Proposing a KIBOR - Free Home Financing Model based on Diminishing Musharakah for Islamic Banks

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Abstract
Most of the Islamic banks operating in Pakistan offer Musharakah based products which are identical with the conventional mortgage products. Islamic banks adopt the model of Diminishing Musharakah (DM) for their home financing in which ownership of the bank decreases and transfers to the user after every successive payment. Islamic banks to calculate their profit uses the prevailing interest rate i.e. KIBOR (Karachi Inter Bank Offering Rate) just like conventional banks. The concept of Musharakah is to share profit and loss actually incurred out of the mutual investment rather than fixing the profits and to impose the fixed guaranteed returns to be paid by one party. This study will diagnose and highlight the problems and issues in the existing practices of Diminishing Musharakah based home financing products through conducting interviews from the bankers and will contribute through proposing an alternative layout of the Diminishing Musharakah that will address the problems of the existing practiced model. The qualitative approach will be followed and the Thematic Analysis will be applied to conclude the interviews.

Keywords: Diminishing Musharakah, KIBOR, Home financing, true spirit of Musharakah, Islamic Banking.

I. Introduction
Islamic banks are supposed to offer their products in compliance with the Shariah standards and parameters. Most of the Islamic banks and their products are based on interpretation made by the different Islamic scholars on the basis of QURAN and SUNNAH. The teachings of QURAN and SUNNAH give the overall guidelines for the Muslims for their financial dealings. The teachings of Islam clearly states that Riba or interest is prohibited, speculation is not allowed, and trading of HARAM goods is not allowed. The Shariah imposes a sort of moral filter on the economic system and its
instruments where permissible and prohibited things are operated distinctly and promotes “Halal” and prohibit “Haram”.

The basic difference between the Islamic banking and the conventional banking is the perception and theory behind the financing scheme. The theory of true Islamic banking does not advocates the typical relationship of borrower and lender between the bank and customer but infect promotes the concept of partnership in which both of the parties’ works for each other for their common interest as partners. This was the overall theme and background of the Islamic banking where returns are based on the actual outcome of the investment instead of typical model where banks remains on the upper hand and ask for fixed determined return irrespective of what outcomes has been derived out of the investment. The concept of partnership has been admired by almost everyone but when it comes to the execution it lefts no difference between the conventional and Islamic products. The Islamic banks are running their products with Islamic tags but does not thoroughly implemented the concepts of partnership.

The meaning of Musharakah is to “share”. According to the Jurisprudence of Islam Musharakah means a joint venture formed for the purpose of business. In Musharakah both the parties share the profits according to the agreed ratio and loss according to the ratio of contribution. Islam cares for the rights of both the parties in every business transactions. When used in home financing, Musharaka is applied as a diminishing partnership. In home financing, the customer forms a partnership with the financial institution for the purchase of a property. The financial institution rents out their part of the property to the client and receives compensation in the form of rent, which should be based on a mutually agreed fair market value. Any amount paid above the rental value increases the share of the customer in the property and reduces the share of the financial institution.

Every Islamic bank follows different model or different theory for the execution of its products. There is no issue with the overall theme of the Islamic banking products but the problem arises when it comes to the execution of some products. Diminishing Musharakah is a partnership based on the principle of profit and loss sharing between the two parties. But when it comes to the practical phase of this product the overall concept and the true spirit is ignored by the Islamic banks. The Islamic banking products have a unique challenge and responsibility to be Shariah compliant. And there is lack of uniform Shariah standards in the different banks so it’s very hard for the Islamic banks to ensure the Shariah compliance.

Still it’s very much sure that the Islamic banking system is at his early stages and it will take a lot of time and efforts to show his full wings and strengthen his roots in current scenario of banking system. The Islamic banks are facing a lot of challenges and obstacles related to the execution of different products.

There are a number of studies pointing out the loopholes and problems in the existing practices of the Musharakah based Islamic banking products. In this study first we will discuss those studies and the criticism enclosed in different researches done by the different researchers of the different regions. Then we will share the results of interviews conducted from the different Islamic banks and their representatives. And finally based on their conclusions and findings will try to solve out the problems and
deficiencies in existing model through proposing the new amendments in the existing practiced model.

II. Literature Review

In literature the Shariah is defined as the religious law of Islam which is binding for the Muslims for their religious life and their social and economical life (Jobst, 2007b and 2007d). The Muslims are not allowed to pay or receive interest and they are not allowed to conduct business with the conventional banking system (Jaffe 2002). The Islamic banking sector is not only supposed to maximize the profits of their shareholders or investors but also to obligate and align their work according to the teachings of Shariah (Archer et al.). This ultimate motive to comply with the Shariah and his teachings is the basic difference between Islamic banking and conventional banking (Sarker, 1999).

In conventional banking system the money is used as a medium of exchange having no intrinsic value and earning interest on such money without bearing any sort of risk does not fit well according the concept of Islamic banking (Rahman 1994, p.14). Islamic teachings and Shariah asks his followers to contribute money on the grounds of profit and loss sharing agreements and need to convert their money assets having some intrinsic value (Usmani, M.T. 1998, p.19).

Keeping in view the loopholes in the conventional banking system the need of the Islamic banking products were on the rise since its introduction and the Islamic banks has offered a number of products in order to fulfill the banking and the financing needs of the Muslim customers. The Musharakah and Mudarabah are two main and famous modes of long term equity based financing. In the current practices of Islamic banks the Musharakah has been used for home financing by the name of Diminishing Musharakah. Islamic banks are offering this product to cater the home financing needs of the customers.

Samad, Gardner and Cook (2005) in a study tried to find out the relative importance of Islamic banks products in theory and practice and come to know that theoretically some of the products are very important and more emphasized like Musharakah and Mudarabah but in practice their overall share is very low. According to them the data available shows that Mudarabah and Musharakah contributes 4 % and 3 % respectively in the overall volume of the banks. In their research they also tried to sort out the different factors for the less interest of the bank in these equity based finance instruments i.e. Musharakah and Mudarabah.

The study done by Febianto & kasri (2007) explains the different reasons behind the low involvement of the banks in the equity based products like Musharakah and Mudarabah. Mudarabah and Musharakah are the main tools of financing theoretically but in reality the banks try to avoid from this sort of financing because of different factors associated with it. Islamic banks prefer less risky and safer short term financing like Ijarah and Murabaha etc. Greunig and Iqbal, (2007) pointed out the different reasons why the banks are reluctant to participate in PLS agreements. According to him banks are very careful in risk taking and avoid riskier financing and that is the reason why Islamic banks avoid PLS financing.

In a detailed interviews from the senior management and executives of different Islamic banks in Pakistan (Lodhi, Rukhsana and Iqbal(2005)) shows that 32% of the
respondents opined that the Islamic banking spirit is missing in the current practices of Islamic banks. Whereas 42% of the respondents complained the lack of proper and formal regulatory framework for the Islamic banks. Hanif & Hijazi (2010) concluded that the existing practice of House finance in Pakistan is against the true spirit of Musharakah. In their study they have pointed out the different issues and problems related to the execution of the Diminishing Musharakah. According to them the lack of determination of appreciation and depreciation mechanism, the linkage of rent on the basis of interest rate (KIBOR) and fixed guaranteed deposits. Chong and Hua Liu (2007), states that Islamic deposits are not interest free and closely related with the conventional products. According to them there is hardly any difference between the conventional product and PLS based products.

Meera & Dzuljastri (2009) reveals that the mathematical model used in the conventional bank and the Islamic banks are same just with the difference of names. The conventional banks call it as interest whereas the Islamic banks name it as rent. Another research Hassan (2012) also gives the same results that Islamic banks use the same formula for the calculation of rent rather than fixing it on the basis of actual rent.

Ahmed (2010) concludes that most of the Islamic banks link their products and their return on the basis of interest rate like LIBOR, KIBOR etc. According to him there is hardly any difference between the conventional mortgage product and the diminishing Musharakah. His research reveals that instead of making the partnership on the basis of profit and loss sharing the banks are more concerned to offer a more close and identical product as compared to the conventional products just with the difference of name. According to him most of times banks calculate their rent (profit) on the basis of interest rate and take the prevailing interest rate as benchmark. So this is against the true spirit of Musharakah.

Ahmed (2014) proposed an alternate model for the diminishing Musharakah in which the bank instead of using the partner’s capital himself buys the house with full payment and then goes in a contract with the customer and if the customer is not willing to buy then ultimately the bank is owner and he can further rent it to other customer. Chaudhary (2006) concluded that while offering Diminishing Musharakah banks follows the Shariah standards very casually based on their own interpretation of the Shariah. Some researchers like Ismail (2011) concluded that Islamic banks miss the true spirit of Islamic banking in their products.

The enormous growth in Islamic banking sector implies certain obligation and responsibilities in terms of transparency, trust and commitment towards service betterment. The customer’s reports that Islamic banks are short of their customers’ expectations and this is the reason why they are asked to adopt a new framework to show their intent in the social responsibility (Farook, 2008)

A. Problem Statement

“Calculating rent on the basis of interest rate and fixed guaranteed returns along with using KIBOR as their benchmark rate raises many questions about the Shariah Compliance and credibility of Diminishing Musharakah based home financing products”
B. Objectives
The major objectives of this study are:

- To understand the existing diminishing Musharakah based products offered by Islamic banks.
- To diagnose and examine the issues and problems in the execution of diminishing Musharakah based products in Pakistan
- To propose an alternative KIBOR-Free Model based on diminishing Musharaka.

III. Methodology/Design
This is a type of exploratory research that explores and discusses the problems in the existing practices of diminishing Musharakah based Islamic banking products. The data that has been required for the study was collected through self-administered semi-structured interviews comprising of open ended questions especially designed in order to achieve the overall objectives of the study. There were almost 18 Questions in the initial interviews and 15 questions are further formulated for further interviews. This refinement in questions always adds to the quality of data and early interviews questions influences the subsequent interview questions, Bogdan and Biklen (1998).

The population of this study consists of the all the Islamic banks operating in the Pakistan. There are almost six full-fledge Islamic banks operating in Pakistan and almost 12-13 conventional banks offering the Islamic banking services.

Quota sampling technique has been used in which we will interview two different branches of each Islamic bank. Further, at initial stage single branch of every bank will be interviewed being a customer in order to get the basic know how of their respective products, features, literature and procedures. The rest of the interviews from the Islamic banks are being conducted as being researchers through asking open ended questions and cross questioning about the different aspects of the products. The convenience sampling technique has been used in selecting the branch of the Islamic bank as the banking operations and products are mostly uniform in all of their branches and virtually it’s impossible to visit every single branch of every Islamic bank.

Three cities are selected for the interviews because currently majority of the Islamic banks are offering home financing in only these cities i.e. Karachi, Lahore, Islamabad/Rawalpindi. Islamic banks do have some plans to extend home financing in other big cities but currently this financing is available in three cities.

In this study Qualitative approach has been followed for the analysis of the data obtained from the interviews of the representatives of the Islamic banks. The Thematic Analysis has been done on the data for the analysis to extract the results and findings from the data. This study is qualitative in nature and open-ended questions are asked in a semi-structured way to explore and gain the inner insight of the Islamic banking products. So there are no issues with the content validity and face validity of the instrument because these tests are more close to the quantitative studies and having less concern with the qualitative studies.
IV. Results and Analysis

In this research we interviewed the representatives and employees of all the banks who deal in Islamic banking products. Initially, in the first interviews, the respondents are asked about the basics of the products. The respondents are asked about how to get the home finance, on which principal does it base and how it will be executed. Initially the respondents are asked about the detailed practical model of the diminishing Musharakah, to know how this product is being executed by the banks. The important findings of the initial interviews are

- All of the Islamic banks follow the method of diminishing Musharakah for their home finance
- According to the employees the home Musharakah model is Shariah compliant fulfilling all the basic parameters of Shariah.
- All of the Islamic banks use the KIBOR for the calculation of the rent of the property
- All of the banks ensure fixed guaranteed monthly deposit to payback.
- Three of the Islamic banks currently do not offer home financing

The Figure 1 projects these results in the graphical form along with their respective percentage.

**Figure 1**

Based on the initial interviews the subsequent interview questions are revised to get the insight of the problems and issues in the execution of the product and to get the response and suggestions from the respondents how to improve the deficiencies and shortcomings in the existing model.

A. Analysis of the Data and Diagnosed Problems in current practices

Instead of going into the market and setting the rent on the basis of market prices, banks eventually calculate the rent or their profit rates on the basis of prevailing interest rate i.e. KIBOR (Karachi interbank offering rate). According to the response of the interviews about 95% o the banks uses KIBOR rate for the calculation of Rent or uses
bank readymade calculator which is also based on KIBOR. Setting rent on the basis of interest rate and using KIBOR as their benchmark rate raises many questions about the Shariah Compliance and credibility of this product.

The Existing model ignores the Proper Mechanism of Revaluation (Rent & Property). About 85% of the banks calculate annual rent based on KIBOR and the revaluation will be subjected to the state bank revision of prevailing interest rates. This is against the very spirit of Diminishing Musharakah. Ideally the revaluation of Rent should be based on the actual market changes rather than on any artificial value.

Most of the Islamic banks and their representatives try to differentiate the DM based Islamic banking products through its Shariah compliance; they used to call it as an Islamic product fulfilling the Shariah parameters whereas the rest of the conventional products are non-Islamic. About 70% of the respondents tried to differentiate it in terms of its religious affiliation. Inflect the difference lies in the practical approach and execution of the products as conventional products are interest based and the Islamic products are based on the true returns and profits out of the investment. But most of the Islamic banks are too far away from the basic idea of partnership and involves in using the interest rates (KIBOR) for the determination of Profit. According to the 75% of the interviewers the chief motivating factor for the DM is its religious motivation whereas few of them tried to differentiate it in terms of its execution, its flexibility in terms of penalties and other rationale grounds.

Islamic Banks Determine rental value in advance by linking it with KIBOR (Karachi Inter Banks Offered Rate). In Pakistan inflation is getting higher and higher and rental value of the underlying property is increasing every year. Setting rent in advance is not justified as it is not a typical conventional product. It is an agreement of profit and loss sharing (PLS) that means to share the rewards and risks actually associated with the property. The rent should be based on the actual market prices.

Another important aspect of the practiced model is the revaluation mechanism. The revaluation of the rent should be based on the market mechanism. The rent should be revalued as per the change in the market price of the area where the property is located or even they can agree to increase it through some specific percentage but Islamic banks use to fix the rent throughout his tenure and subject it to the change in the revised interest rates of the state bank of Pakistan.

In the existing practiced model of home finance the Islamic banks fix the prices of equity units that the customers have to purchase. This is a kind of guarantee that ensures the fixed returns for the Islamic banks just like conventional banks do. To ask for the client to pay the fix amount over and over again irrespective of the increase/decrease in the value of the jointly owned property throughout the transaction contradicts the very nature of Diminishing Musharakah.

B. Proposed Model

Based on the findings of the interviews from the respondents, the representatives of Islamic banks and their employees, it has been concluded that Diminishing Musharakah based Islamic home financing products miss the true spirit of Islamic banking and it has many flaws from its Shariah compliance to its practical execution. The
existing practices of the home finance products are closer to the conventional products rather than being to the Shariah.

In our extended model we have tried to remove and address the issues and problems that gave the Diminishing Musharakah a conventional look. The problems and the issues are diagnosed through the findings of the interviews made from the bankers as discussed earlier. We had proposed the further amendments in order to sort out the existing problems. Now we will discuss them in details. Our proposed model has been shown in Figure 2.

The basic framework is same and we will remain in the same framework with further additions and amendments. The initial phase of the model is same where the customer approaches to bank and ask for the financing. On fulfilling the basic criteria and fulfilling the pre requisites, the bank agrees to finance for the home finance. Then the matter of tenure will come into the consideration and both of the parties will settle for the tenure of the financing e.g. 20 years, 10 years. Here the relationship of bank and partner will be developed between the two parties. The bank is financer and the customer is user.

Figure 2
The proposed model has been divided into four phases and we will discuss the whole model by discussing every phase separately.

**Phase 1**

In Phase 1 as shown in Figure 3 after addressing the initial settlements the bank and the customer agree to acquire a property. Up till now it’s same from the existing model. Here we will suggest the introduction of field expert or third party consultation or some specialist for the real sector to deal with the issues of property acquisition and the other market related mechanism. The introduction of a third party or intermediation or expert will set a positive impact on the overall flow and Shariah compliance of the product. This expert of the concerned field will analyze the market value of the property to be purchased both for the bank and for the customer. This expert with his expertise also fulfills the other legal and technical issues involved in the purchase of property. The introduction of expert will also opens a new window for the banks to offer and extend this product of home financing to other sort of financing. As by hiring experts of different fields the bank will be in a position to finance the different sectors of the society with expertise and less headache and responsibilities.

**Figure 3**

![Diagram of the proposed model](image)

The most important problem in the existing practice is the headache and responsibilities of the bankers that automatically rises if they go into the market for the evaluation of the property and the periodic evaluation of the rent. This could make the bankers uncomfortable and the reason why the banks prefer to remain in the bank and calculate profit on the basis of. The expert or mediator can give the bank more choices in terms of selection and on the basis of the opinion of the expert bank can easily decide in which areas the bank will finance and in which areas bank will not. Here someone can ask how the third party or expert will be rewarded in this whole transaction and answer is very simple. Just like in ordinary day to day transactions we hire brokers or professional mediators for the sale and purchase of the property and they charge a commission on it. So same is the case here and the expert will be rewarded through the commission on the purchase of the property just like we normally do.
Phase 2

In Phase 2 the determination of equity units will be decided. After hiring the services of a property expert, the bank and the customer will feel it very easy to execute for the initial phase of the transaction i.e. acquisition of asset. After the initial purchase of the asset the bank and the customer will be very much cleared about their share, the share of the owner or customer and the share of the bank. Depending on their respective shares in the overall property both of the parties will settle for their respective ownership. Suppose the bank financed 80% of the financing it means the bank will be entitled to the 80% of the ownership. It’s been same like existing model and both of the parties will settle for the principal amount to be distributed on the overall tenure of the transaction. In this way the bank will distribute its finance amount or his share of ownership in terms of small units to make it easy for the customer for further purchase. This Phase has been shown in Figure 4.

Figure 4

After the determination of ownership units, In Phase 3 the rent of the property will be determined. This phase has been demonstrated in Figure 6. Here again the role of field expert or real estate agent will come into play. In existing model the bankers determine rent on the basis of their investment and adding the interest rate in it through the readymade calculators provided by the banks. But we suggest instead of setting the rent on the basis of KIBOR the rent should be determined according to the market value of the property and prevailing rent in the surroundings. It will be the expert or third party who will helps the bank or customer in determining the rent of the property. So in this way we can easily eliminate the role and usage of KIBOR rate in this whole transaction. This has been a very major objection made by the critics of Islamic banking in the execution of the Diminishing Musharakah based Islamic banking products. By setting the rent on the basis of market value of the property with the help of expert will help the banks to make it different from the conventional products and to make it more appealing for the Muslim customers. These steps will make this transaction a true picture of profit and loss sharing agreement and without the involvement of any interest rate or benchmark.

Phase 3

After setting the rent on the basis of market value of the property with the help of field expert or third party the next phase will be the revaluation of the rent. Normally in existing practices bank subject it to the revision or changing of interest rates from the state bank or from the bank itself. But in our case again the rent will be revalued according to the value of the market and according to the fluctuations of the market. This
could be even more appealing and easy for the customers as well as for the banks. The change in rent or revaluation of rent differs in area to areas and location to location. Eventually it will give bank more benefit as in some areas rent increases on the basis of 10 % annually and in some areas this ratio is 15 % or 20 % annually. So by determining the rent on the basis of KIBOR can result in relatively less profits for the bank whereas the determination of rent on the basis of market value of the property can result in relatively more profit for the bank. This whole process has been shown in Figure 5.

**Figure 5**

Even if in some areas the rent increases with lower ratio or does not increases this will be mutually good for the customer and the bank as the PLS agreement makes the two partners equally responsible for the loss incurred in any transaction and the loss is a part of business. This will although increases the risk for the bank but ultimately this will multiplies the confidence of the customers and users on the credibility of Islamic banks. In order to minimize the risk the bank can further divide the rent revaluation in two parts.

**Fixed Method**

In fixed method the bank and the customer with the help of the field expert or third party can agree for the pre-decided annual increment of the rent. At the time of acquisition of asset both of the parties can settle the annual increment in rent based on the market mechanism of the area. This could further ease the process for both the customers and for the banks. For example if the bank and customer jointly purchased the property of 5 million with the respective ratio of 80 % and 20 %. Depending on the market value both of the parties agree for the rent i.e.20000 per month. So at the start of the agreement, both of the parties can agree on percentage annual increment in the rent. In this way after one year the rent of the property will be adjusted accordingly and the bank will be in a position to compensate the inflation in the overall economy. It will cost relatively higher for the customer but not at the cost of Shariah compatibility. This will make this diminishing Musharakah based home financing a true Islamic product and in lines with the teachings and principals of Shariah without the involvement of any interest benchmark.
**Fluctuating Method**

In fluctuating method both of the parties can agree to annual revision in the rent on the basis of market fluctuations. If after one year the inflation rises rapidly and the market shows the 15% increment in the rent then the customer will have to pay the rent with 15% addition. And if the market and the area does not increase the rent due to any crisis then depending on the market norms the rent will remain the same. In this way the bank and customer can make this product Islamic and can demonstrate the true picture of profit and loss sharing arrangement between the two.

**Phase 4**

Finally in Phase 4, the repayment of the principal will be discussed as shown in Figure 6. The existing model propose that the principal amount will be divided into the total tenure and will be distributed in small units and impose the customer to purchase a unit after one month along with the rent. So we suggest it to remain on the discretion of the customer whether to purchase or not. If he is willing to buy 3 or 4 units in a month he is allowed to do so and if he decides not to purchase any unit in any month even then he should allowed doing so. To make this transaction and framework of Musharakah to be pure Islamic we have to convert it into the profit and loss sharing venture. The bank will have to change his strategy and mindset by changing the perception of the customer. The bank will have to perceive his customers to be his partner rather than assuming him to be his customer or typical buyer lender relationship.

**Figure 6**

The freedom of purchasing a small unit at any time or annually or bi-annually will relax the user or customer and ultimately it will results in the satisfaction of the customer as well as it will make this product to be a true demonstration of profit and loss sharing agreement. This arrangement will make it different from the conventional products and
will address the other issues in the execution of this Islamic banking product. The critics’ raises questions about fixing the principal amount on monthly basis that make this product close to the conventional product. So by letting the customer free to buy the principal amount in terms of unit it will be beneficial for both of the parties. Some people may raise the questions about the recovery of the principal. If the customer do not buys the small units monthly or annually ultimately he will have to suffer in terms of increased rent that the bank is entitled to receive according to his share in the property. As in DM the rent or profit of the bank decreased after every successive purchase of equity units on the behalf of the customers, but if the customer will not purchase them periodically this will increase the profit of the bank. Even if the customer does not purchase all the equity units and the agreement matures, the bank will be in a position to claim up to his share in the property. In this way the bank will also be in a position to enjoy the appreciation in the price of the property. In every case bank have to ensure the safe recovery of his payments and in this case bank is relatively more safe in terms of recovery and safety as the bank is in partnership or joint ownership in the property and if the user o customer will not pay back principal on regular basis then the bank will be having a major share in the ownership and he will also be entitled to receive the rent up to his share.

References


