.2 Murabahah Financing

Saiful Rosly defines Murabahah financing as a contract of sale in which the object of sale is sold at price equivalent to the cost price and the profit margin. He stated that, there are two types of murabahah. Cash murabahah that is a cash sale where the seller sells a commodity with a price equal to the cost price plus a profit margin and the purchase is settled in cash, and in other words is a spot sale. The second one is credit murabahah (BBA) that is a credit sale where the seller sells an object with a price equal to cash murabahah price plus premium to reflect time value of money. Rosly (2005, p.88) stated that in Malaysia short term credit sale is called murabahah with payment payable in lump-sum. However, the long term credit sale is called BBA. BBA is a sale with deferred payment. He added that BBA is also known as Bay' Mua'ajjal in Pakistan and Murabahah in the Middle East countries.

2.2 FOUNDATION OF TRADE – BASED ISLAMIC FINANCING

The Islamic law distinguishes between al-Bay' (sale) and riba (interest). Sale is permitted and encouraged while interest is prohibited and condemned. This distinction between the two fundamental to Islamic financial system. The al-Qur'ān regulates these transactions (2:275). The three prominent ancient commentators of the al-Qur'ān that is Ibn al-arabi, al-Qurtubi and al-Jassas, mentioned that the term al-bay'

in this verse covers spot as well as all permissible deferred sales. (See Mustafa Omar, p.15).

Permissible deferred sales are usually of four forms, namely, salam sale (price is paid at the time of the contract but object of the sale, whether goods or services, become due as an in-kind debt); mu'ajjal sale (object of the sale is delivered at the time of the contract but the price becomes as debt); Istisna' sale (price is paid at the time of the contract or deferred for future date and delivered later, object of sale to be manufactured) and the fourth one is *al-Ijāra* (sale of use of rights of assets are delivered to the user, who in turns Pay periodic rentals in advance or on deferred basis). However, during the early seventies another form of credit sale- the deferred form of murabahah (mark-up based financing) was rediscovered from the traditional fiqh that is Islamic legal literature (see Mustafa Omar, p.15.)

Indeed, most of the Islamic banks and financial institutions are using Murabahah as an Islamic mode of financing, and most of their financing operations are based on it. That is why this term has been taken in the economic circles today as a part of banking operations, while the original concept of "Murabahah" is different from this view. Originally, murabahah was thought of as a particular type of sale and not a mode of financing. The ideal mode of financing according to *Shari'ah* is mudarabah or musharakah. However, in the perspective of the current economic set up, there are certain practical difficulties in using mudarabah and musharakah instruments on a large scale. Therefore, the contemporary *Shari'ah* experts have allowed, subject to certain conditions, the use of murabahah or deferred payment as a mode of financing.

2.2.1 Conditions for the permissibility of a mark – up sale

The Supreme Court of Pakistan in its historic judgment delivered on December 23, 1999 - after sixteen years of the observation of mark up sale, gave the following verdict:

- a) The major condition for the permissibility of a mark-up transaction is that, it should not be charged on lending or advancing money. It must be based on the genuine sale of a commodity with all its substantive consequences.
- b) Al-murabahah or al-bay' mu'ajjal is a transaction of sale affected on the basis of deferred payment.
- c) Although mark-up sale is lawful, it is not ideal mode for the extensive use by the Islamic banks; however, the banks will resort to this transaction in certain cases, especially in the initial phase of transformation.
- d) Usmani cited some additional conditions for bay' Murabahah.
- e) The price to be paid must be agreed upon by both parties and fixed at the time of the contract. It may include any amount of profit.
- f) Total possession of the object in question must be given to the buyer while the deferred price is to be treated as debt against him.
- g) Once the price is fixed, it cannot be decreased in case of early payment nor can it be increased in case of default.
- h) In order to secure the payment of price, the seller may ask the buyer to provide a security either in form of mortgage or in form of an item.
- i) If the commodity is sold on installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date; the remaining installments will become due immediately.