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RISK MANAGEMENT IN HOUSE FINANCING IN ISLAMIC FINANCIAL INSTITUTIONS

(COMPARISON WITH CONVENTIONAL HOUSE FINANCING)

A thesis submitted in partial fulfillment of the requirements of the degree of

LL.M Islamic Commercial Law

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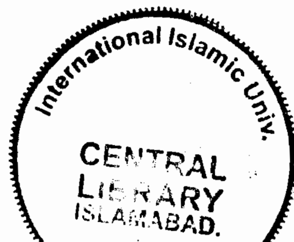

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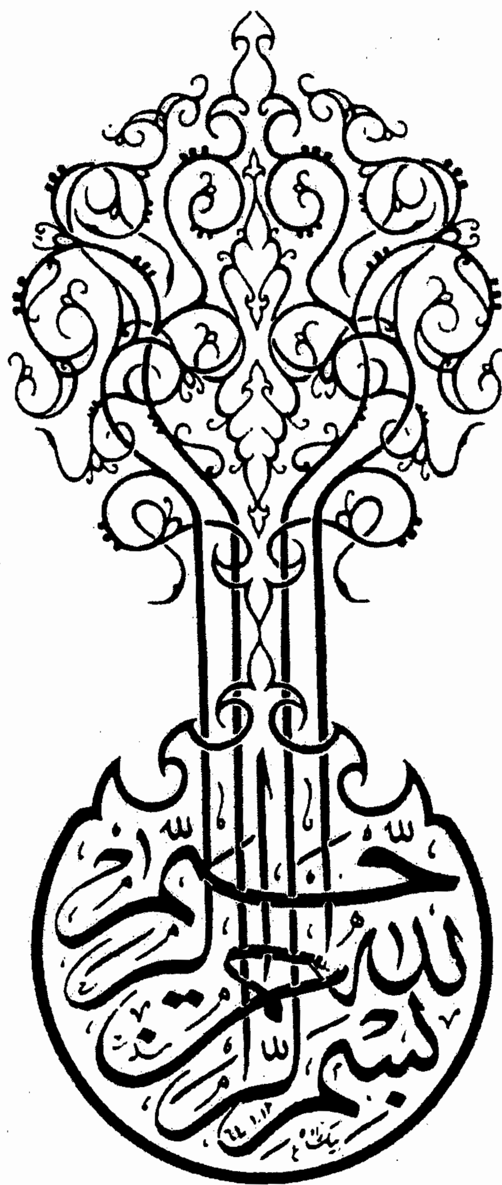

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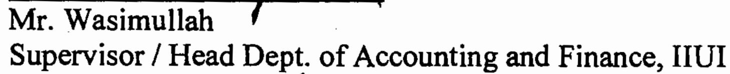

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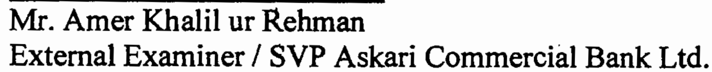

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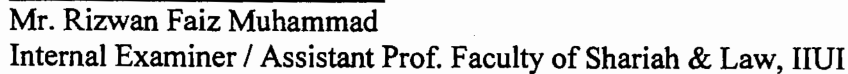

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DEDICATION

To the soul of my beloved father Soetaman, your memory has always been inspiring me.

May Allah grant you Mercy…

To my beloved mother Hj. Mas'udah, your prayers have always kept me growing.

May Allah reward your sincere deed and patience…

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I am responsible for any errors and mistakes that remain.

Isyrokh Fuaidi Soetaman

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ABSTRACT

The house financing products are important part of Islamic finance. The purpose of this research is to examine the performance of existing house financing model which is commonly practiced in Islamic and conventional financial institutions. It also presents risk management measures used by most of the financial institutions, either Islamic or conventional system while offering housing finance to their clients. This study does not cover all aspects of Islamic financing system rather it gives basic information about the theory and actual practices concerning housing system.

The paper will disclose and evaluate the current practices of different types of products offered by Islamic financial institutions (IFIs) concerning housing finance. These include diminishing ***musharakah*** (Islamic partnership), ***murabahah*** (cost-plus sale), ***ijaraha muntahiya bi-al-tamleek*** (lease ending with ownership), ***bay al-mu'ajjal*** (deferred sale) and ***istisna'*** (manufacturing). There are also some relevant issues in each products which need to be addressed accordingly to have financing process practicable and applicable in the field.

With regard to conventional house financing model, the paper investigates the prevailing practices used by conventional housing system in most of the practicing countries specially European and American countries. The study includes the term and conditions of contract, determination of interest, loan-to-value (LTV) ratio, mode of payment and other relevant matters such as collateral and penalty. A subprime mortgage issue is also noted in this paper as an example out of conventional house financing practices that has been used in western countries.

At last, the risk management measures taken by both Islamic and conventional system are discussed accordingly which includes the risks that associates with both formulas –Islamic and conventional- but there are also certain risks inherent in the Islamic financing model only such as *Shari'ah* risks, legal risks and operational risks which, to many extents, make it different from the conventional system. The study concludes that both systems differ in the model of financing particularly with regard to the treatment of interest, principle, certainty and fairness of the contract.

Abbreviations

AAOIFI	: Accounting and Auditing Organization for Islamic Financial Institutions
ARMs	: Adjustable-Rate Mortgages
AUBUK	: Ahli United Bank United Kingdom
BBA	: Buy Back Agreement
BCBS	: Basel Committee for Banking Supervision
CIB	: Credit Information Bureau
CRR	: Cash Reserve Ratio
IFIs	: Islamic financial institutions
IIMM	: Islamic Interbank Money Market
IRTI	: Islamic Research and Training Institute
IDB	: Islamic Development Bank
LIBOR	: London Interbank Offered Rate
MCB	: Muslim Commercial Bank
PMI	: private mortgage insurance
SLR	: Statutory Liquidity Requirement
SSB	: Shari'ah Supervisory Board

Chapter I

INTRODUCTION:

House is a basic need for human life which, by nature, can provide pleasant sleep, rest and shelter instead of protecting the occupants from the heat of sun and the swift rain. So, naturally, every human being is inclined to own house as it is a place to dwell in comfort and sharing happiness. Most of the familial matters, daily activities and emotional senses are often shared and dealt with in such a comfortable place such as a house. The Quran says: *"And Allah hath given you in your houses an abode, and hath given you (also), of the hides of cattle, houses which ye find light (to carry) on the day of migration and on the day of pitching camp; and of their wool and their fur and their hair, caparison and comfort for a while."* (an-Nahl: 80).

And the Prophet Muhammad (pbuh.) also pays attention to this regard by saying: *"The happiness of son of Adam is determined by three things: a pious wife, a good home and a good vehicle, and the misery of son of Adam is determined by three things: an impious wife, a bad home and bad vehicle"* (Musnad Ahmad: 1368)

As owning a house to make shelter in and having pleasant livelihood is an instinct of every individual, people try to realize this want by different means: they may construct a house on their own, buy or rent it from others or raise finance from financial institutions. Fortunately, the project of housing sector is much profitable as the demand will remain high due to the constant population growth and rural-urban migration in many countries specifically in developing countries[1]. For many Muslims who consider that conventional

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[1] In Pakistan itself with the population of 170.6 million the total housing backlog is estimated at 7.57 million units in 2009 (see, *Expanding Housing Finance to the Underserved in South Asia* at http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1269620455636/6907265-1284569649355/Chapter2SARHousingFinanceOctober2010.pdf , taken on 12 October 2010), according to economic survey 2004-2005, for the next twenty years, the housing production requires more 820,000 units annually (Hanif and Hijazi, 2010). In Indonesia, it is estimated that the country is experiencing a backlog of 8-9 million housing units in 2010 (see, http://www.tempo.co.id/hg/nasional/2010/06/21/brk,20100621-257187,uk.html, taken on August 23, 2010). In wider perspective, there are more than a billion people worldwide and 14% (around 212.5 million people) of South Asians live in inadequate housing. (see, Robert Bestani and Johanna Klein, Housing Finance in Asia, available at http://www.adb.org/PrivateSector/Finance/Housing-Asia.pdf or see, *Expanding Housing Finance to the*

home mortgage is deemed as *riba*-based financing which is illicit in Islam, they opt Islamic home financing to be the best alternative for being *Shari'ah*-compliant model. Currently, the prevailing model of house financing is through *murabahah* and the diminishing *musharakah* contracts. In addition, another mode of Islamic home financing may be in the form of *istisna'* and *ijarah*.[2] These different means of finance are to serve firstly the need of Muslim communities whose desire is not to indulge in *riba*-based activities and secondly to provide an ideal alternative to the global market that Islamic *Shari'ah* has an established financing model to meet the need of the people regarding the ownership of a house.

Furthermore, instead of being essential part of human life, housing plays a significant role in the economy. The recent subprime mortgage crisis –started in 2007- shows how it caused great disruption on human society and economy. That is a financial shock that spread quickly and inflicted extensive damage on markets and financial institutions. The trillions of dollars have been lost, some large investment banks and many mortgage companies went bankrupt, shut down or were sold and leaves hundreds of thousands of people jobless.[3] This reality attracts many analysts and economists to say that the present conventional house financing model needs to be replaced with new design of financing system which promotes the financial stability and minimum risk in its operation viz. Islamic house financing system.

Statement of the Problem

To fulfill the increasing demand of people in owning house, Islamic and conventional financing institutions are continuously competing each other in this global market world. The viability, practicability, easiness, certainty would be the attracting factors in the mind of the

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Underserved in South Asia - South Asia Regional Housing Finance Conference, January 27-29 2010, New Delhi, India, can be seen at http://apuhf.info/Presentation_more/Expanding%20Housing%20Finance%20to%20the%20Underserved%20in%20South.ppt, taken on 12 October 2010)

[2] The whole details of the practices can be seen at "Islamic Banking Modes For Building Financing", The Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB), Jeddah Saudi Arabia, edited by Mahmoud Ahmad Mahdi, First Edition 1426 (1995).

[3] In 2007, around 100 mortgage companies were either closed or sold. As of August 2008, most of financial firms worldwide have written down their holdings of subprime related securities by US$501 billion and it is estimated at around $750 billion had been lost as of November 2008. (see the impact of the crisis in more detail at http://en.wikipedia.org/wiki/Subprime_mortgage_crisis#Impact_in_the_U.S.)

desiring consumers. However, the prevailing housing financing market is still at the grip of conventional-based system through its conventional mortgage but Islamic housing is currently gaining it shining prospect due to the subprime mortgage crisis 2007. This phenomenon is a challenge of the Islamic financial institutions as to provide and prove more sustainable, easier and stronger formula that will benefit the interest of the people as a whole specifically the Muslims. Further task of Islamic finance is to always develop acceptable *Shari'ah* compliant products which will satisfy the mind of the Muslims instead of providing a new alternative for non-Muslims community as well. Therefore, the concept of Islamic and conventional housing along with its risk management become an important issue as to identify and determine the ideal model of home ownership financing that can be implemented accordingly in recent industries. The following questions will be clarified to guide the collection and analysis of the study of the research:

1. What are the models available in house financing system?
2. What is the application of housing finance in Islamic and conventional institutions?
3. Does the mode of Islamic house financing differ from the conventional model?
4. What are the associated risks in house financing?
5. Are there specific risks that associate only Islamic housing finance?
6. How these risks are managed accordingly in each Islamic and conventional financial institutions?

Objectives of the Study

The objective of this research work is to examine the application of house financing products available in comparative Islamic and conventional financial institutions and how risk management measures are accordingly taken by both systems. That is to explore theoretical and practical application on how the financial institutions mitigate the possible risks when they afford housing finance to their clients. It is desired that it will contribute the expansion of literatures and knowledge regarding Islamic finance products and can benefit the interested readers and teachers in this field.

Previous Studies:

Books relating to general house financing can be easily found in several publications. But, literatures with regard to specific Islamic house financing are rarely found except written in journal and papers in seminar programs. It seems to be similar that there are several books on regular risk management but it is rare too to find that of Islamic risk management in house financing. However, we highlight here some publications that relate to the topic either in the form book, a collection of papers of seminar or a kind of already research work.

1. "An Introduction to Islamic Finance" written by the renown muslim scholar, Muhammad Taqi Usmani, which speaks about the concept of various Islamic mode of financing such Diminishing *Musharakah, Murabahah, Ijarah, Istisna'*, etc and its appraisal with Shari'ah principles.
2. "Financing in Islam – an Operational Approach" by Mohammad Hafeez Arshad Malik which discusses all forms of financing techniques suitable for Islamic financial institutions.
3. Book of "Islamic Law of Contracts and Business Transactions" by Dr. Tahir Mansoori is also relevant to discuss some related points with regard to identifying the valid and void contract in the eye of Islamic law.
4. A thesis on "Demand and Supply Conditions of Islamic Housing Finance in the United Kingdom: Perceptions of Muslim Clients" by Mohammed Elkhatim Mamoun

Tameme focuses on the development of Islamic housing finance in the United Kingdom.

5. "Islamic Banking Modes For House Building Financing", that is collection of papers in seminar in result of Workshop organized in Khartoum (Sudan) during 18-21 Rabi' Thani 1412H by The Islamic Research and Training Institute (IRTI). Such paper had broadly discussed specifically about house building financing in Islamic perspectives and its theoretical issues.
6. Then most of the classical sources of Islamic books have spoken about Islamic financial transaction in such theoretical and contractual manner, so it will help to identify the validity of any particular business and transaction.
7. A book written in Indonesian language "Jangan Ada Bunga di Antara Kita: Serba-Serbi Kredit Syariah" (Never be any Interest Among Us: Sundries in Shari'ah Credits), Jakarta: Elex Media Komputindo, 2005 by Ahmad Gozali which discuss some Islamic house financing practices in Indonesia.
8. In conventional house financing, there are several books written on it some of which are mentioned here such as: "Home Buying for Dummies" by Eric Tyson and Ray Brown. Then "The Complete Idiot's Guide to Buying and Selling a Home" by Shelley O'Hara, and Maris Bluestein. Further, there is "The Rise and Fall of the U.S. Mortgage and Credit Markets" by James R. Barth et.al which elaborate the matters pertaining to subprime mortgage in USA. "Housing Finance Policy in Emerging Markets" is also useful book with regard to the development of conventional housing financing worldwide.
9. Regarding the risk management, there are also several books have been written such as "Risk Management: An Analysis of Issues In Islamic Financial Industry" by Tariqullah Khan and Habib Ahmed which speaks about risk management in Islamic financial institutions.
10. "Risk Analysis for Islamic Banks" by Hennie van Greuning, Zamir Iqbal. So, the issue regarding house financing had almost already been discussed in above mentioned books and papers, but the discussion that focuses specifically on risk management of

house financing in respect of Islamic and conventional point of view still requires further investigation.

Methodology of the Research:

The research basically follows qualitative method in which primary data and information are gathered from library materials as well as soft (computerized) materials to investigate the research topic in question. Different research papers, journals and articles are also used to find all available related secondary information pertaining to Islamic and conventional housing practices. Modern or contemporary books will be used as reference for obtaining necessary information.

The research also follows descriptive and explanatory as it attempts to investigate the prevailing trend, products, practical application, rising issues pertaining to Islamic housing finance. Besides, methodology of some Islamic rulings will be inserted to derive any necessary rule which justify the legal status of the contract. English language is preferably used in the research but whenever it is necessary to include the Arabic term it will be included. Secondary sources will be exercised to support the primary sources and used whenever it is deemed good.

However, this research has certain limitations regarding the following matters:

1. The ability to cover all different modes and detailed structures of finance: house financing is practiced differently in different financial institutions worldwide though the general principles is applied and commonly used but some particulars matters, due to different local and geographical environment, they differ from one institution to another and from one country to another country. This is like the tenure of financing, minimum and maximum age of client, minimum share by the client etc.
2. The data collection method was also limited to library materials which sometimes could not describe in detail with regard to house financing formula and therefore needs supporting materials such as research papers, journals and to some extents online materials.

3. This study is pertaining to Islamic and conventional housing system in general perspective which does not confine to only some specific financial institutions as the sole and ideal example but if there are practical examples taken from some financial institutions it gives just an example which does not represent all remaining financial institutions.
4. This paper discusses the practices of both systems; Islamic and conventional house financing along with its risk management but does not speak about the subprime mortgage crisis as in the view of mine it does not serve the purpose of the research. Subprime mortgage is discussed to the extent that how the conventional house financing rules and application in field.
5. The research work also does not provide the actual example of house financing application forms (written contract) that being used by financial institutions, though it may benefit the readers to understand in clearer and more detailed manner. Because this does not serve much benefit as the general principles and rules have been discussed accordingly and moreover usually the form of housing finance used by most of financial institutions contain several pages that give not much advantageous values.

Structure of the Thesis

The research work consists of five chapters including the introduction and ended with a conclusion and recommendation.

Chapter One: Introduction - It gives an overview of the research which highlights the significance of housing finance specially in Islamic-motivated perspective. The introduction also includes the research methodology used in this work.

Chapter Two: Introductory Study - It provides an overview with regard to the understanding of house financing, characteristics of Islamic financing and also general definition of risk management.

Chapter Three: House Financing Practices: Islamic and Conventional - It speaks about different modes of Islamic housing model prevailing in the Islamic financial institutions which includes *murabahah, musharakah, istisna', bay al-mu'ajjal* and *ijarah.* The chapter also discusses the model of conventional housing system currently available in market which includes the case of subprime mortgage financing.

Chapter Four: Risk Management for House Financing – This chapter focuses firstly on investigating risks associated with the house financing process and then how these risks are accordingly managed and mitigated in each models of Islamic and conventional system.

Chapter Five: Comparison Between Islamic and Conventional House Financing – This is the last chapter of the research which provides comparison between two models of housing finance. The comparison is focused on the objective, product specifications, operational process and the associated risks that require proper management by the financial institutions.

At last, it is concluded by a conclusion which presents the summary of the findings of the research and followed by some recommendations which are necessarily required.

Chapter II

INTRODUCTION TO THE STUDY

2.1 House Financing Defined

"House" can be defined as a building for people to live in usually for one family.[4] "Home" is another similar word which reveals the same meaning and many have used it interchangeably without any distinction.[5] Both can be categorized similar as they serve the meaning of residential property or real estate whose usage is for shelter, dwelling, domicile or residence. However, there are various meanings with regard to the term house, for example: in parliament it denotes a group of people who meet to discuss and make the laws of a country, such as House of Commons or House of Lords in Britain. House may also be used purporting situation in theatre, groups of student in a school, or also referring to a company or institution.[6] In this research, it is employed to signify the first meaning.

Afterwards, the word "Financing" has no single concerted definition among the scholars and practitioners. It is rooted from the word "finance" which denotes providing money for a project.[7] Another meaning refers to the supply of money capital or credit, provided by the person (household), or an organization.[8] It is also the decision of which resources or funds are to be brought into the business from external investors and creditors in order to be invested in profitable projects.[9] In broad sense, finance is the science of funds management and in Arabic literature it is transliterated into التمويل which bears the close meaning to above previous definitions, that is to provide a capital or material requirements for some projects or financial operations.[10] In the technical and legal definition used in financial institutions, finance covers various aspects in field of economics as it refers to the science of

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[4] *House,* Oxford – Advanced Learner's Dictionary, Oxford University Press 2000, 6th Edition.
[5] See, *House,* Webster's Dictionary of English Usage, Merriam-Webster inc., Springfield, Massachusetts and see further definition of "home" at Oxford p. 621.
[6] *House,* Oxford.
[7] *Finance,* ibid.
[8] *Islamic Financial Instruments for Public Sector Resource Mobilization,* Seminar Proceedings No. 39 of Islamic Development Bank, Jeddah: Islamic Research and Training Institute, 2000, p. 65.
[9] *Financing,* Encyclopedia of Business and Finance, Farmington Hills: Gale Group, Volume 1.
[10] *Financing, Mu'jam al-Mustalahat al-Iqtisadiyah wal-Islamiah,* Al-Jumah, Ali bin Muhammad, Riyadh: Maktabah al-Abikan, 2000, 1st Ed.

managing money, the theory and practices of monetary credit, banking and its operation, investment, speculation, foreign exchange, etc.[11] Monzer Kahf[12] defines that generally Islamic Financing is the provision of factors of production, means of payment and even goods and services without requiring an immediate counterpart to be paid by the receiver. A Bank is considered to have financed its customers when it provides money for them to use for their necessity of purchasing goods or conducting any commercial activity.[13] So he likely emphasizes the presence of time deferment or space limit for conducting finance. From such various definitions, it can be summarized that finance is the "process of raising funds or capital to meet any financial need of a person (client or client) or to carry out any business operation within a stipulated time". Finance can be conducted by or to individuals or business organizations. Illustratively, the people come to a Bank to deposit their money for particular purposes such as to place in saving account, current account, etc. The Bank then lends the money out to corporations or other individuals for consumption or investment purpose as the case may be. The Bank, in exchange for its financial assistance, charges interest on the loans it provided as it is practiced by conventional institutions. In Islamic financial institutions, the return is not derived in the form of interest but on the basis of recognized Islamic contractual arrangement such as in profit and loss sharing (*musharakah*/joint venture) or on cost plus sale (*murabahah*) or on leasing (*ijarah*).

As the scope of finance is very broad in its theory and applications, the discussion will confine in the matters relating to the knowledge of financing activities which is commonly known to and practiced in the financial institutions. That is how the financial institutions deals with their customers in order to provide financial assistance and enable them of attaining their material wants or running some business projects though they have limited capital. So, if a person wants to own a house or if he wants to carry out a business but with less capital in his

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[11] Charles J. Woelfel, *The Dictionary of Banking*, Chicago: Probus Publishing Company, p. 104
[12] He was born in Damascus on 1940, and he is a professor of Islamic economics and finance attaining his Ph.D. in economics from University of Utah in 1975.
[13] Hassan, M. Kabir and Lewis, Mervyn K., (ed.) *Handbook of Islamic Banking,* Cheltenham: Edward Elgar Publishing Limited 2007, p. 277

pocket, he may approach any financing body (Bank) to provide him financial assistance or loans. This situation is commonly known by the term financing through financial institutions.

From the said description, it comes to know that house financing is such method or activity through which any financial institution provides finance or capital to its customer(s) for a specific period, either in the form of loan or mortgage with interest or any other kind of possible way of financing so that it enables them owing a residential property for living in. Both benefit each other from making contractual relationship between the two as the former gets return for granting funds to the customer in need and the later, though being deficit and less capital, gets benefit for being financed by the institutions.

The need for financing is based on different important reasons as follow:[14]

1. Different resources.

   It means that in this world people differ in their ability. Some may have financial resources but unluckily find no ways for having profitable trading activity. Conversely, some may have trading skills and unfortunately have no capital to carry on a business. So, it requires both capital and trading skill to be jointly employed to start a profitable project desired. The difference in human and capital resources that necessitates the need for financing among the people in order to meet their mutual goal of earnings.

2. Making growth of wealth.

   By conducting financing activity the user has a motive to derive income from the business he run. Either Islamic and conventional financial institutions are of the same direction in this regard. As financing usually involves in trading activity, definitely the process is always associated with the expectation to generate income and return which grows the wealth of the party involved.

3. Benevolent act.

[14] See, Kahf, Monzer and Khan, Tariqullah, *Principle of Islamic Financing*, Research paper no. 18, Jeddah: Islamic Research and Training Institute-Islamic Development Bank 1992, p. 13-15

Beside above two reasons, there is one more factor base on which the financial institutions involve financing operation. That is benevolent act-based financing which does not require any return or interest granting finance. Thus, the purpose of financing, to some individuals or body, is to financially assist a person who is under pressure and is facing adversity. This financing is commonly known in Islamic law as "*qard al-hasan*".

Element of Financing

With regard to the basic elements required in financing activity, at least there are four elements to form the finance operation, viz.; capital, goal, time, and contract all of which will be summarily described below:

First: Capital

By "capital" it commonly means the initial funds or total monetary resources either owned by the financier or the clients for conducting any financing activity or business. It is the wealth called as financial capital on which the financing activities rely upon and any financial profit can be generated from after utilizing it in any project or business operations. And the capital comes in number of forms: human capital such as the assets in the form of individuals that a company employs in their competitiveness and knowledge, or intellectual capital in the form of knowledge and skill held by a company, or financial capital in the form of money used by entrepreneurs or corporations to carry on some businesses or make some products or conducting any commercial services such as house financing. This is to say that the capital is one of the basic elements at initial stage for an individual or a financial institution to start any commercial activity.

Second: Purpose

The relationship built in a financing activity is motivated by mutual aspiration to derive a financial goal in the form of profit for the contracting parties. The Bank, by offering finance it to its client desires to generate profit from the financing services. For instance, as in

case of conventional institutions, the goal will be the entitlement of profit in the form of fixed interest charged upon loans provided to its clients. For Islamic financial institutions (IFI), the profit is acquired from the operations offered through different modes of Islamic financing; like in profit-and-loss-sharing (Musharakah), the profit will be the return agreed between the partners; and in cost-plus sale (Murabahah), the profit will be the fixed amount added to the cost which is previously mentioned in the contract; and there are some other different modes of financing[15] each of which could not be described in this para. Conversely, the customer also gets benefit by approaching to the bank for raising finance as if he doesn't have enough funds available for fulfilling his business expenses or purchasing some desired property –such as a home, car etc. These mutual benefits are the actual motivation for which the financing is conducted between the parties. In conclusion, any financing activity is conducted to earn profits and advantages mutually desired by the contracting parties in achieving their specific goals.

Third: Time

It is the duration within which the financing operation shall take place. Commercial Banks grant financing loans on the basis of interest in various terms. For instance, "short-term" is usually meant to a year or less than one year, "medium-term" is to indicate one to three years and "long-term" is over five years.[16] The different durations above are determined according to the nature of finance offered by the institutions and they may differ from one to another depending upon their terms and conditions of the services. The possible form of loans in the commercial Bank may come in the shape of productive loans such as industry, business, etc; or consumptive which does not generate profit or durable loans such as household goods, automobiles, etc; or cash credit like overdrafts; or discounting of commercial papers like notes, bills of exchange, etc.[17] These loans are categorized under the medium-term-based finance. The long term basis may refer to house financing as the duration

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[15] With regard to the Islamic modes of financing would be elucidated in the next chapter of the paper.
[16] See, Ayub, Muhammad, *Understanding Islamic Finance*, Chichester: John Wiley & Sons, 2007, p. 183.
[17] See, Ibid

used in this scheme is usually much longer than other services. In Islamic financing system, a short-term basis is being carried out for trade, acceptance and hire purchase. On medium term basis it covers loans, agricultural, business development credits and lease financing. On the long term basis it is extended to mortgages, equity financing and project financing operations.[18]

Fourth: Contract

According to modern banking terminology it is an agreement involving an arrangement or promise that the law will enforce, rights being acquired by one party or parties to certain acts or forbearance from acts from the part of another or others, being written, oral, or implied, the legal elements of a binding contract in offer and acceptance consideration.[19] Further it is said that "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty."[20] And the formation of a valid contract requires three elements, viz.: offer, acceptance and consideration.[21] An offer is the expression of a willingness to enter into a bargain. An acceptance is the communication of mutual assent made by the offeree in response to the offer. The co-relating two activities of offer and acceptance result in an agreement containing the binding terms of an offer in which the "consideration" is a bargained for exchange or the existence of mutuality of obligation that both parties must derive some benefit or, alternatively, both parties must experience some detriment or forbearance for a contract to exist.[22]

In Islamic law, it is also considered as a basic element to make a contract valid and legally binding which has been described in great detail in Islamic law by different schools of thought. The form of agreement is called "*Ijab* and *Qabul*" (offer and acceptance) between the contracting parties which conveys their willingness to do something in a commercial

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[18] Malik, Mohammad Haafeez Arshad, *Financing in Islam – an Operational Approach*, Malik, 1st ed., 1999, p. 8
[19] *Contract,* The Dictionary of Banking, p. 61
[20] *Contract,* Encyclopedia of Business and Finance
[21] *Formation of a contract*, Ibid.
[22] Ibid.

activity.[23] This inter-related agreement that consists of the offer and acceptance between the parties and gives rise to certain legal consequences is considered as a contract. Both Islamic and conventional view regards it as an instrument which determines whether or not an agreement exists and legally binding between them. However, Islamic law differs from other legal systems on the ground that it insists on the session of contract (*majlis al-'aqd*) indicating that both the offer and acceptance must be jointly connected in one single session without any gap in time or place.[24]

2.2 Islamic Financing

2.2.1 Introduction

Shari'ah, with its broad set of rules and guidelines are the Divine's law that promotes the interests of human being, including the establishment of equality, justice and prosperity as laid down by the objectives of the Shari'ah; preserving religion, life, intellect, progeny and property. Therefore, IFIs such as Islamic banks are obligated follow the precept of *Shari'ah* in order to meet the desires and interests of human being. On such basis too that makes Islamic financial system different from its conventional counterpart in most aspects, as the *Shari'ah* principles must be kept tightly while involving in any kind of financial services and operations.

So, Islamic financing is a form of financing –as described above- which requires additional requirements that is the compliance with the Islamic principles pertaining to money and practices of commercial business and transactions.[25] The followings are the major characteristics as to identify the valid Islamic financing formula which comprise rules and principles based on the recognized Islamic legal laws

[23] *Ijab* is a term in Islamic law denoting a declaration made first in order to create an obligation. And *qabul* is the subsequent declaration in respond to the *ijab* (Majallah al-Ahkam al-Adliyah, Art. 101-102). And this offer and acceptance can be conveyed by spoken words, in writing or through indication or conduct. For further explanation on this issue can refer to Islamic law books for not only knowing the different definitions among the Muslim jurists but also the requirements and technical forms on how to make an offer and acceptance according to Islamic legal system.

[24] Iqbal, Jaquir, *Islamic Financial Management*, Global Vision Publishing House2009, 1st ed., p. 62

[25] See, Ibrahim Warde, *Islamic Finance in the Global Economy*, Edinburgh: Edinburgh University Press, 2000, p. 5

2.2.2 Characteristics of Islamic Financing

1. **Interest-free finance.**

Many say that this is the main feature of Islamic finance system that any business or commercial transactions involved must not indulge in interest or *riba*, either taking or giving is the same. As there are various definitions on *riba* from Muslim jurists and scholars[26], I only pick one out of which I consider sufficient and relevant to describe the term *riba* in view of commonly most Muslim scholars without neglecting another definitions of Muslim jurists due to their vast and deep knowledge in the field of Islamic law. *Riba* is "the practice of charging financial interest or a premium in excess of the principal amount of a loan".[27] Then with regard to *riba* in financial transaction, it basically refers to the additional amount that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in the duration of loan. There are at least four characteristics to define the prohibited *riba*: (1) it is positive and fixed *ex-ante;* (2) it is tied to the time period and the amount of the loan; (3) its payment is guaranteed regardless of the outcome or the result of which the principal was borrowed; and (4) the state apparatus sanctions and enforces its collection.[28]

It is much worth to mention here regarding the legal evidences that prohibit *riba* though it has been discussed by numerous jurists and scholars. In conclusion, it is affirmed that the issue of *riba* is always pivotal in the field of Islamic commercial and contractual transactions. Besides, the basic rationales behind the prohibition of *riba* are also important to note for knowledge.

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[26] Since the advent of the four classical Islamic schools of thought uptill the contemporary Muslim scholars, *riba* is variously defined according to their different explanations and expressions, however, the meaning and general point that can be derived from among these differences are substantially the same. They divide Riba into to two kinds: *al-Nasiah* (dealing with money-to-money exchange) and *al-Fadl* (dealing with barter exchange).

[27] See, Zamir, Iqbal and Mirakhor, Abbas, *An Introduction to Islamic Finance – Theory and Practice,* Lahore: Vanguard Books, 2008, p. 54.

[28] Ibid, p. 56

In Islamic law, there are several explicit evidences in respect of the prohibition of *riba* either from Quran or Sunnah, viz.:

- "That which you give in usury for increase through the property of people will have no increase with Allah: but that which you give for charity seeking the countenance of Allah, it is these who will get a recompense multiplied".[29]
- "That they took usury though they were forbidden and they devoured people's wealth wrongfully; we have prepared for those amongst them who reject faith a grievous punishment."[30]
- "Oh you who believe! Devour not usury doubled and multiplied; but fear Allah that you may prosper."[31]
- "Those who devour usury will not stand except as stands one whom the Satan by his touch has driven to madness. That is because they say, "trade is like usury", but Allah has permitted trade and has forbidden usury".[32] "Allah will deprive usury of all blessing, and will give increase for deeds of charity, for he does not love any ungrateful sinner."[33]
- "Oh you who believe! Fear Allah and give up what remains of your demand for usury if you are indeed believers."[34] "If you do not, take notice of war from Allah and his Messenger but if you repent you shall have your capital sum. Deal not unjustly and you shall not be dealt with unjustly."[35]
- The Prophet Muhammad (p.b.u.h.) is reported to have said in his last *hajj* Sermon "Allah has forbidden you to take usury (interest); therefore all interest obligation

[29] Quran, 30:39.
[30] Quran, 4:161.
[31] Quran, 3:130.
[32] Quran, 2:275.
[33] Quran, 2:276.
[34] Quran, 2:278.
[35] Quran: 2:279.

shall henceforth be waived. Your capital, however, is yours to keep. You will neither inflict nor suffer any inequity."[36]

- A hadits says: "Beware! All *riba* of pre-Islamic era is annulled and the first claim of *riba* which I cancel is that of my uncle."[37]
- From Jabir, who said: "The Messenger of Allah (p.b.u.h) cursed the one who charges *riba:* he who gives it; the one who records it; and the two witnesses; saying that "they all are equal".[38]
- From Abu Sa'id al-Khudri, who said: "The Messenger of Allah (s.a.w.s) said: "Do not sell gold for gold except when it is like for like; nor misappropriate one through the other; nor sell silver for silver except like for like; nor misappropriate one through the other; nor sell things that are absent for those that are present".[39]
- From Ubadah ibn Samit who said: "The Messenger of Allah (p.b.u.h.) said: "Gold for gold, silver for silver, wheat for wheat, barley for baley, dates for dates, salt for salt, like for like, in equal weights, from hand to hand. If those species differ, then sell as you like as long as it is from hand to hand".[40]

As for the wisdom behind the prohibition of *riba*, the contemporary Muslim scholars have provided various rationales for this prohibition by alluding to the consequences of the existence of interest in modern society. It can be sum up as follow:

- **Unjust and exploitative activity**

The wealth derived from interest is considered as taking something unjustly as the receiving party takes extra amount for nothing from the giving party and it leads to exploitation as the lender is guaranteed a fixed return regardless of the possible risks borne by the borrower. It is definitely unjust when a person bears himself all sorts of risks in addition to putting in his skill and labor.

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[36] Bukhari, Sahih, 1623.
[37] Muslim, Sahih, Chapter of Hajj.
[38] Bukhari, Sahih, *Kitab al-Buyu',* Chaoter on *Riba.*
[39] Muhammad ibn Ismail San'ani, Subul al-Salam, Beirut: Dar al-Fikr, 1938, vol. 3, p. 37.
[40] Ibid.

- **Unjustified enrichment**

Riba which represents unequal taking and therefore unjustified monetary benefit is differentiated from trade which promotes exchange of counter values in a more justifiable fashion.

- **Wrongful appropriation of other's property.**

Similar to above, the taking or receiving interest is unlawful because it is considered as appropriating property of another without giving him anything in exchange. A person by lending Rs. 1000 for Rs.1500 gets the extra amount for nothing.

- **Violation of principle of property rights.**

The presence of interest violates the principle of property rights as it claims rights outside the legitimate principle of individual property rights. When a lending contract based on a fixed interest is concluded, the borrower bears an additional right for the benefit of the lender though he does not know the outcome of the enterprise whether he will lose or success. In either case that the money being used in productive or unproductive manner, both reveals the same judgment as it would amount to unjustly taking of property right. In case the money lent is used productively, the money lent can not have any property right claim to the incremental wealth because the lender does not bargain for appropriation of the additional wealth but for a fixed return. Similarly, in case the money is used unproductively, since no additional wealth, property or assets are created by the borrower, the money lent can not be used to claim any additional property since none is created.[41]

- **Lessen aggressive effort for work**

The indulgence and dependence on interest leads the people to refrain from real effort in earning money. Since the person with some amount of Rupees can earn extra Rupees through interest, the value of work which is encouraged in Islam will not be consequently taken care of in his mind, and he will opt such easier way rather than bothering himself to engage in risky business activity. Eventually, this will also lead to

[41] See, Ibid, p. 63-64

economical disorder of the people as the business cannot run without industries, trade and commerce, building and construction, all of which will need capital at risk.

- **Diminishes human personality**

Allowing the indulgence in *riba* will morally discourage people from doing good to one another. While the prohibition of interest will bring the people in behaving good deeds and mind. The lender would expect from his money back not more than what he has loaned. In case the interest is permissible, the needy person then will be required to pay back more than he has borrowed then definitely weaken his feelings of friendliness toward the lender. The ignorance of moral aspect will deprive the spirit of mercy and the rich will be wealthier by exploiting the poor borrower. The result is that it will create socio-economic gap between the rich (the have) and the poor (the have not) within a society and naturally, this generates envy, hatred and aversion among themselves.

2. **No uncertainty (Gharar)**

Generally, *gharar* means lack of knowledge about the material terms of a contract which can be described from the followings circumstances:

- Uncertainty about the existence of the subject-matter.
- Uncertainty about whether it can be handed over or not.
- Inability to deliver the object of sale.
- Lack of knowledge with regard to necessary characteristics of the subject-matter.[42]
- Gambling and speculation in which the result is not known to the parties like lottery and mostly conventional insurance.[43]

3. **No prohibited commodities / activities**

On this principle, only permissible activities in Islam are allowed in Islamic finance. There are certain commodities or activities which *Shari'ah* considers it *halal* or *mubah* is permissible in Islamic point of view. The commodity and services which are

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[42] See, Muhammad Tahir Mansuri, *Islamic Law of Contracts and Business Transactions,* Lahore: Izhar Sons, 2nd Ed., 2004. p. 114-115.
[43] See, Ayub, Op.cit., p. 62.

considered *haram* by *Shari'ah* such as wine, pork, intoxicants, discotheque, prostitutions and the likes can not be conducted in this regard.

4. **Various contractual relationship**

This is also the special characteristic found in Islamic financing that there are number of established contracts in Islamic law each of which has its own effects with regard to the contracting parties. These will create different contractual relationships among the parties involved and such relationship in Islamic financial institution depends upon the nature of transactions. It could be a creditor-debtor relationship (*qard al-hassan*), a mutual partnership (*musharakah*), a seller-buyer relationship (*murabahah*), or a lessor-lessee relationship (*ijarah*). These relationships have only one form in the conventional financial institution which is only a creditor-debtor relationship.

5. **Capital participation and risk sharing**

Another characteristic of Islamic finance is the underlying principle of partnership and the sharing of risks. As capital provider he has to bear the loss, if any, and as entrepreneur he has to pay the wages, rentals and other expenses and gets the residual, if any, all participants in a joint business have similar rights, liability and profits according to the terms and conditions of the agreement. So, in Islamic model of financing, the concept of risk sharing partnership is implemented by utilizing the funds in a profit-and-loss sharing basis.

6. ***Shari'ah* supervision**

The activities carried out by Islamic financial institutions are controlled under the supervision of an independent body named Shari'ah Supervisory Board (SSB) comprising Islamic legal scholars (in the field of Islamic commercial jurisprudence/*fiqh al-mu'amalat*) whose responsibility is for auditing and approving *Shari'ah* compliant products offered by the institutions. So, the legal status of any contract and mode of finance available in the Banks is legally guaranteed. It is assured that the products provided to the clients are in accordance with *Shari'ah* principles so that it would definitely differ from the conventional products as no monitoring body to

be found and the only purpose of finance is aimed to attain maximal profit without considering any *Shari'ah* precepts.

With regard to SSB, it would be useful to highlight here with regard to the features and roles as described by The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)[44] by its Governance Standard No. 1 on the *Shari'ah* supervisory board. According to the standard, every Islamic financial institution will have an SSB with the following characteristics:

a. It is an independent body of specialized experts or jurists in the field of Islamic commercial jurisprudence (*fiqh al-mua'malat*).
b. It is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic *Shari'ah* framework.
c. It can issue legal opinion and rulings (*fatwas*) which 'shall be binding on the Islamic financial institution.
d. The body consists of at least three members who are appointed by the shareholders upon the recommendation of the board of directors (not including directors or significant shareholders of the Islamic financial institution).
e. It prepares a report and analysis on the compliance of all transactions, contracts and dealings according to the *Shari'ah* rules and principles,
f. The body also provides supervision on the allocation of profit and losses charged from the clients related to investment accounts, and finally,
g. The *Shari'ah* Supervisory Board gets remuneration from the institutions fixed by the board of directors under the authorization of shareholders.[45]

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[44] AAOIFI is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic financial institutions and the industry. It was established in 26 February, 1990 in Algiers. AAOIFI comprise 200 members from 45 countries including Islamic financial institutions, Central Banks and other bodies from international Islamic banking and finance industry around the world.

[45] Hassan, Op.cit., p. 136.

2.3 Risk Management Defined

"Risk" literally means a danger or a chance and possibility of harm and loss.[46] By definition, it is the uncertainty of outcome, whether positive opportunity or negative threat, of actions and events.[47] In banking term, it denotes the probability that the actual return of an investment will differ from what has been expected due to various factors such as liquidity risk, interest rate risk, inflation risk, operational risk, market risk, business risk, financial risk, country risk and many others.[48] In Arabic term, it is said *mukhatarah* which denotes the situation in which there is probability of deviation from the path that leads to the expected or usual result (Elgari, 2003)

"Management" is the process by which human efforts are coordinated and combined with other resources to accomplish organizational goals and objectives or, the art of getting things done through people through the utilization of five basic functions: planning, organizing, directing, leading and controlling.[49] Then, "Risk Management" is such efforts undertaken to reduce or control various types of risks by variable means, such as insurance, hedging and diversifications[50]. If the risk can not be avoided or eliminated then the management is to reduce the probability of risk to an acceptable level.[51]

In a simple example, riding in a car can possibly result in an accident that cause to injury or death. To minimize the risk, the driver may obtain sufficient training course or purchase a car with various safety features. These precautionary measures taken by the driver can be considered as managing risk to reduce the loss as well save his life. Actually, risk involves in all spheres of human life and by proposing risk management it actually does not necessarily mean eliminating it but rather aiming to minimize and mitigate its impact.[52] This paper will not cover such broad discussion of different kinds of risk rather it confines in such issues and necessary matters pertaining to house financing related-risks.

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[46] *Risk,* NTC's Pocket Dictionary of Words and Phrases, Richard A. Spears (Ed.), The McGraw-Hill Companies.
[47] *The Orange Book - Management of Risk - Principles and Concepts*, London: HM Treasury, p. 9.
[48] See, *Risk,* The Dictionary of Banking, p. 202.
[49] Ibid, p. 151.
[50] *Risk management,* Ibid, p. 203.
[51] See, Vlasta Molak, (ed.) *Fundamentals of Risk Analysis and Risk Management*, USA: CRC Press, p. 381.
[52] See, Anthony Tarantino (ed.), *Governance,Risk, And Compliance Handbook* (Canada: John Wiley & Sons, Inc., 2008), p. 15.

CHAPTER III

HOUSE FINANCING PRACTICES: ISLAMIC AND CONVENTIONAL

3.1 INTRODUCTION

The significance of house financing has received so much consideration from contemporary Muslim scholars since around two decades ago when a joint workshop on "Islamic Banking Methods for Housing Financing" could be organized by Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) in Khartoum, Sudan for three days, in 27-29 October 1991.[53] The workshop was to explore the ways and possible means that are permissible in Islamic *Shari'ah* for providing finance to the housing sector and to evaluate the experiences of some financial institutions that are already involved in this field. As the program was preciously participated by Muslim experts of *Shari'ah* disciplines as well as some practitioners in Islamic financial institutions, it provides so much worthy outputs for the Muslim world particularly for current developing Islamic financial institutions. It had resulted in some theoretical papers and case studies presented to the workshop. In addition to that, it proposed certain financing techniques that can be practiced in housing sector, problems and technicalities faced by the financing body, and also some important recommendations related to housing projects in order to be seriously taken by Muslim thinkers and practitioners as to promote the compatibility of Islamic financing model in this modern atmosphere of human life. This chapter would elucidate matters pertaining to the modes of Islamic housing finance, rules and principles that must be followed under the views of the recognized Muslim jurists. Moreover, the current practices of housing finance available in most of the Islamic financial institutions are also much worthy to be noted here.

Islamic financing practitioners –with the help of Islamic scholars- have utilized a number of instruments that are acceptable within *Shari'ah* point of view. Categorically, it is

[53] See, Mahmoud Ahmad Mahdi, (Ed.) *Islamic Banking Modes for House Building Financing,* Seminar Proceedings Series No.: 28, Jeddah: Islamic Research and Training Institute- Islamic Development Bank, 1995, p. 17.

grouped into five contractual headings from which the current Islamic house financing is offered to the prospective customers, these are: *murabahah, musharakah, bay' bi al-thaman al-ajil, ijarah* and *istisna'*. These different models of financing are considered to be viable, feasible and flexible products to meet the wants of the people along with their choices, financial abilities and definitely, for the Muslims, to meet their aspiration of compliance with basic rules of the *Shari'ah.*

3.2 ISLAMIC HOUSE FINANCING PRODUCTS

Here below the different modes of house financing models which have been practiced by Islamic financial institutions:

3.2.1 MURABAHAH (WITH ORDER TO PURCHASE)

Murabahah is a familiar term in Islamic law in respect of commercial transaction. The term is expressed by the Muslim jurists in various definitions though it reveals a single sense of meaning, that is a sale on the basis of actual cost plus a profit margin.[54] According to Islamic classical sources, it is simply considered as a part of sale contracts (*bay'*) with all its implications prescribed by *Shari'ah* pertaining to sale. Specifically, it is a trust sale (*amanah*) as the purchaser relies upon the sincerity of the seller with regard to the actual price he mentions to the purchaser. However, in the classical sense of *Murabahah*, the contract is between two-sided parties; buyer and seller, and no third entity is involved. The buyer would purchase the commodity directly from the seller on cost plus mark-up basis as per rules prescribed by Islamic *Shari'ah*. So, initially it has no correlation with financing activity as it occurs in the current practical operation. But further, with the arising of dynamic circumstances of human atmospheres and the necessity to meet their different needs, and also to provide the *Shari'ah*-compliant alternative to interest-based financing, it is observed that such mode of *murabahah* financing is necessary to be established without neglecting another

[54] See, 'Alau al-Din Abi Bakr bin Mas'ud al-Kasani, *Badai'u al-Sanai' fi Tartibi al_sharai'*, Cairo: Sharikat al-Matbuat al-Islamiyyah, vol. 7, p. 93; Muhammad Khatib al-Shirbini, *Mughni al-Muhtaj*, Beirut: Daar al-Ma'rifat, vol. 2, p. 102.

approved form of *musharakah* and *mudharabah*[55] which precede in its existence. The *murabahah* model is being implemented by many Islamic financial institutions worldwide following the rules and necessary principles of *Shari'ah* as would be explained later.

The legitimacy of *murabahah* contract is based on the Qur'anic verse, the Sunnah, the consent of the Muslim jurists and the analogy (*qiyas*). In the Qur'an, the sale contract is permitted in general sense by its saying: "*Allah has permitted trade and prohibited riba*"[56]. The Prophet Muhammad (saw) also provides legitimacy of the *murabahah* based on general principle of Islamic law that everything is permissible as long as there is no contradiction with the rules of *Shari'ah*. In one of His sayings: "*The best earning is what man earns with his own hands and from a permissible trade*".[57] Furthermore, the consent of the Muslim jurists can be traced out from their worth and remarkable literatures in Islamic jurisprudence which shows their sanction on *murabahah* contract. Regarding the analogy, since the Prophet (saw) has approved the *tawliyah* sale[58], the sale on mark-up will be equally permissible as both subject to the determination of cost and making it known to the buyer.

3.2.1.1 Rules Regarding *Murabahah* Contract

As a contract of sale, definitely it must comply with the requisites of its originality, being a sale contract. It is enumerated below the conditions on which a valid sale can be attained in the light of Islamic Law. These comprise the following four elements which are subjected to its own conditions in a sale, i.e.:

1. **Conditions for contractual form:**
   a. **Clarity of both offer and acceptance.** Both can be conveyed in spoken words, writing, or through indication or conduct. But the current contractual practices in

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[55] However, trade or sale is ideally preferred as it is mentioned in the Qur'an 2:275 that Allah has permitted trade and forbidden *riba*.
[56] Al-Qur'an, al-Baqarah:275.
[57] Narrated by Hakim
[58] *Tawliyah* is a sale based on cost price

most Islamic financial institutions adopt such in written form as to make it legally binding upon the parties involved before law.

b. **Conformity of the offer and acceptance on the same subject matter.** The necessary details of the subject matter must be agreed upon by and known to the contracting parties.

c. **Continuity between the offer and acceptance, actually or constructively.** According to classical Islamic point of view, the offer and acceptance must occur in the same meeting or session. However, in view of modern jurists it is interpreted as whatever time is necessarily taken by the promisee to communicate his acceptance can be assumed as continuity of offer and acceptance. It is to solve some practical problems occur in many bigger transactions in which a promise would really need a longer time for communicating his acceptance as, for example, in a sale of a factory, he will require inquiry into the title, power to sell, value of machinery, value of building, profitability, etc.[59]

2. **Conditions for contracting parties:**

a. **Having legal capacity to enter into a contract (*Ahliyyat al-Ada*).** It means the parties has attained full mental development and acquires the ability to employ his reasoning (*'aql*) and discretion (*rushd*) on a contract. This capacity is measured and presumed through the signs of puberty: ejaculation in a male, menstruation in a female, or having attained 15 years for both male and female according to the majority of the jurists.[60] In case for a minor or lunatic whose deficient capacity, the permission from guardian is required to obtain this capacity according to Hanafi jurists.[61]

b. **Having legal authority to enter into a contract either as the actual owner or by delegation.** A delegated authority means such authority granted by actual

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[59] See, Tahir Mansuri, ibid, p. 29-33.
[60] See, ibid, p. 49.
[61] See, ibid.

owner to another called as his agent (*wakalah*) and has same affect as being from the real owner.

3. **Conditions for the subject matter of contract:**
   - **a.** The subject matter should be lawful. The commodity like pork wine carrion, etc is not allowed according to this principle.
   - **b.** The commodity should exist at the time of making contract or it should be capable of being delivered in future.
   - **c.** The commodity should have been acquired by the seller. Meaning by that is the subject matter should have come into the possession of the seller, either physically or constructively. Constructive possession is when the goods are under his control and all rights and liabilities of the goods have passed on to him though he has not taken physical delivery of the goods. However, there are two exceptions in this issue: one is in *Salm*, and the other is *Istisna'*.
   - **d.** The commodity should be ascertained and known by both contracting parties. So both parties precisely examine and determine the object of the contract with regard to its value, essence and quantity.[62]
4. **Additional conditions specifically pertaining to *Murabahah***
   - **a.** The original cost must be known to the buyer.
   - **b.** The additional mark-up as a profit is fixed and also must be mentioned in the contract.
   - **c.** The first contract must be valid contract.

It is therefore, by fulfilling those requirements of sale contract as well as the special provisions of the *Murabahah* transaction, any house financing on the basis of *Muarabah lil Amiri bi al-Shira'* can be justified in the perspective of Islamic *Shari'ah*.

[62] Ibid, p. 41.

3.2.1.2 Application of *Murabahah* in Islamic Financial Institutions

In ordinary *Murabahah*, as slightly mentioned above, no additional parties are involved except the two contracting parties: buyer and seller. In modern application it can be supposedly exampled if, for instance, a costumer or client (being the buyer in a contract) directly approaches the Bank (being a seller in the same) to purchase some commodity, then the Bank having the commodity required sells it to the client on cost plus mark-up basis. In this regard, it would be no question to its legal status and nature as it would be exactly similar to the classical *Murabahah* and unanimously valid in the eyes of Islamic law. But with the emergence of innovative Islamic financial bodies in the form of banks or any established financial firm in the market, the practice of *Murabahah* differs from that of classical one. It is currently described as sale of an item by the institution to a customer (the purchase orderer) for a pre-agreed selling price which includes a pre-agreed profit mark-up over its cost price, this having been specified in the customer's promise to purchase.[63] So the current application of *Murabahah* takes place between three parties; the buyer/the client who requires a financier to purchase and finance on his behalf, then the original vendor of the commodity, and thirdly is the intermediary/Islamic bank/financier that provides finance to the its costumers.[64]

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To describe further, the following sequent processes are the application of *murabahah* practiced in most of Islamic financial institutions. This application of *murabahah* is basically consists of several phases the details of which are as follows:

Stage 1: First, the client selects the property which he/she deems suitable in respect of the price, place, situation etc. from the vendor.

Stage 2: The client approaches the Bank to place his request for finance. The request can be made verbally or in written form. The Bank then conducts Credit Assessment regarding the financial status of the client such as his monthly income, the ability to pay the

[63] AAOIFI, 2003, p. 134
[64] See, Zamir and Mirakhor, Op.cit., p. 87.

dues to the Bank in time, whether he is a defaulter of any bank, etc. to determine the creditworthiness of the client[65] (Figure 1)

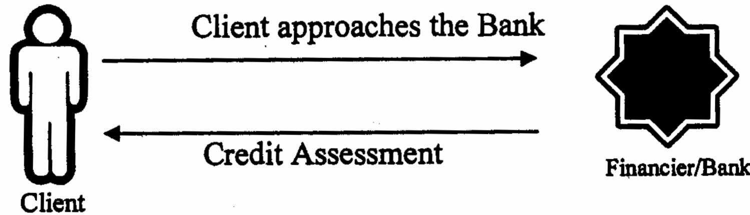

Figure 1

Stage 2: If the Bank is satisfied with regard to the client's financial position according to the credit assessment process, the Bank accepts the client's request. Afterwards, the Bank determines the limit up to which the Bank can offer finance to its client. There are certain limits which are prescribed for granting finance on the basis or *murabahah* such as the maximum and minimum amount the Bank would possibly finance the client, the ratio of profit, the terms and conditions to be followed by the contracting parties, etc.[66] (Figure 2)

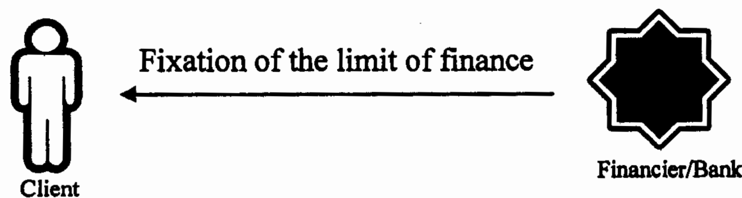

Figure 2

Stage 3: After the terms and conditions have been finalized, the next step is the process by which both parties enter into a mutual contract of *murabahah* in term of house financing service. In this phase both the client and the Bank sign a contractual agreement of *murabahah* in which the client unilaterally promises to buy a specified house conforming the requirements of the Bank on agreed ratio of profit added the actual cost incurred by the

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[65] See, Samadani, Maulana Ejaz Ahmad, *Islamic Banking and Muarabaha,* Karachi: Daarul-Ishaat, 2008, p.15
[66] See, Ibid, pp. 15-16.

Bank.[67] The agreement may specify the limit up to which the facility may be availed.[68] The *murabahah* also allows appointing a third party to be the Bank's agent to carry out the purchase and the client is not allowed to become the agent except in a situation of a dire need.[69] In addition to that, the promise may also consists of an undertaking from the client to pay an amount of money as penalty to be donated to charitable purposes and not to the financier to safeguard that the transaction is really free from the prohibited *Riba.* (Figure 3)

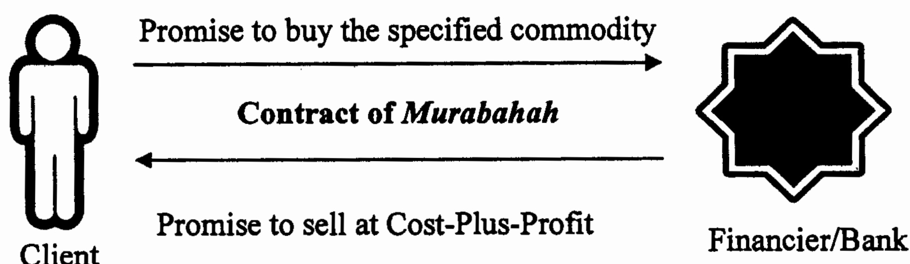

Figure 3

Stage 4: Further stage is the procurement of the house. The institution purchases the commodity from the supplier/vendor by directly making payment (Figure 4). However, the client can also acquire a specific property according to his criteria and propose it to the Bank. In such manner, it is required that the contract of agency must be properly made so that the client will act as an agent of the Bank for purchasing the property on its behalf. (Figure 5).[70] Since the contract is based on the *murabahah,* the relevant rules pertaining to *murabahah* contract shall be followed accordingly. Therefore, the property is still in the ownership of the Bank and it would still be the sole owner until and unless the full repayment of the agreed price is fulfilled. Regarding the mark-up-profit, it must be known to each parties and the contract is finalized by agreeing on the mode of payment, i.e., lump sum or through

[67] See, AAOIFI, 2008, Standard on Murabaha to the Purchase Orderer, Clause 2/3/1; and Usmani, Muhammad Taqi, *An Introduction to Islamic Finance,* Karachi: Maktaba Ma'ariful Qur'an, 2007, p. 107.
[68] Usmani, Ibid, p. 107.
[69] See, AAOIFI, Standard on Murabaha to the Purchase Orderer, Caluse 3/1/3.
[70] Usmani. Op cit.

installments. In addition to these, the Bank also accepts the goods or other assets as collateral against the default risk in payment by the client.

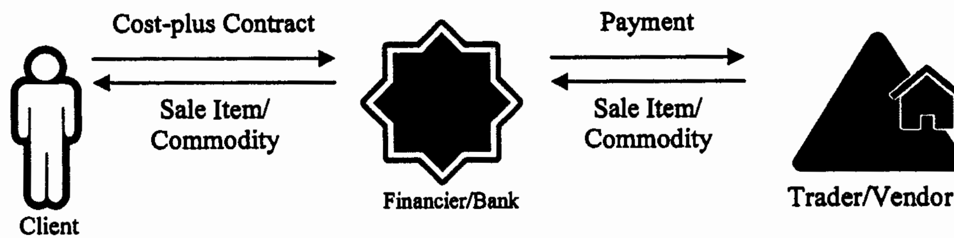

Figure 4

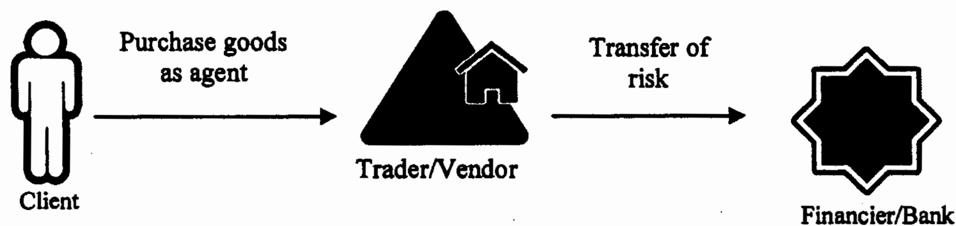

Figure 5

Stage 5: At the time of payment, the client makes payment to the bank which includes the actual cost of the property plus a profit margin for the bank. Further phase is the conclusion of a contract which starts when the ownership of the property along with its risks is transferred to the client (Figure 6).[71] Usually, in the *Murabahah* to the Purchase Orderer, the payment is deferred, but such is not one of the essential conditions of the transaction as it can be arranged in no deferral payment.[72]

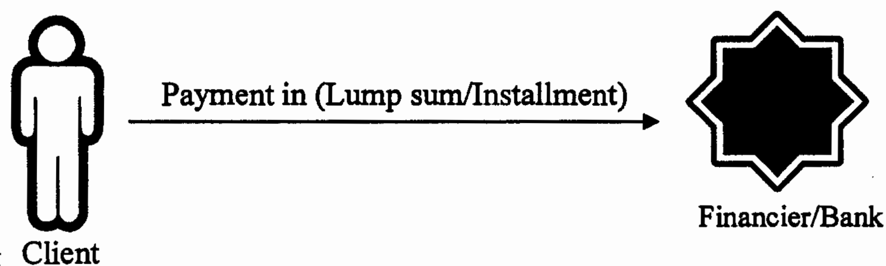

Figure 6

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[71] Ibid. ; Iqbal and Mirakhor, Op.cit., p. 87-89.
[72] Shari'a Srandards, Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), 2003, p. 134; See, Samadani, Op.cit, p. 18.

To sum up, the contract of *Murabahah* in modern application takes place when the bank buys commodity for cash from the original seller and then sells it to the client on cost plus fixed profit basis paid on lump sum or installments (deferred payment). Thus, the contractual relationship in such contract includes a promise to buy (undertaking for purchase by the buyer/client), an ordinary contract of Murabahah as the original price is known to the client and the additional mark-up is determined in the contract, and also a deferred sale contract (*bay' al-mu'ajjal*) as the payment is made at specified dates in future. The contemporary name used in most Islamic financial institution as well as according to AAOIFI, it is called *Bai al-Murabahah lil-Amiri bi al-Shira'* (Murabahah to the Purchase Orderer).[73]

These step by step practices have been used by Islamic financial institutions such as the Jordan Islamic Bank[74] or the Al-Baraka International Bank London[75] in financing real estate. Practically, keeping in view the above general steps of financing process, some banks may differ in some additional-technical and particular matters due to each bank has its own discretion, circumstances, terms and conditions to be followed by the client. Besides, they have their different customary applications to meet the different client's proposal and choices.

In Jordan Islamic Bank, it is basically identical to the above system that the Bank fulfills the request of the client by purchasing what the client demands subject to his commitment to purchase what he has ordered and as per the method or determination of profit and repayment mutually agreed upon. They provide two types of techniques to their clients with respect of the commodity dealt in house financing. The first is when the commodity is in the form of building materials such as cement, steel, water supply devices, electrical equipment, doors, windows and the like. The Bank sets down flexible terms and conditions

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[73] See, Ashraf Muhammad Dawabah, *Dirasat fi al-Tamwil al-Islami,* Cairo: Daar al-Salam, 2007, p. 26; AAOIFI, 2003, p. 113.

[74] The bank was founded under a special act issued in 1978, and was registered as a public joint stock company in 1978 with an initial capital of four million dinars which was increased to six million dinars in 1986 and 7.2 million dinars in 1990. It was for carrying out all kinds of banking, financing and investment activities in compliance with the provisions of the Islamic *Shari'ah*. By the end of 2008, the number of its employees reached 1656 distinguished employees who have sufficient experience.

[75] The bank was established in 1982 in London offering exclusively Islamic banking services under the 1987 Banking Act.

for the purpose of granting finance according to the wants the customers. The terms and conditions include the followings:[76]

a. The plot and land on which the house is to constructed should be owned by the beneficiary himself. This condition is applied also to a house which needs to be expanded or completed.
b. The maximum period of repayment is eight years.
c. Installment (monthly or annually) should not be more than 40% of the beneficiary's income (for the period). It should be noted that this condition has taken into consideration the other living needs of the beneficiary which he should meet. The client therefore, would not burden himself with building a house with enormous financial commitments that he may find himself incapable of confronting.
d. The beneficiary should obtain the necessary license from the concerned authorities,
e. Appropriate guarantees, should be provided by guarantor/s who is/are financially capable of acting in this capacity provided that the installment is within the limits of 25% of the guarantor's income. The property should be mortgaged in favor of the bank in an initial lien if the value of the finance exceeds four thousand dinars.
f. The bank sometimes grants a period of grace of not more that 6 months from the beginning of the utilization.

The second method of *al-Murabahah lil-Amiri bi al-Shira* is provided in the commodity of a finished house (whether an apartment in a building, or an independent residence villa). This method encountered the problem of double registration of the units sold with land registration authorities that is the Bank should, on purchase of the house, register it in its name first then in the name of the client when the purchase deal is finalized. As the registration department collects fees on transfer of ownership and registration of the sold property in the name of the new owner at a rate of 10% of the sale price (6% to be borne by

[76] Hasni Abdul Aziz Yahya (1995), 'The Experience of the Jordan Islamic Bank in Financing Housing Projects', Mahmoud Ahmed Mahdi (ed.), *Islamic Banking Modes for House Building Financing*, Jeddah: Islamic Research and Training Institute, Islamic Development Bank, pp. 85-86.

the purchaser and 4% by the seller), the cost increases in this way by about 16 of the total price.[77]

In Al-Baraka International Bank, the application of *al-Murabahah lil-Amiri bi al-Shira* is provided in the following technical manners:[78]

1. The financing is granted for short or medium term business operations with a time-span not exceeding two years.
2. Under this method, the Bank buys the property directly from the owner and resells it to its client.
3. To avoid paying the registration taxes twice, which would increase the price and reduce profits, the Bank authorizes its client to buy directly from the owner-seller.
4. The client pays to the bank the first down payment which amounts to 30% of the price, at the time of buying the unit. The rest of the price –including the profit of the Bank – is paid by the client according to the agreement reached with the Bank, either upon completion of the modifications and sale of the units or in monthly or quarterly payments.
5. In guarantee of its rights, the Bank maintains a monopoly of ownership in lieu of its loan to the client which it gives up only when full repayment is made.
6. Another condition imposed by the Bank under this system is an insurance policy borne by the client against the dangers of fire, destruction, or occurrence of any damage to the property.
7. Like the Jordan Islamic Bank, the Al-Baraka International Bank also provides finance in building materials needed for construction or modification of units. In this case, the Bank requires that the funding provided by the Bank does not exceed 50% of the price of these building materials. The Bank buys these materials directly from their supplier and resells them to its clients at a profit. The total price is paid by the client either in installments or upon completion of the restoration and sale of the property.

[77] Ibid, p. 87-88.
[78] Ibid, p. 125-126.

3.2.1.3 Relevant issues on *Murabahah*

The aforementioned interrelated different contractual arrangements have revealed some criticisms passed by some Muslim analysts with regard the legality of the contract in the light of Islamic principles. Here are the some relevant issues pertaining to the contemporary contract of *Murabahah*:

3.2.1.3.1 Different pricing for cash and credit sale

The issue is regarding the different price applied by the financier/Bank when providing *murabahah* on the basis of deferred payment. It means that there is difference between spot and future prices of the commodities, so as to say that the price in *Murabahah* transaction is always higher than the prevalent market price. Therefore, according to this opinion, the transaction is not in line with the *Shari'ah*. In this regard, the objection throws the following points:[79]

a. The increase from the spot into cash sale is considered as analogous to the *riba* charged on a loan. This is based on the view that the increase applied in such transaction is being in consideration of the time given to the purchaser for a deferred payment. In another word, the cash price fixed by the seller already contains a profit margin for the seller. Then the further increase in the price for deferred payment is only against time. If, for example, a seller says to a buyer that the cash price of goods is Rs. 100,- and credit price is Rs. 150,- it is clear that the increase of Rs. 50,- is against nothing but he time.
b. There is no authority from the Qur'an and the Sunnah to prove the permissibility of increase in price for deferred payment.
c. The approved deferred payment sale in *Shari'ah* does not mean that charging of high price than the prevalent market price is permitted. It amounts to *ghabn fahish*[80] which renders a contract invalid.

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[79] Tahir Mansuri, Op.cit., p. 224-225

[80] *Ghabn Fahish* refers to loss which can not be estimated by the experts or it refers to a situation where a seller charges an exorbitant profit from the buyer.

d. In Islamic law the basis to be considered in the contracts is the meaning and underlying objective of the contract, not its forms and words. In such credit sale the objective of the seller is to make profit from the time given to the purchaser and that is substantially similar to *riba* transaction.

e. It amounts to exploitation of the need of the buyer. The increase of the price does not represent a real consent of the buyer as he agreed to the price owing to his inability to pay cash.

The above questions are argued that the issue of *riba* in case of late payment is applied only when the subject matter is money in both sides. Since it is not, it is permitted to set two fixed prices of a commodity that is in cash and credit price and give an option to the buyer to choose any of the two as the whole price is against commodity and not against money.[81] Further, it is not always prohibited to charge a higher price in credit sale for some particular considerations and factors, as it is commonly practiced that in a shop which is nearer to the buyer, or when the shop's atmosphere is cleaner and more comfortable, or the seller is known to be more trust-worthy than others, etc, in all of these cases, it is permissible in the eyes of *Shari'ah* to charge higher price as it is known and fixed in the contract and it is accepted with open eyes on the part of the purchaser.[82] In short, the pricing is considered as a business decision and not under the *Shari'ah* policy and consideration.

3.2.1.3.2 Promise to purchase

In *Murabahah* finance, as practiced above, it requires a promise from the client (undertaking) by which he is obliged to purchase the property when it is acquired by the Bank. The reason is to overcome a possible unexpected risk of loss in case the client refuses to purchase the property whereas the Bank has incurred huge expenses to acquire it. Therefore, the client is required to sign a binding promise to purchase the property. However, the issue further arises as to whether or not such promise is binding and enforceable before the courts of law.

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[81] Ibid.; See, Usmani, Op.cit., p. 115-116.
[82] See, Ibid.

Regarding the status of promise in Islamic law, a simple promise is not legally binding and enforceable before the court of law, but it is morally and religiously binding upon the promisor to fulfill his promise. There are a number of evidences that demands the fulfillment of a promise:

1. It is stated "And fulfill every engagement, for every engagement will be enquired into".[83]
2. "Oh those who believe, why do you say what you not do. It invites Allah's anger that you say what you not do".[84]
3. It is narrated "The Hoy Prophet saw is reported to have said: there are three distinguishing features of a hypocrite: when he speaks. Tells a lie, when he promises, he backs out and when he is given something in trust, he breaches the trust".[85]

However, in addressing this issue, the Muslim jurists are divided into three different views with regard to the enforceability of the promise in the courts of law. First view opines that a promise is neither mandatory nor enforceable through courts of law, but fulfilling such promise is always advisable and its violation is reproachable. This view is adhered to Hanafi, Shafi'i, Hanbali and to some Maliki jurists.[86] The second view opposes the former and says that fulfilling a promise is mandatory and enforceable. This view is attributed to Samurah b. Jundub, Umar b. Abdul Aziz, Hasan al-Basri, Sa'id b. al-Ashwa', Ishaq ibn Rahwaih and Imam al-Bukhari. The same is the view of some Maliki jurists, and it is preferred by Ibn al-'Arabi and Ibn al-Shat, and endorsed by al-Ghazzali, the famous Shafi'i jurist, who says the promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah. The third view is of some Maliki jurists. which says that in normal conditions, promise is not binding, but if the promisor has caused the promise to incur some expenses or undertake some

[83] Qur'an, Al-Isra/1
[84] Qur'an, Al-Saf/2-3.
[85] Sahih-al-Bukhari
[86] Usmani, p. 121-122

labor or liability on the basis of promise, it is mandatory on him to fulfill his promise for which he may be compelled by the courts.[87]

In this regard, the modern Muslim scholars seemingly support the last opinion and consider that a promise in commercial transactions that causes the promisee to incur some financial risks and liability is generally held enforceable at law. This view is in accordance with the enforceability of a promise in the form of guarantee or *ju'alah*[88] in Islamic law.[89] The International Islamic *Fiqh* Academy is of similar view but laid down certain conditions for the enforceability of a promise in commercial dealings as follow:

1. One-sided promise which means that the promise shall not be made by both contracting parties.
2. The promisee has incurred some loss and liabilities due to such promise.
3. Principally, a mere promise can not conclude a sale contract. So, the promise to purchase something does not create any liability until the actual sale takes place by the exchange of offer and acceptance at a specific time.
4. In all these situations, the court may legally force the promisor either to purchase the commodity or pay actual damages if he backs out of his promise.[90]

Out of these differences, the view saying that the promise is binding for the promisor is more acceptable on the grounds that, instead of relying on some clear evidences from the Qur'an and Sunnah, logically if a promise is not enforceable in the commercial practices, it will definitely undermine commercial atmospheres and jeopardize any involving parties in their commercial transactions. If a customer approaches a Bank and orders to purchase for him a property promising that he will purchase it after being acquired and therefore the Bank arranges to afford it by incurring huge expenses for its expenditure, it can not be justified for the client to break his promise as it would cause losses on the part of other.

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[87] Ibid.

[88] *Ju'alah* is a unilateral promise to reward any person who brings about desired results. For example, a promisor says "I will pay Rs.10.000 to anyone who returns may lost wallet".

[89] See, Mansoori, Muhammad Tahir. *Shari'ah Maxims on Financial Matters*, Islamabad: International Islamic University, 2007, pp. 150-151.

[90] See, Resolution no. 2, 3, Islamic Fiqh Academy, Academy's Journal No. 5, vol. 2, p. 1509.

3.2.1.3.3 The use of interest rate as bench mark

While determining the profit or mark-up in *Murabahah*, many institutions use current interest rate such as LIBOR (London Interbank Offered Rate)[91] as the criterion.[92] A question arises that this profit which is based on interest rate is identical to interest itself which is forbidden in Islam. But this objection is contended by many *Shari'ah* scholars who opine that *Murabahah* is basically considered as sale contract. So, its validity is determined by its compliance with all necessary ingredients and principles of Islamic sale as have been described earlier. Applying the interest rate as a benchmark is used only for indicator in measuring and determining the profit and therefore permissible in the transaction since all the conditions and requirements of *Murabahah* contract is fulfilled.[93]

3.2.1.3.4 Buy-back agreement (BBA)

"Buy-back" or known as *bay' al-'inah* in Islamic *fiqh*, which is prohibited in view of majority of Muslim jurists, is supposed to have been involved in the contract.[94] But this allegation is redressed as the Islamic banks, while conducting *Murabahah* to Purchase Orderer, have to be assured that the goods being required by the client are not already owned by him. The institution must ensure that the party from whom the item is bought is a third party and not the customer or his agent.[95] Thus, there are necessarily three parties involved to render the transaction valid and the buy-back contract can not be perceived to exist as it requires two parties to be involved in a contract.

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[91] LIBOR is the interest rate which is determined by the British Banker's Association at which banks in London lend funds to other prime banks in London and usually it is used as a benchmark rate among the interbank offered rates around the world.

[92] See, Choudhury, Sultan and Abbas, Shaher, 'Islamic Mortgage", (ed.), Islamic Mortgages – A guide for International business and investment, United Kingdom: 2008, p. 48.

[93] Usmani, Op.cit, p. 118-119; see, Ayub, Op.cit, p. 448.

[94] *Bay' al-'Inah* is a double sale where a person sells a property on credit for a certain price and then buy it back at a price less than the sale price on prompt payment basis, both the transactions take place simultaneously in the same session of contract. As such, it is deemed as a legal device to circumvent the prohibition of *Riba* and therefore prohibited.

[95] AAOIFI, 2003, p. 114.

3.2.1.4 Difference between *Murabahah* and Conventional Mode Housing

Instead of general uniqueness of the contract which is based Islamic *Shari'ah*, the difference between *murabahah* and conventional mode of financing is that in *murabahah*, the profit (mark-up) is derived from the underlying asset (subject matter) whereas in conventional system, the profit is derived from the interest generated from extending the loan. The fixed profit margin in *murabahah* also makes it dissimilar to floating rate of interest in traditional banking activities. Moreover, since the commodity in *murabahah* must be firstly possessed by the financier and the client has an option to turn down the offer before it has not been handed over, the financier is exposed to *Shari'ah* risk in the form of refusal of the client and even if the commodity is finally transferred to the client the financier is further exposed to credit risk and price risk. It is credit risk if the client is unable to fulfill his financial obligation and it is price risk as the price of the commodity is subject to probability of high and low rate with the passage of time. Moreover, when the client is defaulted, the financier can not charge additional amount for its own benefit.

3.2.2 MUSHARAKAH

Basically *musharakah* (Islamic partnership) is a term of Islamic law which refers to a contract between two or more people for participation in capital and its profit.[96] It is defined in another word as a form of partnership where two or more people combine either capital or labor, to share the profits and losses and where they have similar rights and liabilities.[97] The legal evidences of *musharakah* is the Qur'anic verse *"Verily many are the partners in business who wrong each other except those who believe and work deeds of righteousness and how few are they"*.[98] Besides, it is narrated in the Sunnah that al-Sa'ib Ibn Abi al-Sa'ib al-Makhzumi was a partner of the Prophet (saw) in business at the beginning of Islam. The partnership is recognized as one of primary transactions practiced by the Muslims since the

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[96] Ibn 'Abidin, Muhammad Amin, *Radd al-Mukhtar*, Quetta: Maktabah Majidiyyah, 1982, Vol.3, p. 364.
[97] Iqbal and Mirakhor, Op.cit, p. 92.
[98] Al-Qu'ran, al-Sad:24.

advent of Islam indicating that the validity and permissibility of the Islamic partnership is based in its practical consensus since the time of Prophet Muhammad (s.a.w.)[99]

Categorically, there are various types of partnership in Islamic law with regard to the subject matter, level of the partner's authority and obligations and the type of their contributions, namely *Shirkat al-Milk, Sharikat al-'Inan* (partnership by restricted authority and obligation), *Sharikat al-Mufawadhah* (partnership in capital and labor), *Sharikat al-A'mal* (partnership in services), *Sharikat al-Wujuh* (partnership in goodwill) etc. But in this research, the details of these kinds could not serve much purposes of our relevant discussion. Hence, we will confine study in the *Shirkat al-Milk* (partnership by ownership) which is considered as part of the Islamic partnership qualifications and relates to the prevailing type of modern *musharakah* being practiced by the Islamic financial institutions in housing sector. Such a new type of *musharakah* is named in different terms but has similar meaning, i.e.: *musharakah mutanaqisah* partnership or diminishing *musharakah*,[100] or redeemable *musharakah*.[101]

3.2.2.1 Rules and Principles of Diminishing *Musharakah*

The diminishing *musharakah* is a compound of at least three different contracts, i.e. *shirkat-al-milk, ijarah* and *bay'*. As it consists of three types of contracts, each contracts will be described accordingly with regard to the general rules and principles prescribed by the Islamic law. This is to identify the legal status of the contract whether or not it falls under the precept of *Shari'ah* and henceforth it is properly used by the clients of Islamic financial institutions.

3.2.2.1.1 Rules of *Shirkat al-Milk* (Co-ownership)

One of contracts involved in the diminishing *musharakah* is the contract relating to *Shirkat al-Milk*. The *Shirkat al-Milk*, in Islamic *fiqh*, is defined as joint ownership of two or

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[99] See, AAOIFI, 2003, Standard on Musharakah, p. 218.
[100] Usmani, Op.cit, p. 82.
[101] Mansuri, Op.cit, p. 271.

more persons in particular property.[102] The principles regarding the nature of *Shirkat al-Milk* are as follow:[103]

1. The key element (*rukn*) of Islamic co-ownership is the mixing of shares (*al-khalt*).
2. The co-owner is like a stranger with respect to the share of the other co-owner. Thus he can not use or dispose of the share of the co-owner. The only exception is a house which may be used by both.
3. The partners are no not allowed to undertake any act of disposal with respect to the other's share except with the latter's permission.
4. Each partner can sell his own share without the other partner's consent, except in cases where share of one partner can not be distinguished from the other.
5. The share of one partner in the possession of another co-owner is governed by the rules of *wadi'ah* (deposit). If one –co-owner further deposits such property with a third party without the permission of his partner, he is liable for compensation (*daman*) if the property is destroyed.
6. Right to demand the recovery of debt belongs to each co-owner jointly and severally. A debt possessed by one partner is governed by the rules of *sharikat al-milk*. Further, postponement of the recovery of a debt can not be granted by one co-owner without the permission of the other.
7. Sharing of profit is not necessary in *Shirkat al-Milk* in ascertained property.
8. The division of usufruct or revenues of *Shirkat al-Milk* always follow the ratio of shares.

3.2.1.1.2 Rules of *Ijarah* (leasing)

The contract of *Ijarah* or leasing generally means to give something on rent[104] or it is a contract on usufruct in exchange for a particular consideration.[105] In Islamic law, the term

[102] Usmani, Op.cit, p. 31.
[103] See, Al-Sayid Sabiq, *Fiqhu al-Sunnah,* Cairo: Al-Fathu lil-A'lam al-'Araby, 2006, vol. 3 , p. 203 ; Imran Ahsan Nyazee, *Islamic Law of Business Organization-Partnership,* Islamabad: The International Institute of Islamic Thought and Islamic Research Institute, 1997, pp. 36-38.
[104] Usmani, Op.cit, p. 157.

"*Ijarah*" is employed in two divergent situations. First, *ijarah* signifies a condition in which a person employs the services of another (employee) on compensation given to him as a consideration for his hired services.[106] The employer is called *'musta'jir'* while the employee is *'ajir'*. Second, *Ijarah* which signifies the transfer of the usufruct of a particular property to another person in exchange for a rent claimed from him. This kind of ijarah is called as *ijarat al-ashya'*.[107] In this paper, the latter type of *Ijarah* would be preferably dealt with as it would have relevancy to the issue of *musharakah* in which the transfer of usufruct of a particular property is involved.

The rules and characteristics concerning *Ijarah* are mentioned below:[108]

1. In *Ijarah,* the owner of commodity transfers its usufruct to another person for a specific period in exchange for agreed consideration such as money.
2. The subject matter of *Ijarah* must be valuable.
3. The object and purpose of the contract should be lawful.
4. The subject matter will remain in the ownership of the lessor. Only its usufruct is transferred to the lessee.
5. All the liabilities arising from the ownership shall be borne by the lessor, but the liabilities referable to the use of the property shall be borne by the lessee.
6. The period of *Ijarah* must be defined in clear terms.
7. The lessee shall use the leased asset for the purposes according to the specified agreement in the lease contract.
8. The lessee is liable for any damages in the leased property due to negligence or any misuse on the part of the lessee.
9. During period of *Ijarah*, the lessor shall bear any loss caused by the factors beyond the control of the lessee.

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[105] See, Al-Mausu'ah al-Fiqhiyyah, Kuait: Wizarat al-Auqaf wa-al-Shuun al-Islamiyah, p. 252.
[106] This kind of Ijarah is called as *Ijarat al-Ashkhas.*
[107] See, Usmani, Op.cit, p. 157-158.
[108] See, Ibid, pp. 159-163 ; See, Mansuri, Op.cit, p. 231-235.; See, Mohammad Haafeez Arshad Malik, Op.cit, p. 128-129.

10. In case the property is jointly owned by two or more persons it can be leased out and the rental is distributed between all the joint owners according to the proportion of their respective shares in the property.
11. A joint owner of a property can lease his proportionate share to his co-sharer only, and not to any other person.
12. The rental must be determined at the time of contract for the whole period of *Ijarah.*
13. It is permissible that different amounts of rents are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of affecting a lease.
14. Unilateral increase of the rent is not permissible.
15. The lease period shall commence from the date on which the leased asset has been delivered to the lessee.
16. The property hired is a trust in the hand of the lessee.
17. Unlike sale, Ijarah can be enforced from some specified future date.

3.2.1.1.3 Rules of Bay'

Regarding the rules and principles of Islamic sale (*Bay'*), they have been previously mentioned while examining the contract of *murabahah lil-amiri bi al-shira'*. Hence, such rules would be also applied to identify the validity of diminishing *musharakah* transaction.

3.2.1.1.4 Ingredients of Diminishing *Musharakah*

These different rules and principles of each contracts –*shirkat al-milk, ijarah* and *bay'*- must be followed accordingly to render the contract of diminishing *musharakah* valid in the eyes of Islamic law. Keeping in view of these contractual ingredients and conditions, there are some specific requirements that must be adopted as to form a valid diminishing *musharakah* in the current Islamic finance. These are:

1. The contract is formed for the purpose of joint ownership in the property.
2. It is required that the capital is contributed by both contracting parties.
3. The financier gives his share to the client on rent.

4. The expense for repair, maintenance, insurance etc. are borne by both parties (Hanif and Hijazi, 2010)
5. The profit generated from the contract is shared according to the agreement while loss is shared according to the share in equity.
6. In modern *musharakah* practice, the client is required to make a unilateral promise to purchase the units of share of the financier.
7. The client purchases the units of share at different stages usually on installments basis.
8. The payment of the rental is adjusted gradually according to the remaining share of the financier available in the property.[109]
9. The purchase of each unit is made separately through different transactions in order to fulfill the requirements of sale in Islamic contract which takes place through a proper offer and acceptance.[110]

3.2.2.2 Application of Diminishing *Musharakah* in Islamic Financial Institutions

As mentioned earlier, the current practice of Islamic financial institutions propose a new form of *musharakah* which practically comprises three different contracts, viz. ordinary Islamic partnership (*Shirkat al-Milk*), Islamic leasing (*Ijarah*), and sale (*Bay'*). The combination of these multiple ingredients is called diminishing *musharakah* in the present operation of Islamic finance. AAOIFI defines diminishing *musharakah* as a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him.[111]

The application of this contract is, suppose, when a person wants to purchase a house without having adequate funds in his pocket, he then approaches the Bank to raise finance by making an Islamic partnership contract for purchasing the house. He further affords 30% of the house price as his initial capital and the 70% remainder is contributed by the Bank. In this

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[109] See, Usmani, Op.cit, p. 85

[110] See, Sadique, Muhammad Abdurrahman (2008), 'Financing Micro And Medium Sized Enterprises Through Decreasing Partnership (Mushārakah Mutanāqisah): Refining Sharī'Ah And Banking Aspects For Enhanced Applicability', Mohammed Obaidullah and Hajah Salma Haji Abdul Latiff (Ed.), Islamic Finance For Micro And Medium Enterprises, 2008, p. 59.

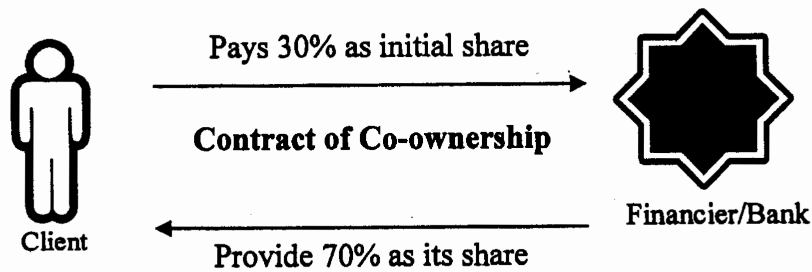
[111] AAOIFI, 2003, Standard on Sharika, Clause 2/1, p. 214.

case, the financier owns 70% of the property while the client owns 30% as his share. After the property has been acquired, the client has right to use the house for his benefit such as for his residence. Consequently, the client pays rent to the financier for using his share in the property. The payment of rent is calculated on the basis of units which have been divided from the financier's shares. Suppose that the share of the Bank is divided in to seven equal units, each unit presenting 10% ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, after the first term of three months he purchases one unit of the share of the financier by paying $1/10^{th}$ of the price of the house. It reduces the share of the financier from 70% to 60%. Hence, the rent payable to the financier is also reduced to that extent. At the end of second term, he purchases more another unit increasing his share in the property to 50% and reducing the share of the financier to 50% and consequently reducing the payment of rent to that proportion. This process goes on in the same fashion until after less than two years, the client purchases the whole share of the financier reducing the share of the financier to zero and increasing his own share to 100%.[112] In case the client is unable to make payment of rent within the agreed time, the financier shall firstly identify the reason why the client has been defaulted. If it is proven that there is no justifiable ground for the non-payment, the financier can impose financial penalty on the client which further must be distributed to a third party as charity. The amount of penalty is determined according to the period of default and may be calculated at percent or per annum basis.[113]

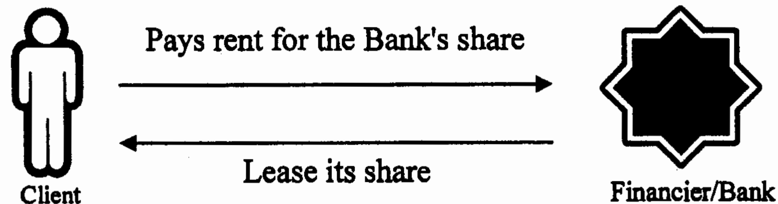
The following applications are enumerated to describe step-by-step the diminishing *musharakah* contract in providing finance to the clients:

1. The client approaches the Bank and enters into a partnership contract under the concept of *Shirkat al-Milk*[114] agreement to co-own the asset. For example, the client pays 30% of the property as the initial share to co-own the asset, whilst the Bank provides finance for the remaining 70% as its share.

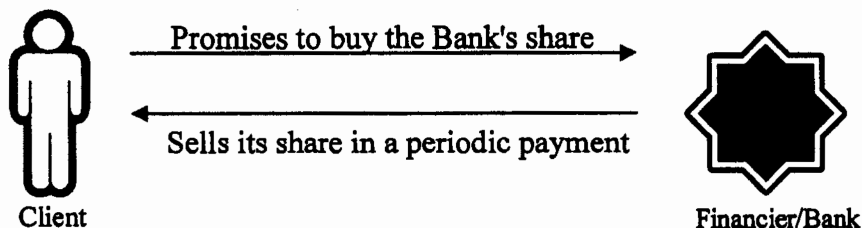
[112] See, Usmani, Op.cit, p. 82-83.
[113] Ibid, p. 172.
[114] Shirkat al-Milk is generally understood as joint ownership of two or more persons in a particular property.



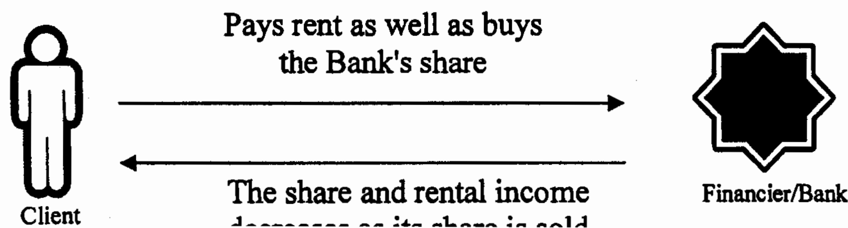
2. The bank further leases its share which is divided into a number of units as described earlier to the client under the concept of *Ijarah* (Islamic leasing) and accordingly the client pays rent to the Bank for the use of its share of the property.



3. At the same time, the client promises to periodically buy the units of Bank's share at an agreed portion until the property is fully owned by the client.



4. So the client provides the periodic payments in two parts; one paying a proportionate rental to the Bank based on the Bank's share of the property and the other is for equity contribution to purchase the Bank's share of the equity.



5. Gradually, over time, the client is able to buy out the Bank's share and thus acquires complete ownership of the property.[115] To demonstrate further, below is the practical application adopted by Al-Baraka International Bank, London with regard to financing technique of diminishing *musharakah*.

In Al-Baraka Bank, it presents The Islamic Trust Funding Agreement, based on decreasing *musharakah* with the client. The relationship between the client and the Al-Baraka Bank is based on joint ownership of the property and the Bank retains the right to rent its part to the client. The property is registered in trust for both parties according to his own share, usually 70% for the Bank and 30% for the client. Assume that the price of the property is Rs.100.000,-, the Bank share would be Rs.70.000 and that of the client Rs.30.000. The price of the property is divided into shares and the price of these shares would remain unchanged throughout the contract period. Each share is priced at Rs. 1, thus the al-Baraka Bank would own 70.000 shares and the client 30.000. The al-Abaraka Bank's shares are divided over the time period that was agreed upon and which could reach 20 years. The client must buy a certain number of shares and make payment monthly or quarterly. The client may buy any number of shares once he has the means to do so, while the Bank must sell its shares upon request. Thus, the Bank's ownership in the property decreases gradually until it ends up with the end of the period agreed upon or earlier as the case may be and the client holds full ownership of the property. The user's fees also decrease with the client's increasing ownership of the property until it vanishes with the end of the contract period. Total user's rights are assessed by adopting the ratio of financing in the real estate market as an indicator to reach the estimated value. The Bank's share is then calculated in accordance with its share in

[115] See, Iqbal and Mirakhor, Op.cit, p. 93.

ownership represented by the number of shares it holds. Since the Bank's ownership decreases annually, the user's fees are reviewed annually on the date when more shares are bought.[116]

The following is the practical application to demonstrate the operation of diminishing *musharakah*: Suppose the price of the house is Rs. 10,000,000 (ten million) and the client contributes 3,000,000 (30%) as his share, the remaining 7.000.000 (70%) is paid by the Bank as its share. This creates a combined client-to-bank ownership ratio of 30:70. After buying the house, it is leased to the client at yearly rent of Rs.100,000. It is further agreed that the client will buy 10% additional share from the Bank every year at a price of Rs.1000.000 (one million). Accordingly, the share of the client in the annual rent will increase and that of the Bank will decrease. So, on the basis of diminishing *musharakah* the client will pay on the following order:

Amount : 7,000,000 | Units : 7

Unit Price : 1,000,000 | Duration : 7 years

Yearly Rent: 100,000 | Facility : Diminishing *Musharakah*

Year	Client-to-Bank ownership ratio	Client's share in the rent	Bank's share in the rent	Purchase of units in ownership by the client	Payment made to the Bank
0	30:70	30,000	70,000	0	70,000
1	40:60	40,000	60,000	1,000,000	1,060,000
2	50:50	50,000	50,000	1,000,000	1,050,000
3	60:40	60,000	40,000	1,000,000	1,040,000
4	70:30	70,000	30,000	1,000,000	1,030,000
5	80:20	80,000	20,000	1,000,000	1,020,000
6	90:10	90,000	10,000	1,000,000	1,010,000
7	100:0	10,000	0	1,000,000	1,000,000

[116] Shaltut, Khalil (1995), 'The Experience of the Al-Baraka International Bank London in Financing real Estate", Mahmoud Ahmed Mahdi (ed.), *Islamic Banking Modes for House Building Financing*, Jeddah: Islamic Research and Training Institute, Islamic Development Bank, pp. 128-129.

3.2.2.3 Issues in Diminishing *Musharakah*

The followings are the issues arising from the contract of diminishing *musharakah*:

3.2.2.3.1 Combination of Contracts[117]

The question arises on the legal status of the various contractual relationships incorporated in a single transaction in the light of Islamic *Shari'ah*. It is presumed that the contract is like conducting several contracts each of which is made conditional to each other which is void in the eye of Islamic law.[118] However, it is argued that each contract is made independent and the client's promise to purchase does not contain clauses of condition on which the validity of another contract is depending upon. If the condition is mentioned in the promise then it will render the contract void. Therefore, the client's promise to purchase the Bank's share in units is made unilaterally and separately.[119] Regarding the legal status of unilateral promise, it has already been examined in the previous discussion. The issue of combination of contracts may be inferred from the *murabahah lil amiri bi al-shira'* as it adopts the concept of deferred payment which (*bay' al-mu'ajjal* in). Same reasons and grounds for the latter contract should be used accordingly.

3.2.2.3.2 Substitution with interest rate

Another issue is that the diminishing *musharakah* is deemed to be substituting the rental rate with the market interest rate. This behavior gives an amortization schedule similar to conventional financing. Actually it does not so. The different rental rate of diminishing *musharakah* is determined by periodically making review in the rental rate, such as every three to five years. The amount of rent for each phase –five years as the case may be- is clearly agreed upon at the time of affecting a lease contract. For example, when a client wishes to buy a house priced at 3.000.000, and he pays 20% of the price, i.e. 600.000, and the

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[117] Ibid, p. 58.
[118] That is based on the view that two sales in one contract is considered as *fasid* (unenforceable/irregular) contract as it amounts to uncertainty and defective consent and it is clearly prohibited by the Prophet s.a.w. that He prohibited two sales in one sale (See, Zuhaily, Opcit, p. vol. 4, p. 471.)
[119] See, Sadique, Op.cit.

financier provides finance the remaining 80%, i.e. 2400.000. Further the client wants to redeem the financier's share within 20 years and the rental is agreed upon to be 10.500 per month for the first 5 years, but would be reviewed to 10.800 for the next 5 years and 20.000 for the remaining 10 years. By following this formula, if the client pays 10.500 only every month, it would take more than twenty years to fully own the house. Therefore, some additional amount is required in order to completely redeem the share of the Bank within twenty years. On above example it shows that the rental payment formula may vary and subject to adaptation according to the prevailing rental rates. However, estimating the rental is somehow could prove burdensome and costly towards the client. Therefore, it is suggested that house price indices or the rental indices are preferably used to estimate the new rental rather than the service of independent real estate agents. This is to avoid bearing additional costs of the Bank side.[120]

3.2.2.3.3 Issue of varying property value[121]

Another criticism is concerning the value of the property which is subject to appreciation in value. If two parties (financier and client) co-own an asset and share its rental income, they should also share the asset's price appreciation because they are tied by the partnership contract. So it would be justified if the income is shared accordingly. For this, two points can be taken into consideration: first, the client, during the time of partnership, no full ownership is acquired. By the end of the diminishing partnership contract, only then he deserve any price appreciation as he has achieved full ownership. Secondly, an asset is subject to valuation only when there is a sale of the property which would involve the full transfer of ownership. During the *musharakah* contract, full transfer of ownership does not take place except the gradual transfer of ownership within the duration of the contract.

3.2.2.3.4 Early redemption, default and termination of contract[122]

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[120] See, Meera, Ahmed Kameel Mydin and Razak, Dzuljastri Abdul, *Islamic Home Financing Through Musharakah Mutanaqisah and al-Bay' Bithaman Ajil Contracts: A Comparative Analysis*, J.KAU: Islamic Econ., vol. 22 no. 1, p. 133

[121] Ibid, p. 130

There are three situations where the client plans to early terminate the contract. First is when he intends to settle up the payment and obtain the house before the completion of the agreed contract. Second is when the termination is due to death of the client and the last is when he intends to leave the house without any desire to own it such as in case of default. In case of the former, suppose, the tenor of the *musharakah* is agreed 20 years, but he intends to early redeem the house at the end of 10 years, the redemption amount will be based on the balance outstanding and revaluation of property is thus not required. However, the Islamic Bank can grant a rebate as discretionary measure to the client by reducing the amount of debt in subsequent transactions. As a discretion, it must not be mentioned in the contract otherwise it amount to prohibited interest.[123] In the second case, law of inheritance will be applied accordingly and this can be further mitigated through *Takaful* insurance policy. For the last case, a revaluation is required to offset the outstanding amount and the residual amount will be shared between the client and the Bank based on the prevailing profit sharing ratio. Suppose if the client is defaulter, the house will be sold in the market and the price will be divided between the client and the Bank after deducting all outstanding arrears, liquidation costs, etc.

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[122] See, Ibid, p. 131.
[123] Ayub, Op.cit, p. 290.

3.2.3 ISTISNA' (Order to Manufacture)

Istisna' is defined a sale by which a purchaser orders a manufacturer to manufacture a specific commodity (such as a house) for the purchaser. It is a kind of sale which differs from many other Islamic transactions as the subject matter is transacted before its existence. *Istisna'* is also used as mode of financing in housing sector. Generally, financing under the concept of *istisna'* can be conducted where the client has his own land but does not have sufficient fund to construct a house. Then he seeks financing from the Bank or any Islamic financial institutions for the house construction based on *Istisna'*. The Bank will construct for him a desired house as per agreement with the client. But if the client has no land, he can also purchase the land along with the request for house construction from the Bank.[124]

Practically, *istisna'* financing is conducted by two parallel contracts: the first contract is between the financier and the requesting client, and the second contract is between the financier and the contractor. The financier does not provide direct manufacturing to the client, but he establishes second contract with the third party (such as contractor) who actually manufactures or constructs the desired property –say a house, then sells it to his client. Upon the completion of the work, the Bank delivers the property to the client, and the client will pay -usually on deferred terms- the cost plus the profit fixed by the Bank either in installments or in full upon the completion of the house. The payment of price on installment basis by the client may start from the day when the contract of *istisna'* is signed by the parties, and may continue during the construction of the house and after it is handed over to the client. The financer can keep the title deeds of the house or land, or any other property of the client as collateral, until the client pays the last installment. The price difference is the profit of the financier. This model of modern *istisna'* is called parallel *istisna'* which is usually practiced in the Middle East countries (Hanafi and Kasim, 2006; Tameme, 2009). This mode of house financing is suitable specially for those middle and low income groups who own the land but cannot afford the construction cost. So, the desiring client can approach the financing body to build him a house according to certain specifications, in return for an agreed cost.

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[124] See, Usmani, Op.cit, p. 199.

The validity of *Istisna'* is based on the principle of *Istihsan* (public interest) in Islamic jurisprudence, and there is no bar in *Shari'ah* point of view as it provides benefits and promotes interest of the people in the commercial activities. It is reported that the Prophet (saw) had ordered someone to manufacture (*Istisna'*) a ring for him, likewise when he had ordered to manufacture a podium in a mosque.[125] Another ground is based on the maxim "The underlying principle in contracts and stipulations is the permissibility and validity until it is clearly proven being prohibited by the *Shari'ah*".[126] So, justifiability of the contract is based on the doctrine of freedom of contract since there is no explicit text from the Qur'an and Sunnah concerning the legality of the contract. In addition, the principle of *istihsan* which is based on need and necessity is relevantly applied in this context.[127]

3.2.3.1 Rules and Principles of *Istisna'*

The underlying principles of *Istisna'* can be described as follow:[128]

1. The elements of *Istisna'* are three: the contracting parties, the subject matter and the offer-acceptance.
2. The price is fixed and known to the party. It is permissible that the price of *Istisna'* transactions varies in accordance with variations in delivery date. The price, once it is determined, cannot be unilaterally increased or decreased.[129]
3. The subject matter or *Istisna'* is those things which need manufacturing or construction, and the items to be manufactured are specifically identified in clear term[130]. So the house is much suitable to raise finance under *istisna'*.
4. The contract of *Istisna'* creates a moral obligation on the part of the manufacturer to manufacture the goods, and the effect of *Istisna'* is binding upon the requestor if it is in accordance with the specifications agreed upon.[131]

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[125] Mausu'ah al-Fiqh al-Muasirah, Dar al-Wafa, 2005, vol. 2, p. 155.
[126] Taymiah, Ibnu, *Al-Fatawa al-Kubra*, Beirut: Dar al-Kutub al-Islamiyah, 1987, vol. 3, p. 474.
[127] See Al-Amine, 2001, for more detail regarding the legal basis of *istisna'* and the elaboration on the concept of freedom of contract in Islamic law.
[128] See, Usmani, Op.cit, pp. 195-196
[129] Ayub, Opcit, p. 265,
[130] Ibid, p. 264.

5. Any one of the contracting parties in *istisna'* can cancel the contract after giving a notice to the other as long as the manufacturer has not started the work.[132]
6. It is not the requirement on *istisna'* that the price is paid fully in advance.
7. The time of delivery is not essential in the contract of *Istisna'* but the client can put the maximum period of the manufacturing to be completed.
8. The manufacturer arranges both raw materials and the labour.[133]
9. The financier has dual capacities in the modern application of *istisna'*. He may act either in the capacity of a manufacturer or of purchaser. In the former, he constructs the property on his own and as for the later he orders the original constructor to manufacture a house and then purchase it for his client.
10. The financier can give or demand a security deposit (*'Urbun*), which may be considered as part of the price if the contract is completed, and can be forfeited if the contract is rescinded.[134]

3.2.3.2 Issues in *Istisna'*

3.2.3.2.1 Sale of Thing which is Non-Existent

The issue lays with the subject matter of the contract. The contract of *Istisna'* is basically a future trading where the subject matter of the contract is non-existent at the time of the contract. When the manufacturer is ordered to manufacture an object, he is considered to have promised to sell something which is non-existent and therefore prohibited in Islam. This legal suspicion is responded that beside the above valid evidences from the Sunnah, *maslahah, istihsan* and logical reasoning, in the contract of *Istisna'*, the jurists allow option of inspection (*khiyar al-ru'yah*) which is evidence of the fact that it is a sale as options are applied in contracts only, and not in promise. Furthermore, the involving parties also have

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[131] Majallah, clause 392. The basis of this seems to be the logical reason that if it is not binding while some huge expenses have been incurred, the system will collapse whereas it is held that repelling an evil will be preferred to securing a benefit.
[132] Ibnu Abidin, *Radd al-Mukhtar*, vol. 5, p. 225.
[133] Muhammad Ayub, Op.cit.
[134] AAOIFI, claluse 3/3/1, p. 182

right to resort to the court in case of any dispute arising from the contract, indicating that it is a contract of sale as litigation can be entertained in contracts which are binding on parties. [135]

[135] Mansuri, Op.cit, p. 207

3.2.4 BAY' AL-MU'AJJAL

The other popular terms referring to *bay' al-muajjal* is deferred sale, credit sale or *bay` bi al-thaman al-ajil*. It is defined as a sale contract in which the payment of the price is deferred and payable at a certain particular time in the future.[136] The legality of this contract is based on the consensus of the Muslim jurists on this contract. Further it is laid down by the Prophet that he bought a camel from his Companion, Jabir outside the city of Madinah whereby the payment was settled later on in Madinah. Also another *Hadith* was narrated that the Prophet purchased some foodstuff from a Jew on the basis of deferred payment and he pledged his armour by way of security.[137]

3.2.4.1 Rules of *Bay' al-Muajjal*[138]

1. The payment of price must be deferred to future time.
2. The amount of payment must be clearly fixed in the agreement.
3. The fixation of due time of payment can be made in particular date or by specifying a period, like one year, etc.
4. The commencement of the contract is started from the time of delivery unless the parties have agreed otherwise.
5. The amount of deferred price may be higher than the cash price provided that it is fixed at the time of sale.[139]
6. Once the price is fixed, it can not be decreased in case of earlier payment, nor increased in case of default.
7. In order to secure the payment of price, the seller may ask the buyer to furnish a security whether in the form of a mortgage or in the form of a lien or a charge on any of his existing assets.

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[136] See, Abu Ghuddah, Abdu al-Sattar, *Al-Bay' al-Mu'ajjal* 1 (A series of lectures), Jeddah: Islamic Research and Training Institute-Islamic Development Bank 2nd ed., p. 15
[137] Sahih Bukhari, Kitab al-Salam, Bab al-Kafil fi al-Salam, no. 2251.
[138] See, Usmani, Op.cit, p. 102.
[139] It has been discussed earlier in the issue of *Murabahah*

Beside these rules, there are some additional requirements of *bay' al-mu'ajjal* applied that must be followed by contracting parties during the operation, viz. the Bank may demand the client to sign a promise indicating his responsibility that he, in case of default, will donate some specified amount used for charitable purposes. In addition, the seller may ask the buyer to sign a promissory note or bill of exchange.

Following these rules and principles, house financing can be raised by the client approaching the financier who owns a home which he then sells to the client at a profit on deferred payment basis. Usually the price is made in installments[140] specified in the contractual agreement. If the financier specifies the profit margin instead of the actual cost incurred by him then the contract is considered as *Murabahah* though it still comes under the purview of the *bay' al-muajjal.*[141]

The matters above are the basic requirements of *bay'al-mu'ajjal* that must be met to have a valid contract. It is also understood that the emphasizing element in the *bay'al-mu'ajjal* is the existence of a deferred payment in a contract. Otherwise it would amount to a simple sale or prompt contract. However, the modern usage of Islamic financial institutions often combines several contracts in one set of transaction, such as *bay'al-mu'ajjal, musharakah,* and *ijarah* –though they are made separately for legal purpose- then they are named in a particular term as in diminishing *musharakah* or *al-murabahah lil amiri bi al-shira'*. This has been mentioned in earlier discussion. So, it may be said that the current practices of Islamic transactions by the name of *bay'al-mu'ajjal, musharakah* or *bay' al-murabahah* are probably an extension over their classical sense as they involve an agreed rate of return, rent as well as credit that are used consecutively in a single construction.

The issue in *bay'al-mu'ajjal* contract is pertaining to the practice of increasing the price due to the deferment in the payment. But it needs no further elucidation as it has been discussed earlier in the issues of *musharakah* contract.

[140] Theoretically, it can be made in lump sum as well.
[141] Usmani (1995), 'The Experience of the Jordan Islamic Bank in Financing Housing Projects', Mahmoud Ahmed Mahdi (ed.), *Islamic Banking Modes for House Building Financing*, Jeddah: Islamic Research and Training Institute, Islamic Development Bank, p. 63.

3.2.5 IJARAH (ISLAMIC LEASING)

In the earlier section, *ijarah* has been discussed sufficiently in respect of its general definition as well as the basic principles that shall be fulfilled for conducting ijarah *contract.* In that situation the *ijarah* is a part of the elements compounded in one set of modern transaction called 'diminishing *musharakah'*. Now the relevant matter in this discussion is to independently examine the possible mode of house financing on the basis of so called *ijarah muntahia bi-al-tamleek* (leasing with transfer of ownership) which is basically derived from the classical ijarah in its origin. But it slightly differs when it is used as a mode of financing in the current practices in Islamic financial institutions.

The *ijarah muntahia bi-al-tamleek* is defined as a lease that concludes with the legal title of the asset is transferred to the lessee upon the completion of the lease. Suppose, the user (client) leases the property from the owner (Bank/financier) at an agreed rental over a specified period, upon expiry of the leasing period, the user enters into a second agreement of transferring the ownership of the asset from the owner at an agreed price. Thus, it is purely *ijarah* at the beginning of the transaction. So all rules pertaining to *ijarah* in the classical sense of Islamic *fiqh,* are taken into consideration. To that extent the contract is not a sale contract –which transfers the ownership of property- but it is merely transfer of usufruct for a specified period against some agreed consideration. But, when the contract is incorporated with some additional element entailing the transfer of a leased asset from the lessor to the lessee, then the *ijarah* contract has been modified into a mode of financing which requires some other necessary principles and rules to be taken into account. As the modern application of *ijarah* is a modified form of the classical *ijarah*, it has attracted some criticisms from many Muslim scholars questioning its validity.

3.2.5.1 Application of *Ijarah* for Housing Finance

In order to have clearer understanding about the practice of the contract, the followings are general procedures by which the house financing is conducted through *ijarah muntahia bi-al-tamleek*:

1. Initially, like in the case of *murabahah* contract, the client approaches the Bank for requesting the contract of lease.
2. In such contract, a master agreement (undertaking agreement) may be signed by both the client and Bank setting out the general terms and conditions of the *ijarah* contract which are considered as the offer and acceptance.[142]
3. Similar to *bay' al-mu'ajjal*, the Bank can demand the client to furnish a security in the form of money in order to assure the commitment of the client.[143]
4. The Bank purchases the property for a lease and obtains the title of ownership from the vendor.[144]
5. After acquiring the ownership of the property, the Bank leases the asset to the client pursuant to the lease agreement.[145]
6. The client makes periodic rental payments as per the contract[146] and the rental must be specified either on a lump sum or installments basis and is started from the time when the lessee starts to benefit from the asset or once the lessor makes the usufruct of the asset available and usable to the lessee.[147] Moreover, the rent paid by the client can be reviewed in periodical phases, like on yearly basis, as also been discussed earlier.
7. At the completion of the tenure, the client acquires full ownership of the leased property by purchasing the asset from the Bank with the help of separate sale agreement. In this regard, AAOIFI provides three possible ways of transferring the ownership of the leased asset, i.e.:
    a. By a promise to sell for token consideration or other amount as specified in the lease.
    b. By a promise to give it as a gift.

[142] See, AAOFI (2003) Standard on Ijarah, Clause 2/3, p.139
[143] Ibid.
[144] However, the leased property is either possibly owned by the lessor (Bank/financier) him self or third party from whom the client wishes to take on lease (see, AAOIFI, 2/1). If the property is owned by the financier then it would be no question regarding the ownership of the property, the financier being lessor can directly execute an *ijarah* contract to his client without prior process of acquiring ownership from a third party.
[145] See, Ibid, 3/1 (b), and this is to comply the requirement of *ijarah* that the property shall be in the ownership of the lessor as mentioned in the earlier issue.
[146] Ibid, Caluse 5/2/1.
[147] Ibid, Clause 5/2/2.

c. By a promise to give it as a gift, contingent upon the payment of the remaining installments.[148]

d. By legal transfer of the title in the leased asset to the lessee at the end of the lease.

By complying the above elements most of the Islamic financial institutions is considered to have granted finance to their clients on the basis of *ijarah muntahia bi-al-tamleek.*[149]

We may take an experience of Dubai Islamic Bank (DIB)[150] and Ahli United Bank of UK (AUBUK) to have a practical example. The following procedures are summarily used by the DIB for granting finance in housing sector under *ijarah* contract:[151]

1. When the client approaches the Bank for a contract of *ijarah muntahia bi-al-tamleek*, he is required to sign a promise that he will lease from the Bank.
2. Upon that promise, the Bank purchases the property in its own name so that the Bank becomes the sole owner of the property.
3. After the property is owned, it leases out to the client according to *ijarah* agreement.
4. At the end of the lease period, the purchasing cost and profit is recovered and then the Bank transfers the ownership of the property to the client.
5. The transfer of the ownership in the property can be conducted either by way of sale or gift made in a separate contract at the end of the lease period.
6. The payment of rent is reviewed on annual basis and in AUBUK it is clearly mentioned that the basic rent will never be higher than 3.50% above 12 month Bank LIBOR.

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[148] See, Ibid, Clause 8/1.

[149] Faruq Ahmad, Abu Umar, *Theory and Practice of Modern Islamic Finance: The Case analysis from Australia*, Florida: Brown Walker Press, 2010, p. 214.

[150] DIB is the largest Islamic bank in the United Arab Emirates (UAE), situated in Dubai which was established in 1975 as the world's first full-service Islamic banking and also presumed to have adopted the Shari'ah principles in all of its financial practices.

[151] See, http://www.dib.ae/en/realestate_lease.htm, taken on May 4, 2010.

7. Beside these principal rules, some other relevant matters regarding additional terms and conditions which the client shall follow as his rights and liabilities such as the possibility to refinance, the minimum down payment that shall be furnished, making full payment at any time, and other necessary fees such as solicitor fees, stamp duty land tax fee, valuation reports and survey fee, and building insurance fee.[152]

3.2.6 INTEREST FREE LOAN (*QARD AL-HASAN*)

In this mode, house financing is conducted under principle of cooperation or benevolent act and for the sake of Allah. *Qard al-hasan* has been practiced in some Muslim countries such as in Egypt and the Muslim community in India usually in the form informal set-up or organization (Tameme, 2009). By this model, the client gets loan (*qard*) for purchasing property from organization on condition that the loans will be returned to the original owner (organization) without charging any interest. He will pay only the actual amount he borrowed from the lender. Though *qard al-hasan* on housing finance is highly encouraged in Islamic *Shari'ah* as alternative to the interest-bearing mortgage, however, it does not serve much consideration from modern IFIs. That is a logical phenomenon as the arrangement can not generate any profit for the Banks whereas the profit is commonly considered as primary concern for any financial institutions. Therefore, such particular type of house financing will not be discussed further as this paper will focus on such instruments which are mostly practiced in Islamic financial institutions.

3.2.6 FEATURES OF ISLAMIC HOUSE FINANCING

After we know the possible modes of house financing in the current practices of various Islamic financial institutions, we shall come to know that Islamic mode of house financing reflects at least the following features:

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[152] See, the leaflet of AUBUK in Risks and Features of This Home Purchase Plan downloadable at http://www.iibu.com/buy_home/ijaraforms.aspx

1. **Riba-free based financing**

Islamic financing is based on the rules of Islamic law which prohibits indulgence in *riba* as already discussed previously in the chapter of the characteristics in Islamic financing. Therefore, during the operation of housing projects, the Islamic financial institutions provide interest-free financing model irrespective of the various types of products they may offer. Though there are probably a number of particular issues arising out with regard to the legality of current Islamic transactions, generally all are still unanimous with regard to the prohibition of *riba* in any contract. The issue on *riba* is always the main feature that differentiates Islamic Banks from its conventional counterpart.

2. **Different techniques of contract.**

It has been already discussed that there are various ways by which Islamic Banks grant house financing to the clients. It may be in the form of *murabahah, musharakah, istisna', ijarah, bay' al-mu'ajjal,* or special kind of contract which is an extension of the classical sense. Each contract is different from the other which adopts different rules and conditions under Shari'ah provisions. This unique design provides the flexibility and feasibility to the contracting parties to meet their wants according to their possible circumstances. This special feature is also not found in the conventional house financing, rather than the client is granted a loan with interest and freed to choose what kind of housing technique to be used.

3. **Asset-backed Financing.**

The good characteristic of Islamic financing is that the project is always based on such a commodity that creates real assets and inventories. Therefore, the Islamic house financing provides sound operations that promote the creation of real assets by generating profits through renting out or sale of property. In the case of *murabahah,* financing is affected through purchasing specific real asset such as a house from a developer and selling it to the client on mark-up basis. In case of *istisna',* it involves manufacturing the real asset. Similarly, in case of *musharakah, ijarah* and *bay' al-mu'ajjal,* all of which are an asset-backed financing. On the contrary, the conventional

house financing is based on interest-bearing loan which is basically not related to creating any real asset.

4. **No Absolute contract.**

It means that the Islamic contracts which are prescribed by the Muslim jurists in their remarkable works of Islamic *fiqh* are valid and useful in the context of Islamic transactions. But, this is not in the absolute sense as the Islamic contracts are subject to modification and adaptation in order to properly meet the newly emerging circumstances of modern era. The above different techniques of Islamic house financing are sufficient example that in those contracts, proper legal modification and adaptation have been carried out by the Muslim scholars. The contact is not purely as understood in the sense of classical point of view but adjusted to be applicable in accordance the needs of the people. For instance, in case of *murabahah lil-amiri bi-al-shira',* or diminishing *musharakah,* etc, several contracts have been involved to cater for various financial needs of the client. The result is that such contact deserves different names though they are combined in one set of transaction. The *murabaha lil-amiri bi-al-shira'* can be named as *bay' al-mu'ajjal* as it uses deferred payment. Likewise diminishing *musharakah* can be said *ijarah muntahia bi-al-tamleek* as there is a leasing ending with ownership in the contract, etc. If we observe the classical books of Islamic law, this never happens.

5. **Flexibility of Islamic transaction.**

Another derived conclusion is that there is flexibility of the Islamic contracts in order to meet the changing circumstances of modern economic atmospheres. This flexibility leads to the emergence of various new modified contracts that compatible with the current situations of financial markets. *Ijarah*, obviously refers to a simple transfer of usufruct against some consideration in a specified period, but currently the Islamic Bank uses it as one type of financing technique incorporated with the sale agreement at the end of the contract. In current *murabahah* too, the practice is actually a simple sale with a fixed profit margin which originally does not amount to a mode of financing. It has been modified in a manner that it can be used as a mode of financing

to meet the needs of the people. Similarly, another various modern Islamic transactions are subject to innovative adaptation from their original sense so that they are still practicable in the modern situation. The underlying factor of this jurisprudential development emanates from the methodology of *Shari'ah* in the field of transactions (*mu'amalat*) that unlike the matters of *'ibadat* (worship) which have been discussed in detail by the *Shari'ah*, the matters relating to *mu'amalat* have been deliberately dealt with in general terms.[153] Moreover, it shows there is an Islamic maxim from the Muslim jurists saying that "In *mu'amalat,* anything is permissible until and unless there is a clear evidence which indicates its prohibition". The wisdom behind this is that they are subject to modifications and flexibilities by way of legal reasoning along with the observation of the surrounding-affecting situations. However, by realizing this flexibility, the Muslims are bound to follow the basic and fundamental principles which have been regulated by the *Shari'ah* tenets.

6. **Integration of Divine laws and Human reasoning.**

Islam, instead of consisting of complete code of life, is a balanced system and principles. The absolute Divine laws brought by the Prophet in his holy Qur'an and Sunnah are dealt with by deep reasoning of Muslim jurists so that it provides a compatible set of rules in regulating all matters pertaining to human life. The main objective of such fantastic work is to realize the objectives of the Shari'ah that are firmly for the benefit of all humankind. The Divine laws and teachings can not serve their purposes without the involvement of human reasoning called as *ijtihad* (legal reasoning to make a legal decision), similarly the humankind, by its nature are free to use their thinking and reasoning, can not be let freely to create a legal judgment according to their subjective wants and logics. Therefore, the integration of Divine laws interacted with the legal reasoning by the competent individuals are a must in order to establish a balanced system compatible with the human conducts and affairs. This integration is not met in the conventional system as it bases on only the human

[153] See, Mansuri, Op.cit, p. 3.

reasoning which is subject to inconsistency, changeability, subjectivity and likelihood that very often it has been proved to be deficient in its nature as well as its implementation.

3.3 CONVENTIONAL HOUSE FINANCING

3.3.1 Application of House Financing in Conventional System

After sufficiently discussing the various Islamic modes of house financing, what remains further to be discussed is regarding the practices of conventional housing finance which is commonly known as a conventional mortgage. The financing process in conventional system differs from the previous Islamic housing mode though the end point of the two is alike, i.e. obtaining finance and the ownership of house. As very previously highlighted, the basic understanding of conventional mortgage is taking a loan out from a lending entity to buy a home. For instance, in conventional mortgage allows an individual (borrower) to purchase a home worth Rs. 2 million even though he himself has far less money than that to put toward the purchase. In such case, the client who desires to own home and raising finance from conventional Banks shall follow rules and requirements which sometimes are identical to Islamic mode of housing finance, but to some other extent are different in respect of principles applied.

The followings are general practices used in conventional housing finance:

1. The initial step is not much different with the Islamic mode of finance. The desiring client inspects the house which he deems suitable for finance. So, the client must firstly know the developer of the house. Usually the developer may suggest the client to raise finance from any particular Bank which has mutual cooperation between the two (Bank and developer).

2. He approaches the Bank for obtaining finance. At this stage, the client is required to provide all necessary data and information about his personal situation (documentation). This includes filling form related to financing and providing all necessary particulars such copy of ID, his monthly income, accounts, collateral deeds,

etc which the Bank considers required. Such procedure is an initial process taken by the Bank (as a lender) in determining the client's eligibility for finance.[154]

3. A step further is acceptance of the Bank. Upon being convinced with client's financial and personal creditworthiness, the Bank grants a loan on interest basis. The Bank usually grants loan if the client has approximately 20-30% out of the total house rate. However, this limitation differs among different Banks as it depends on their own policies implemented in the institution.[155]

4. If the Bank accepts the proposal of the client, it will set rules, applications and agreements of the finance which includes the methods of payment, interest rate, maturity of loan and any other characteristics related to the contract.

5. If an agreement is reached by both Bank and client, house finance will be conducted accordingly following the term and condition of the loan prescribed by the Bank.

Those are the general view with regard to the practices of conventional housing finance in financial institutions. However, the Bank will conduct certain means in accepting the proposal of the client. Similarly, the application of finance also follows certain rules and principles on which the client must follow for obtaining finance. The following matters are well defined by the financial institutions while the client raises a housing finance:

1. Initial Process Regarding Creditworthiness of Client

As highlighted before, at initial stage the Bank will carefully study the details of the client to determine his creditworthiness in obtaining the facility. Instead of fulfilling procedural documentation, the client is subject to the credit assessment to indicate his/her ability to perform payment of the loan. It includes source of client's income, net worth, any past dealings with the Bank and other financial institutions, available collateral, credit report, and any information acquired through any relevant credit

[154] See, Hardjono, Suzanna, *Mudah Memiliki Rumah Idaman Lewat KPR (Easy to Own Ideal Home with Credit Home Ownership)*, Yogyakarta: Pustaka Grhatama, 2008, p. 27 ; See, Rini, Mike, *Mewujudkan Rumah Idaman* (Realizing Ideal Home), Jakarta: Elex Media Komputindo, 2006, pp. 116-118.
[155] See, Ibid.

rating agency.[156] Credit score of the client is also used by most of the Banks to determine the creditworthiness of the client. The better the credit score the client has, the better the rate he can get on a loan.

2. **Size of loan and Down payment**

Down payment (DP) is also demanded by the Bank as requirement to be furnished by the client. DP is defined as a portion of a home's purchase price which is not part of the mortgage loan. Its value varies from one Bank to another depending upon the discretion of the Bank in determining the loan-to-value ratios (LTVs)[157]. However, 20 percent of the property's purchase price is considered as the nominal standard of down payment for it is sufficient amount to protect the Bank form client's default. Standard Chartered Bank in Pakistan grants loan up to 60 percent of the property value[158] indicating the minimum down payment required is 40 percent of the property value. In MCB, the debt equity ratio applied is 70:30 showing the facility of 70 percent loan can be extended to a prospective client.[159] However, there is possibility of paying down payment of less than 20 percent on condition that the mortgage is insured[160] under private mortgage insurance (PMI)[161] as it commonly practiced in western states such as USA. Home loans with down payments of less than 20 percent are called "low down payment mortgages".

3. **Term of Mortgage.**

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[156] In Pakistan, such information can be obtained from Credit Information Bureau (CIB), an organization that collects credit data on clients/borrowers for financial institutions in the form of credit reports for the purpose of credit assessment, credit risk management and credit scoring. This database enables the financial institutions to ascertain the financial creditworthiness of a person through his credit history so that it would enable them in making a more prudent decision for granting loan (See, *Understanding Credit Information Bureau Consumer Awareness Program*, taken form http://www.sbp.org.pk/bsd/CIB_Awareness.pdf, 25 June 26, 2010).

[157] LTVs is a limit which is used to determine the percentage of the share in a mortgage against the value of the security. eg. If a house is worth Rs.1 million, and the mortgage over the property is Rs. 700,000 then the LTVs is 70%.

[158] See, http://www.standardchartered.com/pk/personal/loans-mortgages/en/home-purchase.html, 25 June 26, 2010.

[159] See, http://www.mcb.com.pk/psc/loans/pyara_ghar.asp, 27 June 2010.

[160] See, Tyson, Eric and Brown, Ray, *Home Buying for Dummies,* Hoboken; Wiley Publishing, Inc, 2009, 4th Edition, pp. 58-59 ; O'Hara, Shelley ; Bluestein, Maris, *The Complete Idiot's Guide to Buying and Selling a Home*, Indianapolis: Penguin, 1994, p. 10.

[161] PMI is private mortgage insurers whose function to protect lenders against loss if a borrower defaults. In commonly practiced in United States which refers to insurance payable to a lender (Banks) that is required when taking out a mortgage loan with less than 20 percent down payment.

House financing is considered as long term finance. Most of conventional Banks usually grants loan on housing within the term of 15 years but to some Banks it is up to 30 years depending upon the retirement age of the borrower.[162] The advantage of a longer term of finance is that is has lower payment of installment born by the client than that of less term, but the interest rate would be higher on the longer term of finance because the longer-term loans are a little more risky for the lending Banks.[163]

4. Interest rate.

The interest rate which is charged on housing loan is of two types: *fixed rate mortgages* and *adjustable rate mortgages*. The fixed rate mortgage is interest rates that are fixed (unchanging) during the whole term of the loan while the adjustable-rate mortgages (ARMs) is floating rate that varies (or adjusts) depending upon interest rate in the market. The interest on fixed rate mortgages stays the same, and the monthly mortgage repayment amount never changes. As for ARMs typically adjusts every 6 to 12 months, but it may change as frequently as every month.[164] The proportion of ARMs varies from country to country. In western countries such as United States, France, and Germany, the majority of mortgage interest is fixed rate. While in countries such as Spain, Australia, and United Kingdom follows adjustable rate (Rubio, 2009; Scanlon and Whitehead, 2004). However, instead of these two models, there is third kind of interest rate called as "intermediate ARMs" which is the combination of fixed rate and ARMs named as hybrid loans. In hybrid loans, the initial rate is fixed for a specified period such as two to three years but afterwards the rate is converted to floating rate (ARMs).[165] Further, in ARMs, it may be a *capped*

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[162] See, Ben-Shahar, Danny, Leung, Charles Ka Yui and Ong, Seow Eng, Mortgage Markets Worldwide, Chennai: Blackwell Publishing Ltd, 2008, p. 50.
[163] See, Tyson and Brown, Op.cit, p. 108.
[164] See, Ibid, pp. 96-97
[165] See, Ibid, p. 101; See, Ben-Shahar, Leung, and Ong, Seow Eng, Op.cit, p. 50.

rate which limits the minimum decrease (called as interest rate decrease cap) and maximum increase of the interest (called as interest rate increase cap).[166]

5. **Mode of repayment** (Milevsky, 2001)

Essentially, the followings are the ways how the mortgage repayment is conducted:

a. The payment is made in accordance with the term of finance obtained by the client. The duration of paying off the loans is determined by the period of time during which the mortgage agreement is made, for instance 15 or 30 years term of loan. The longer the period it takes the higher the interest rate will apply but fortunately the lower the payment will pay.

b. The monthly payments will cover both the interest charged and a part of the principal loan. The interest rate, as noticed before, is either fixed, variable or hybrid rate which will affect the amount of repayment. The greater the size of loan the higher the interest rate and the larger the monthly payments will be. However, there is also *interest-only mortgage* mode in which the monthly payments require only the interest charged for a specific interval such as two years then after the interest-only period ends, the monthly payments jump to cover both the interest and the principal.

c. The payment is made usually on monthly installment basis following the amortization period agreement.

d. In short, the whole practice of conventional mortgage is that the client initially receives a lump sum cash of loan and then repays it in installment including both the interest and the principal.

6. **Late Payment Penalty**

Risk of late payment is differently ruled by conventional housing finance. Usually, the lending institution gives grace period for the defaulting borrower to pay of the loans.

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[166] See, Guttentag, Jack, *The Pocket Mortgage Guide - 60 of the Most Important Questions and Answers About Your Home Loan,* New York: McGraw-Hill, 2004, p. 42.

The grace period is commonly 15 days during which the late payment is to be paid off without charging any penalty. So the agreement between the lender and the borrower shall clearly disclose matters regarding the failure of borrower in furnishing his loans. In this case, when the defaulting act is established, the lending Banks may impose late fees as a penalty on the delinquent borrower. The late payment also affects the creditworthiness of the borrower which will be recorded in his credit history. To some institutions, late payments may directly lead to sale of the property which is exercised after proper notice from the lender.[167]

7. Collateral

The client is usually required to post collateral as security to mitigate risk of default. In house financing, the mortgaged property which the Bank considers it potentially marketable may be considered as collateral itself[168] and it may be in the form of other precious property like gold.[169] In case of default, the Bank may foreclose the said asset to redeem the outstanding debts.

8. Prepayment Penalty

Some mortgages come with a prepayment penalty clause for early repayment before the end of the loan term by the client. Such penalties can amount to as much as several percentage points of the amount of the mortgage balance that's paid off early. The early payment is obtained for some reasons such as due to want of selling the property or refinance the loan to take advantage of lower interest rates.[170]

9. Insurance

Insurance coverage is almost required by the lending Bank in granting loans to its borrower in the form different insurance coverage applicable. It might be life

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[167] See, *Principles of Mortgage Financing,* Toronto: MediaLinx Printing Group, 2009, p. 379

[168] The collateral in the form of property financed is commonly used in most of the developed countries specially in the US in their the current practices of mortgage loans.

[169] See, Ben-Shahar, Leung, and Ong, Seow Eng, Op.cit, p. 42.

[170] See, Tyson and Brown, Op.cit, p. 100.

insurance, disability insurance, job loss insurance, etc.[171] Generally, property and life insurance are required by the mortgage lenders[172]. It differs from lenders mortgage insurance (LMI) which is sometimes called mortgage default insurance and required to those borrowers whose down payment is less than 20 percent as already mentioned before. The LMI is required as a credit risk management tool that protects lenders from losses due to default of a borrower. Hence, in case the borrower defaults on a mortgage and the foreclosure money is not sufficient to cover the losses, the lending institution can request the mortgage insurer to recover thelosses.

10. Other Variant Characteristics

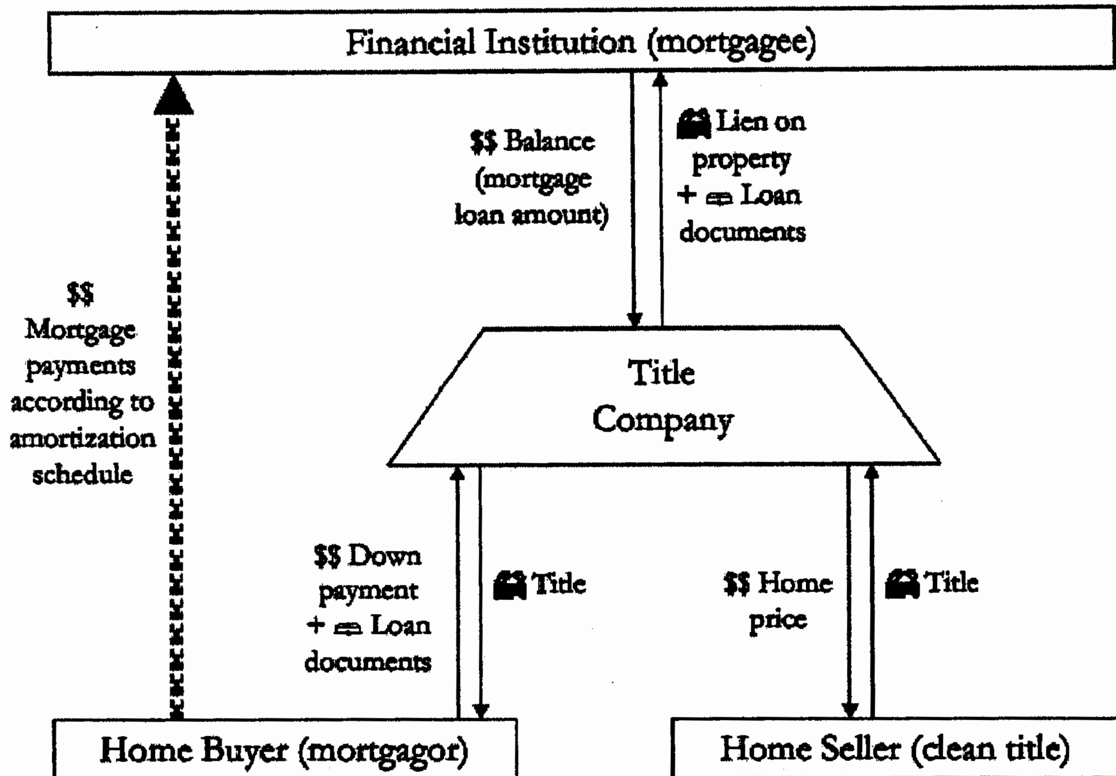
The above matters pertaining to house financing are the essential parts in which most of conventional institutions have in their housing finance facility. However, as similar to Islamic house financing practices, there are some other characteristics which can differ from one institution to another. These are because of different localities, situation and legal frameworks of a country which may form different applications and financial discretions. For example, form of insurance used to mitigate credit risk may vary in its form in different countries. Some countries provide state guarantee insurance some may use only private insurance. Regarding the detailed practices of different practices and characteristics in conventional housing system in several countries may refer to Scanlon and Whitehead, 2004.

The following figure will illustrate an example of some of the conventional mortgage transaction as conducted in many states in the US:[173]

[171] See, Ibid, pp. 281-282; See, *Principle of Mortgage Financing,* Toronto: Real Estate Council of Ontario, 2009, p. 30.

[172] See, Iqbal, Munawar and Llewellyn, David T., (ed.) *Islamic Banking and Finance - New Perspectives on Profit-Sharing and Risk,* Cheltenham: Edward Elgar Publishing Limited 2002, p. 199.

[173] See, El-Gamal, Mahmoud A., *Islamic Finance - Law, Economics, and Practice,* Cambridge: Cambridge University Press, 2006, p. 3.



For instance, from above figure, the client initially pays 20% down payment plus closing cost to the title company and the latter simultaneously collected the remaining 80% from the financier (Banks etc) and subsequently issued a cheque to the seller for the sale price. The client then signed the mortgage loan documents and agreement promising to make mortgage payments according to the agreed upon amortization schedule. Finally, the client received the title of property while the financier still obtained a lion thereon that restricted the client to sell it without permission of the financier. However, the client had the option to prepay the balance for early termination of financing charges.

3.3.2 Case of Subprime Mortgage at Glance

In this chapter, I would like to reveal an example out of conventional house financing systems commonly known as subprime mortgage which has been widely practiced in the

United States[174] and had drawn a lot of attention in recent years due to a credit crisis. It is comprehensively detailed by Barth, 2009 in his book "The Rise and Fall of the U.S. Mortgage and Credit Markets" which I will summarily present only its involved practices and matters that relevant to this research. However, I would bring some pertinent issues from other sources that will relevantly complement the information of the matter.

3.3.2.1 Subprime Mortgage Defined

Subprime mortgage is defined in many ways but generally means a type of loan made to a borrower with poor credit history or/and with a high leverage as measured by either debt-to-income ratio or the loan-to-value ratio (Frame, Lehnert and Prescott, 2008). The credit history is measured through FICO score ranges from a low of 300 to a high of 850. The higher the scores the greater creditworthiness will be; the borrowers with FICO scores above 620 are considered as prime borrowers who can avail mortgage products with less interest.[175] On the other hand, the borrowers with low credit score of less than 620 are called subprime borrowers and will be charged with high interest rate. The benefit of subprime mortgage for the borrowers is that it provides opportunity for homeownership for those who are not qualified for a normal mortgage due to weak financial conditions. But on the contrary, it bears higher risk for the lenders as the borrowers are more risk-associated with defaulted loans.

3.3.2.2 Application of Subprime Mortgage

The mortgage started when the buyers are not able to make the full price of a home all at once, so they raise loan from financial institution for purchasing the property. Given the possibility of obtaining mortgage loan, many subprime borrowers make loans from the

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[174] The total origination of subprime mortgage in United States reached an annual volume of over $600 billion in 2005-2006 representing 20 percent of the total annual mortgage originations (Jaffee, 2008)

[175] Barth, James R. et.al, *The Rise and Fall of the U.S. Mortgage and Credit Markets - A Comprehensive Analysis of the Market Meltdown*, New Jersey: John Wiley & Sons, Inc., 2009, P. 43

mortgage lenders[176] for obtaining the mortgage facility (purchase of house). As the loans are possibly granted to those of bad credit borrowers, the mortgage lenders set different terms and conditions in the mortgage agreement to be followed by the subprime borrowers. These terms and conditions refer to determining higher interest rate and some other consequences with regard to subprime loans as follows:

1. **Relaxed Underwriting Criteria:**

In US subprime mortgage practice, following the housing market boom and to maintain the volume of business by expanding more new loans to more borrowers, the requirement underwriting standards were relaxed during the period of 2003- 2006. 38 percent of subprime loans had a combined LTV of 100 percent and half of all subprime loans had low or no documentation of borrower income or assets (NINJA loans). The lenders rely more on the rising value of collateral to secure the loan than the borrower's ability to repay from income.[177]

Furthermore, in case of credit rating, as common practices, the borrowers are examined to determine their creditworthiness in obtaining loans. In this process, the mortgage lenders use FICO credit score to judge that the borrowers are subprime. FICO uses the following five criteria for making credit score:

- Payment history 35%
- Amounts owned 30%
- Length of credit history 15%
- New credit 10%
- Type of credit in use 10%

This is the formula the FICO uses in determining the subprime borrowers. However, it has been criticized that it ignores certain necessary factors on which the creditworthiness of a

[176] Subprime lenders are those financial institutions that specialize in lending to subprime borrowers such as HSBC Finance, Countrywide Financial, CitiMortgage, etc.
[177] See, Barth, Op.cit, p. 92

borrower can be ascertained, that is regarding salary and employment history.[178] As stated earlier, a credit score of below 620 is considered as subprime and above is referred to prime borrower. In subprime lending, the subprime borrowers are enabled to make loans on mortgage but they are obliged to pay higher interest rate because they present a higher risk for mortgage lenders and therefore subprime mortgages treat them differentially by charging interest rates above the prime lending rate (prime borrowers).

2. **LTV Ratio:** Loan-to-value LTV and down payment depict correlated facts. LTV ratio is the outstanding mortgage balance as a percentage of the price of the home, while the remainder of the percentage of the LTV is considered as down payment. The size of down payment relates to the LTV ratio the lenders extend and will affect the interest rate in a mortgage. As the down payment gets smaller, the LTV goes up and vice versa. The borrowers are normally required to pay some amount of cash down payment to avail mortgage facility. The minimum standard limit of down payment is 20 percent[179] in most of the countries, but in subprime mortgage, the LTV ratio is possible up to 100% the lender can afford which leads to fewer down payments and gives more benefit for the less-credit borrowers. However, the less the down payment can be afforded by a borrower the more interest rate will be charged. For example, a borrower with a same credit score and down payment 30% would be charged a 5.65 interest rate less than another borrower with down payment 10% will be charged a 7.50 interest rate.

3. **Payments:** the subprime loans require both the upfront and continuing costs which are higher than prime loans. Upfront costs include application fees, appraisal fees, and other fees associated with originating a mortgage. While the continuing costs include the payment of mortgage insurance, principle and interest payments, late fees and fines for delinquent payments, and fees levied by a locality (such as property taxes and special

[178] See, Ibid. 44; The details about FICO score can be read in *Understanding Credit & Credit Risk Scores* available at http://www.rels.info/resources/UnderstandingCreditCreditRiskScores.pdf

[179] See, Irwin, Robert, *Tips and Traps When Buying a Home*, United States: McGraw-Hill Professional, 1996, 2nd ed., p. 28

assessments).[180] The payment mode follows the type of instrument the subprime borrower takes which is determined by the different types of interest rate such as ARMs, FRMs or Option ARMs, etc all of which will be explained below.

4. **Interest rate**: The lenders typically offer two types of interest; fixed rate and adjustable-rate mortgages (ARMs). But most of the subprime borrowers opted for hybrid ARMs over fixed rate mortgages because the typical adjustable rate on a home mortgage is initially set below fixed rates.[181] However, when their mortgage interest is reset to the higher variable rate, mortgage payments increase drastically which then leads to the credit defaults in most of the subprime mortgage in US. Many borrowers get benefit from ARMs during periods of declining interest rates and they avoid ARMs during periods of rising interest rates.[182] To slightly demonstrate this type of mortgage loan, there is commonly known as 2/28 and 3/27 model applied in hybrid ARMs. The first type of loan charges low fixed interest ("teaser") rates for two years, then reset semiannually or annually to an index value plus a certain margin (subject to periodic and lifetime interest rate caps[183]) during the remaining 28 years of the loan. Similarly, the 3/27 hybrids offered initial fixed rates for the first 3 years and then reset to higher variable rates for the remaining 27 years of the loan. There is also so called *option ARMs* by which the borrower is offered flexible payment options during the initial period, each month the borrower can choose a low minimum payment, an interest-only payment, or a fully amortizing 15- or 30-year fixed-

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[180] Chomsisengphet and Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, Federal Reserve Bank of St. Louis Review, 2006, p. 32, available at http://research.stlouisfed.com/publications/review/06/01/ChomPennCross.pdf

[181] In 1995, the number of subprime FRMs originated was estimated at 62,000 and the number of subprime ARMs was above 21,000. Since then, subprime lending increased substantially, with the number of FRMs originations peaking at almost 780,000 and ARM originations peaking (and surpassing FRMs) at over 866,000 (Ibid, p. 41). Starting around 2002, the subprime market grew dramatically and in 2006, the total of hybrid loans were nearly two third of all subprime mortgage therefore the hybrid ARMs played bigger role in the subprime market (See, Barth, Op.cit, p. 54)

[182] See, Ibid, pp. 31-32.

[183] Interest rate caps limit the size of the possible increase over a given year or over the entire term of the loan (Ibid, p. 146)

rate payment.[184] All of these different types of interest rate offer different characteristics and instruments in mortgage facility.

5. **Refinancing**

The subprime mortgage also allows the borrower to refinance[185] the mortgage. By this way, the borrower gets benefits for possible lower interest rate or a lower monthly payment or extending the duration of his new loan. Usually, subprime borrowers refinance their adjustable-rate mortgage before or at the end of the fixed initial interest rate period. But in refinancing process, the borrower is usually faced with risk of a prepayment penalty for early payment, payment of upfront fees, and also must ensure that the variable rate of the new loan he intends to get benefit from refinance is lower than his old loans.

6. **Foreclosure**: During the mortgage process, the mortgage property is used as collateral itself to secure the loan and protect the lenders against default. In case the borrower's default, the lender has right to initiate foreclosure proceedings and take the property. In subprime mortgage, as underwriting process was lowered as mentioned earlier, it leads to the defaults of the borrowers and finally caused high foreclosure in mortgage industries. The foreclosure rate accounted for half of all foreclosure though subprime loans accounted for only 12 percent of all loans in June 2008.[186]

[184] This type of interest is also called "pick-a-payment" of "pay-option" ARMs, the loans which carry the risk of very large monthly payments in later years (Ibid, p. 470).
[185] A refinance is taken by a borrower for making a new loan that replaces his existing loan the purpose of which the borrower will get a lower interest rate that can result in a reduced monthly payment on the mortgage.
[186] See, Barth, Op.cit, p. 92.

CHAPTER IV:

RISK MANAGEMENT FOR HOUSE FINANCING

4.1 RISK MANAGEMENT IN ISLAMIC HOUSE FINANCING

The available different instruments of Islamic house financing require different techniques and treatments with regard to surrounding technicalities and procedures. Similarly, it applies to the risks inherent in the financial transactions including those risks in housing sector. These reveal the exposure of different risks that may associate during the implementation of the instruments. In this chapter, it will address this issue by elaborating what types of risks associated with the Islamic financial institutions, the nature of the risks evolved, the root causes of exposure of the risks, the ways how these risks are to be mitigated under Shari'ah principles and how they differ from the conventional risk system. All of these will be discussed in this section.

4.1.1 Risks Associated with Each Modes of Islamic House financing

Risks associated with the financial institutions, in broad sense, reveal the following types of risks: credit or default risk, liquidity risks, interest rate risks, solvency risk, foreign exchange risk, market risks and operational risks, etc[187], but to serve the maximum purpose, the discussion will focus on particular risks pertaining to the practices of the Islamic housing finance. These risks found in Islamic financial institutions differ from that of the conventional institutions due to their different system of intermediation and the products that are necessarily complying with the *Shari'ah* principles makes the risks attached to the Islamic Banks to be more complex as there is risks intermingling and changes at different stages of transaction, this occurs such as in the prevailing Islamic financing operations in most of

[187] See, Bessis, Joel, *Risk Management in Banking*, Chichester: John Wiley& Sons, 1998, pp. 5-12; See, Iqbal and Mirakhor, Op.cit, pp. 229-246.

financial institutions which consist of a combination of several contracts in a single package of agreement.[188]

The proper way to understand the special risks associated with Islamic house financing is to firstly identify what type of instrument is being applied by the Islamic financial institutions in their housing contract, because being well apprehended with the specific contractual transactions under Islamic finance, the respective risks arising from such contracts will be easily ascertained. Regarding the instruments used by mostly Islamic financial institutions in housing finance have already been drawn in the previous chapter which include *murabahah li al-Amiri bi-al-Shira'*, diminishing *musharakah, ijarah muntahiya bi al-tamleek, istisna' and bay' al-mu'ajjal.* A step forward remains is to identify each kind of the specific associated risks found in such modes of finance that will be described below:

4.1.1.1 *Murabahah li al-Amiri bi-al-Shira* Financing

The risk associated with the classical *murabahah* differs from the *murabahah li al-amiri bi-al-shira'* which is currently used is Islamic housing transaction. Khan and Ahmed (2001) view that *murabahah* contract, as a mode of financing in the present financial practices, constitutes some specific associated different risks, i.e.:

1. **Credit risk**:

   It is a part of counterparty risks which stems from the default of the client either by late or non-payment or due to the damage of the product before the customer takes possession. Credit risk is also known as default risk[189] which is defined as the potential risk that counterparty may fail to make payments on its obligations in accordance with the agreed terms.[190] The failure of the debtor fulfill his financial obligations will cause a loss to the bank as creditor (Elgari, 2003). In *murabahah* house financing contract, Islamic Banks are

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[188] See, Hassan and Lewis, Op.cit, p. 148.

[189] Shim, Jae K. and Constas, Michael, Encyclopedic Dictionary of International Finance and Banking, Washington: St. Lucie Press, 2001, p. 56.

[190] See,Iqbal and Mirakhor, Op.cit, pp. 229; See, Peter F. Christoffersen, *Elements Of Financial Risk Management,* California: Academic Press, 2003, p. 5.; See, *Principles for the Management of Credit Risk,* Basel Committee on Banking Supervision 2000, p. 1.

exposed to default risks when the Bank delivers the asset (a house) to the client as per contract but can not obtain the timely payment from the client due to late or other reason of non-payment. The current *murabahah* shows this risk where the payment is deferred, the failure of the client to pay the installment or lump sum amount to the financier at the agreed time of contract will expose to the credit risk. In banking sectors, credit risk is considered as the most important risk faced by financial institutions, irrespective of conventional or Islamic industries. According to the questionnaire survey and interviews from 29 Islamic bankers of different countries specially Malaysia and Bahrain, credit risk is perceived to be the most important one (Ariffin et al, 2008). The Basel Committee[191] also conforms this by stating that the largest and the most obvious source of credit risk stems from loans.[192] As the most conventional Banking businesses based on lending operations, therefore, the exposure to credit risk continues to be the leading form of risk and the actual example is what has currently occurred with regard to subprime mortgage crisis (2007-2008) in USA as the result of the credit risk exposure (See, Chapra, 2008; Ahmed, 2009, Jusufović, 2009).

2. **Liquidity risk**:

It is variously defined in financial businesses literatures. Ali (2004) has sufficiently elaborated liquidity risk issues that affect the Islamic modes of finance. Liquidity risk can be defined as the risk related to a bank's earnings and capital arising from its inability to timely meet obligations when they come due without incurring losses. In term of banking industries, liquidity risk includes both the risk of being unable to fund (its) portfolio of assets at appropriate maturities and rates and the risk of being unable to liquidate a position in a timely manner at reasonable prices (Ali, 2004). Further, liquidity risk may occur when there is difficulty of selling an asset quickly without incurring large losses.

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[191] It is Basel Committee for Banking Supervision (BCBS), an international standard setting body which was established in 1974 comprising a number of states, viz. Canada, Belgium, Germany, France, Japan, Italy, Luxembourg, Spain, Netherlands, Switzerland, Sweden, United Kingdom and United States. (Khan and Ahmed, 2001, p. 86).

[192] BCBS 2000, p. 1.

Greuning and Iqbal (2008) conclude that liquidity is of two types, lack of liquidity in the market and lack of access to funding. The first type is relevant to note as it refers to difficulty for the financial institution to meet its liabilities and financial obligations with respect to the illiquid assets. While the second type which refers to the inability of the Bank to raise fund at a reasonable cost for redemption of deposits and other liabilities[193] does not serve much in this area of discussion. In *Murabahah* house financing, the liquidity risk arises from indirect exposure of realization of other risks (such as credit risk or market risk) that affect the liquidity. For example, the client may refuse or unable to accept the delivery of commodity for some reasons. In such situation, the bank is exposed to liquidity risk by holding the commodity until another buyer is found and the Bank also faces difficulty in disposing of the property (commodity risk). Similarly, in case the client is unable to pay the due amount in timely manner, which is actually a credit risk, this also give rise to liquidity risk for the Bank. (Ali, 2004; Mounira and Anas, 2008).

3. **Operational risk**: By definition it is the risk that arises from human and technical error or accidents. In this risk, the institution will expose to the risk of loss due to inadequate or failure of internal processes, people, and technology or from external events.[194] Khan and Ahmed (2001) describe operational risks may occur in the following situations: there is human failure and incompetence in the operation (people risk), there is also error in telecommunications system (technology risk), and it may be caused by operational risk which occurs due to violating operational control limits, inaccurate transaction or execution or errors in model specifications.[195] In *murabahah* pertaining to housing, the relevant issue may refer to the people risks of fraud where the client may fail to furnish the agreed payment in a contract which would definitely expose the Bank to potential losses. Another form is the risk may appear in the legal ownership of the asset that must

[193] See, Greuning, Hennie van and Iqbal, Zamir, *Risk Analysis of Islamic Banks*, Washington: The World Bank, 2008, p. 154.
[194] See, Khan and Ahmed, Op.cit, p. 29.
[195] See, Iqbal and Mirakhor, Op.cit, p. 231..

be firstly owned by the financier. If the assets have been owned, or consumed before financing take place it will amount to an operational risk as well.

4. **Market risk**: It is defined as the potential risk for losses due to changes in the market prices.[196] The risk arises in the form of unfavorable price movements and volatility in the values of some specific assets, such as rate of return risk, interest/benchmark rates risk, foreign exchange risk, equity and commodity prices. These risks have a potential impact on the financial value of an asset over the life of the contract. In the current house financing on *murabahah*, the Islamic Bank is exposed to mark-up risk as the mark-up rate is fixed for the duration of the contract while the benchmark rate may change. This means that the prevailing markup rate may rise beyond the rate the bank has locked into a contract, making the bank unable to benefit from higher rates.[197]

5. ***Shari'ah* risk**: It occurs when there is some legal deviation from the principles laid down by *Shari'ah* viewpoints during the operation. As the current *murabahah* consists of a number of different contractual arrangements such as the undertaking by the client to purchase the commodity, this nature has brought some Muslim scholars in the field to raise some objections in respect of the validity of the contract and questioning the binding status of the promise as already discussed in the earlier chapter. This absence of Muslim consensus can pose litigation problems of a contract. So, it is risk related to the structure and functioning of the *Shari'ah* boards at the institutional and systemic level that leads to potential litigation problems in case of unsettled transactions.[198]

4.1.1.2 Diminishing *Musharakah* Financing

The application of this mode of finance, as mentioned earlier, requires at least two separate forms of contract, i.e. Islamic partnership and leasing . The partnership in this mode

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[196] Hassan and Lewis, Op.cit, p. 126.
[197] Iqbal and Mirakhor, Op.cit, p. 233; See, Greuning and Iqbal, Op.cit, p. 157.
[198] See, Iqbal and Mirakhor, Op.cit, p. 245.

is based *shirkat al-milk* (joint ownership in a property) by which the partnership is established for ownership and not to make profit from the underlying subject matter among the partners[199] and the *Shari'ah* principle in this regard allows one partner to buy other partner's principle share/face value in future. This is the case in diminishing *musharakah* house financing where the client promises to buy the Bank's share periodically and the Bank generates profit from leasing out its shares to the client. The following risks are the associating risks in Diminishing *musharakah* mode of finance:

1. Credit risks: in case the client can not furnish the purchase payment of the Bank's share and/or the rent on which the client is due, the Bank is exposed to credit risk.
2. *Shari'ah* risk: the risk pertaining to the legal aspect of *Shari'ah* controversy in not much different from the earlier *murabahah* financing.

4.1.1.3 *Istisna'* Financing[200]

In *istisna',* the risks associated with such mode of financing are as follows:

1. Credit risk: in case of counterparty risk, it is similar to risk mentioned under the previous contracts where the client fails to pay dues fully on time. Moreover, there is also failure risk when the financier can not provide the quality of the goods as contractually specified the result of which can delay or default in payment of the client causing the Islamic Banks into financial losses.
2. *Shari'ah* risk: in this case, *Shari'ah* issue relates to the possible option to rescind unilaterally by the client under certain Islamic viewpoints. If the *istisna'* contract is not binding under this principle and the client is given the option to decline or back out from his promise at the time of delivery, the financier is exposed to financial loss or liquidity risk. Besides, the time-bound-delivery which is not the requirement of *istisna'* can also cause liquidity problem.
3. Operational risk: this risk may take in various forms such as in case of failure of delivery with regard to the quality and time of delivery from the supplier's side, or may be damage

[199] This differs from *shirkat al-aqd* where the partnership is made for making profit among the partners.
[200] See, Khan and Ahmed, Op.cit, pp. 57-58 ; Iqbal and Mirakhor, Op.cit, p. 55

to manufactured products, the result of which will cause the refusal of the client and in this case it will expose to liquidity risk (Ali, 2004). Cancellation risks in the nonbinding *istisna'* contract will also expose the Islamic Bank to an operational risk.[201]

4. Market risk: In *istisna'*, the mark-up profit is normally fixed in the contract, but due to long term nature of the contract whilst the market rate fluctuates it is exposed to market risk. In another word, the Islamic Bank is exposed to 'price risk' due to asset price volatility during the time of delivery and the sale of the asset at a prevalent market price.[202]

4.1.1.4 *Bay' al-Mu'ajjal* Financing

This special type of contract has similar risks with the *murabahah* contract as both implies a deferred sale, the difference of which lays only on the express quotation of the profit margin where in the *bay' al-mu'ajjal* the quotation is not required while in the *murabahah* is necessary.

4.1.1.5 *Ijarah* Financing

The followings are the *ijarah* associated risks:

1. Credit risk: the idea is always similar with regard to the credit risk that there is default from the client's side. So, in this case the Bank is exposed to credit risk when the client fails to pay the rental obligation to the financier in time as per *ijarah* agreement.
2. Market risk: it is related to the mark-up risks pertaining to the rental payment of the client which depends on how the rentals are calculated. As these may be linked to LIBOR, it may reduce the impact of market return changes on the value of the instrument. Another form of market risk is that due to a decrease in the residual value of the leased asset at the expiry of the lease term or in the case of early termination due to default.

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[201] Greuning and Iqbal, Op.cit, p. 174.
[202] Ibid, p. 233.

3. Operational risks: related to the asset that may be damaged or destroyed. The loss will be treated depending on whether there is negligence on the part of the customer or some natural disaster.

Therefore, the risks associated with the Islamic housing include the following risks: credit risk, market risk, liquidity risk, operational risk and *Shari'ah* risk. Though these types of risks are commonly found –except the *Shari'ah* risk- in financial risk atmospheres specially the credit risks which mostly associate the conventional industries, the magnitude and risk dimension are much different between the Islamic and conventional system. This is due to the different techniques of financing as the former is formulated under strict regulation and principles of *Shari'ah* while the later is based on the prevailing human system according to their own interest. Due to this, the nature of Islamic financial services provide various modes of financing for the benefit of the client, in some cases, the financier stands as a sharing partner such as in the case of diminishing *musharakah*, in other cases it stands as lessor in case of *ijarah,* or as simple seller at the completion of the agreed transaction. Therefore, the uniqueness of this model that differentiates it from the capitalistic conventional financial system.

Furthermore, it can be concluded that all of different modes of Islamic house financing may involve a common type of risk such as in credit risk. However, they differ as to where and in which phase the credit risk arise. In case of *murabahah* (cost-plus sale) or *bay' al-mu'ajjal* (deferred sale) it appears when the client fails to repay the cost-plus-mark-up installments or lumpsum as agreed in the contract. In *ijarah* and diminishing *musharakah,* the default arises when the client fails to honor his financial obligation in lease contract. As in *istisna'*, the issue of defaulter may not much differ from the *murabahah* and *bay' al-mu'ajjal* as it may occur when the client defaults in the payment of deferred installments or when the client declines to fulfill his promise to accept the delivery agreement.

4.1.2 Risk Management in Islamic Mode of House Financing.

The importance of risk management is an undeniable fact in promoting the development and sustainability of financial institutions. How far the financial institution can

eliminate and mitigate the risk will determine the of success of a company. The current system of risk management is designed mostly for the conventional banking institutions as they precede in the area of financial industries, but the current situation presents a positive development. A new player in respect of financial entity emerges in the form of Islamic financial institutions that are currently ready to compete in world economic contest. With the spectacular development in the financial atmosphere, therefore, the Islamic financial institutions require special attention with regard to the compatible risk management techniques. Based on this significant need, Islamic Banks are obligated to have well defined and an established system of risk management towards the various modes of financing they can afford to the clients, while at the same time it must not contravene the basic principles of Islamic *Shari'ah*. Below is how Islamic financial institutions provide risk management in house financing sectors.

4.1.2.1 Credit Risk

Credit risk involves in most of financial transactions conventionally or Islamically as stated earlier. The various modes of Islamic transaction, the probability of credit risk affects almost all of such financing instruments particularly in above mentioned different modes of house financing operations. It is already shown that how each kind of house financing bears the credit risk exposure. Hencefore, in the following, the management of credit risk will be discussed accordingly:

Credit Risk Avoidance

The Islamic Banks provide specific techniques with regard to the management and mitigation over the credit risks that may appear from the client, keeping in view the *Shari'ah* principles. In this paper, there are at least two different ways by which the Islamic risk management is conducted by Islamic financial institutions. It is differentiated between risk avoidance and that of risk mitigation. Khan and Ahmed (2001), Nasution (2003), Iqbal and Mirakhor (2008) give principal guidelines regarding the means how the credit risks should be managed effectively. These include the initial process of determining the eligibility of the

client for financing which may be considered as preliminary steps of credit risk management. Under this process, the proposal of the client requesting finance from the Bank is properly examined and carefully analyzed by a competent credit analyst, the purpose of which any information relevant and pertaining to the client's credibility is generated for rating and evaluation, on the basis of which the Bank can determine the suitability to provide finance. The information explains relevant matters relating to the past performances of the client and the probability of his default. This is in line with guiding principles of risk management proposed by Islamic Financial Service Board (IFSB)[203] that Islamic Banks shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument. The Bank is required to accurately identify all surrounding related matters as to find the suitable client to whom the Bank grants credit or financing. This includes the following matters:[204]

a. The purpose of the credit.

In this case, the financing mode that is requested by the client should be carefully examined by the Bank in accordance with the client's financial and social situation. Definitely, the financing service is provided in all permissible sectors according to the Shari'ah perspective, and no finance is granted in such prohibited activity such house is built for the purpose of discotheque localities of alcoholic production.

b. The source of repayment.

The Islamic Bank is also required to ascertain the client financial income from where and what it is derived. This can help in assuring the Bank with respect to financial capability of the prospective client.

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[203] IFSB is an international regulatory body concerned with the Islamic finance industry whose role is to advise regulators on how Islamic banks and other *Shari'ah*-compliant financial institutions should be managed, and how international regulatory requirements should be adapted for this distinctive type of banking institution and financial products. IFSB was established in Kuala Lumpur in November 2002, almost 40 regulators have become members, as well as 108 market players and institutions such as the Bank for International Settlements, the International Monetary Fund, the World Bank and the IDB (See, Millar, Roderick and Anwar, Habiba (ed)., *Islamic Finance – A Guide for International Business and Investment* (London: GMB Publishing Ltd, 2008), p. 23.

[204] Ibid, p. 232; See, Khan and Ahmed, Op.cit, p. 33.

2008, Muhammad, 2008; Greuning and Iqbal, 2008). In many cases, the Islamic Bank demands a security deposit (*'urboun*)[210] as a guarantee, which may be considered as part of the price if the contract is completed, and can be forfeited if the contract is rescinded. However, the amount forfeited may be restricted to the amount of actual damage suffered and the remaining amount may preferably be returned to the customer.[211] However, in Islamic Banks creditworthiness of the client (personal guarantee) is preferred to the availability of the collateral (cover guarantee) itself. The more sound creditworthiness of a client will get priority over the others (Nasution, 2003).[212]

Besides, there is also possible ways by which the Islamic Banks can increase the accuracy on information of the prospective client. The Islamic financial institution can have a special team comprising independent personalities whose role is to secretly investigate the actual condition of the requesting client in order to determine his true creditworthiness. The enquiries are to find out the level of loyalty and honesty of the client through his daily conducts and social environment, such as identifying his good moral character, daily routines or his involvement in some known organizations, etc. The related informations generated from such enquiries will benefit the Islamic Bank in ensuring the eligibility of true client in entitling to the finance. This mean emphasizes informal way pertaining to the character measurement rather than the standard formalities of gathering information and formal data of the client.

In conclusion, the Islamic Banks could mitigate and manage credit risk preliminarily through any possible means including the use information technology (IT) applications

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[210] '*Urboun* is the earnest money given at the time of execution of the sale as part of the price (See, Ayub, Op.cit, p. 116.) However, in many cases, the subject matter of the contract itself is accepted as collateral.

[211] AAOIFI, Standards on Istisna', 2003, clause 3/3/1 ; See, Ayub, Op.cit, pp. 266-267 ; See, Greuning and Iqbal, Op.cit, p. 127 ; See also, Lewis, Mervyn K. and Algaoud, Latifa M., *Islamic Banking*, Cheltenham: Edward Elgar, 2001, pp. 74-75.

[212] This consideration is based on the following reasons: that the collateral is subject to obsolescence and physical deterioration that would affect its marketability and liquidity. Further, in case of default the institution will be bothered with legal procedures to enforce its claim. The last is that the institution shall ascertain regarding the acceptable ratio of the market value of the collateral to the size of the credit (See, K.J. Walraven and Mary Elizabeth Ward (Ed.), *Commercial Bank Risk Management*, Washington: The World Bank, 2nd Edition, 1996, p. 28.

system to obtain a better credit history analysis of every customer. Another means shall also be conducted in respect of examining the nature of business, financial history, previous financial records, and existing relationship of the customers at the current Bank. This data tracking process will benefit a lot as it gives cautionary measures to the stakeholders at the bank ensuring the creditworthiness of client and compliance of 'Know Your Customer' (KYC) principle. So, all necessary actions for generating a comprehensive identification of the customer, black listing and monitoring customer account activities for abnormalities should be successfully exercised. (Cherrak and Touzani, 2008).

Credit Risk Mitigation

The above mentioned techniques pertaining to determining the creditworthiness of the client are definitely effective to avoid the exposure of the credit risk. Further elaboration of Wilson (2007) has elucidated in more detail regarding the credit risk mitigation. In his study, the Islamic *Shari'ah* provides clear ways to deal with the credit risk arisen from a financial defaulter. First, there is concept of Islamic leniency, and second is maximum payment safeguard with regard to managing the credit risk. This is described as follows:

1. **Principle of Islamic leniency:**

   The basic principle of Islamic law in the treatment of defaulted client is actually based on a leniency. In current Islamic banking, this principle is still observable and taken into consideration though the liability of the client to fulfill his financial obligation is also pursued according to the terms of the contract. Islamic law clearly permits the exemption toward the debtor from the creditor/financier. This is based on the Holy Qur'an: "*If the debtor is in difficulty, grant him time till it is easy for him to repay. If ye remit by way of charity, that is best for you if ye only knew.*"[213] The exemption is

[213] Al-Qur'an, Al-Baqarah:280.

interpreted in the context of modern financing application as *re-scheduling* keeping in view the same financing method imposes no penalty on the part of the client.[214]

In addition, a concept of leniency can further be exercised by way of providing a *qard-al-hasan* loan which is free *riba* loan in Islamic law. But it raises an objection that as such benevolent loan can not generate any profit necessary for the payment of dividend for the shareholders and returns to their depositors, and it is therefore hardly practicable by most Islamic Banks.[215]

Moreover, another form of Islamic leniency which is also based the above *Qur'anic* verse is the encouragement of debt remission which is termed as debt forgiveness. This way is also far more objectionable than re-scheduling method as the remission is much more costly toward the liability of the Banks.[216]

However, in some very special circumstances, where it is proved that the client faces unanticipated difficulties such as chronic health problems or terminal illness, then remission may be justified on ground of humanity. The benefit of this remission can bring goodwill from other clients in Islamic banks.[217] But this risk can be covered by the requirement of taking a takaful insurance by the client.

2. Maximum payment safeguard:

Given the principle of Islamic leniency towards the client's inability to pay his financial obligation, the Islamic Bank is faced by difficulty to distinguish between an honest incapable client and the deliberate person who likely take advantage of the perceived leniency by Islamic Banks. When such a noble principle of leniency is abused by the deliberate person it will definitely expose to potential moral hazard problems that affect the Islamic financial institutions. Therefore, the remaining logical mean of Islamic

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[214] See, Wilson, Rodney, "Credit Risk Management in Islamic Finance", *Journal of Islamic Banking & Finance,* Sept. 2007, No. 3, p. 55.
[215] Ibid, p. 56.
[216] Ibid.
[217] Ibid.

Banks in keeping the institution sustainable is to safeguard the payment of the client by imposing effective measures as enumerated below[218]:

- **Financial penalty/donation**[219]: so putting a penalty clause in the contract can serve as a deterrent upon default of the client. Through this way, it is expected that the payment of the client can be safeguarded effectively. But as per rule, the amount charged must be given to a designated charity or social-welfare purposes, and not to the Bank itself. Islamic Bank is justified in levying additional charges in order to recover the costs associated with the client's default. In this regard, there are two conditions should be ascertained: first, the defaulter may be given a grace period of at least one-month second, it is proven beyond doubt that the client is defaulting without a valid excuse.[220]
- **Non-Material Penalty:** the Islamic Bank can impose non-material penalty by way of blacklisting of defaulters so that they will not have to recourse to financing from any other banks. AAOIFI states: The institution in entitled to include the name of a debtor in default in a list of undesirable customers (black list) and to send a warning admonition to other companies about the defaulting debtor, either when there is an inquiry from other companies about the debtor or when such 'black list' are exchanged between companies directly. [221]
- **Redress from the Court:** to some practices, the Islamic Bank may have legal recourse to the court for imprisonment or confiscation of passport which is being effective deterrent in the Gulf countries (Wilson, 2007).
- **Confiscation of Assets:** any asset pledged as collateral for the debt as noticed above can be confiscated by Islamic Banks for the liquidation of the debt. To have maximum speedy measure in this process, the Islamic Bank may stipulate its client to give an

[218] Ibid, pp. 57-58

[219] See, AAOIFI, Standards on Default in Payment by a Debtor, 2003, clause 2/1 (h)

[220] See, Usmani, Muhammad Imran Ashraf, *Meezan Bank's Guide to Islamic Banking*, Darul Ishaat: Karachi, 2002, p. 129.

[221] See, AAOIFI, Standards on Default in Payment by a Debtor, 2003, clause 2/4

evidential mandate to sell the pledged asset without recourse to the court.[222] In most of financing practices, the property is considered as collateral itself.

- **Restriction on the Client's Income:** in the contract, the Bank is allowed to demand the income of the client to be paid directly into an account with the Bank, so that in case of default the Bank imposes limits on personal access to the salary until its claim are met or it may be offsetted to the Bank. E.g. in *murabahah* house financing, where liquidity risk may emerge due to inability of the Bank to acquire the price of the property or when there is failure in payment by the client for some reasons (such as litigation risk), so the client may be demanded to keep his business account with the Banks enabling them in releasing the funds in installments which contribute towards maintaining the bank's assets protected and liquid funds at its disposal. (Ali, 2004)

4.1.2.2 Commodity Related Risks

This is a form of liquidity risk as the commodity risk is a source of its exposure. Below is the way how the commodity risk is mitigated accordingly:

1. The flexibility of Islamic transaction to appoint the client himself as the Bank's agent in selecting the commodity according to his criteria is the basic way the Islamic Banks manage risk related to the commodity. Most of the Islamic Banks while providing finance to their clients use such procedure by which the Bank establishes a contract of agency so that the client chooses the commodity on his own desire and then proposes to the Bank for finance. So when the client purchases the commodity such as a house from the original seller, he merely acts as a purchasing agent on behalf of the Bank (financier). In *istisna',* the Islamic bank may allow the customer to inspect the manufactured building or goods from time to time during the construction process in order to verify that the specifications proposed by the client are truly matched. By this way, Islamic Banks avoid any risk arising out of dispute with regard to the characteristics of the commodity that often affect the operational and credit risk exposure. However, even if there is still inevitable dispute that leads to the

[222] See, AAOIFI, Standards on Default in Payment by a Debtor, 2003, clause 2/1 (e).

whereby the manufacturing of an asset involves more time to conclude and often necessitates many changes, the price can be readjusted by the mutual consent of the contracting parties because of making material modifications to the item to be manufactured or due to unforeseen contingencies or changes in prices of the inputs.[227]

4.1.2.4 Liquidity Risk

Islamic Bank is exposed to liquidity risk when the Bank is unable to maintain sufficient funds to meet its obligation when it becomes due as noted earlier. In almost of Islamic housing finance that requires long-term finance it would probably expose the Bank the risk of mismatch between the maturity of assets and liabilities due to the short duration deposit funds with long duration of financing. Unfortunately, since the central banks and the interbank market acting as lender of last resort to address the liquidity risk have involved in interest, the Islamic Banks can not involve in these practices as the conventional Banks would do. Ali (2004) discloses some relevant methods that the Islamic Banks can take in order to meet the liquidity needs and obligation as follows:

- Establishment of Reserves: There are different forms of reserve applied: 1) Cash Reserve Ratio (CRR): the portion that the Bank maintains with the Central Bank of the country serves as the actual cash reserve to satisfy the liquidity and withdrawal demands. 2) Statutory Liquidity Requirement (SLR): the amount which a bank has to maintain in the form of cash, gold or approved securities can also ensure solvency of banks.[228] These means are to insure against liquidity risk that may stem from deposit outflow due to higher returns available in another competing Islamic or conventional banks and also to insure against losses due to default risk.

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[227] See, AOOIFI, Standards on Istisna', 2003, clause 4/1/1; See, Ayub, Op.cit, p. 265.
[228] In State Bank of Pakistan, as of end-June 2009, the CRR and SLR were 5 percent and 19 percent respectively (See, The World Bank, Payments And Securities Settlement Systems In Pakistan, April 2010, p. 14 available at http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/282044-1271859292169/Pakistan_country_book_April_2010_final.pdf).

- Mixing of Deposits: It is meant as mixture of current (or demand) deposits with investment deposits in their use of funds. So far, the current deposits constitute a big portion of total deposits in most of the Islamic banks. Therefore, the mixing of the current and the investment deposits provide Islamic banks a cushion of liquidity instead of also earnings opportunity when it is employed.
- Islamic interbank market: This is the ideal way if the Islamic interbank market can be introduced to benefit all demanding Islamic Bank in the world. It will provide Islamic financial institutions the facility for funding and adjusting portfolios over the short-term formula. Currently, Bank Negara Malaysia, the Central Bank, has developed Islamic Interbank Money Market (IIMM) that can purchase and sell Islamic financial instruments and can conduct interbank investment activities through *mudarabah* interbank investment scheme. However, Majid (2003) added three other alternatives to the conventional interbank market: First, banks make an agreement with other banks for mutual financing facilities as practiced by conventional banks. Banks which are in need of more funds from others may enter into mutual agreement of profit and loss sharing arrangement. The surplus funds can be accordingly placed and arranged to meet the liquidity of Bank and to balance the short-term assets and liabilities. Second, there could be an interbank cooperative arrangement on the basis of *Shari'ah* to extend reciprocal accommodation to each other on condition that the net use of this facility is free from any prohibited interest. Finally, the Banks create a common pool at the central bank to provide mutual accommodation.
- Another method is by the use of different types of Islamic instrument which are known and practiced in the current Islamic banking industries in the form of *sukuk* or Islamic bonds. These instruments are useful tools for mitigating liquidity risk specially in respect of long-term projects financing and infrastructure development.

However, liquidity risk is not as much to be worried about as have been mentioned above when we see closely the Islamic financial institutions on the ground, because practically the IFIs even carry 40 percent more liquidity than the conventional banking. This

is because of different factor such as shortage of long-term *Shari'ah*-complaint investment tools and avenues as 95 percent of their funds are used in short-term *ijarah, murabahah* and *musharakah* instruments. Another factor is difficulty to invest their funds in the conventional interbank market and other short term instruments due to *Shari'ah* requirement not to indulge in *riba*.[229]

4.1.2.5 Operational Risks Pertaining to *Shari'ah* Issues

4.1.2.5.1 Compliance with the Shari'ah Supervisory Board

Islamic Banks are exposed to risks of non-compliance with *Shari'ah* due to the failure in implementing their financing operations in accordance with *Shari'ah* rules or due to unrecognized practices in respect of different contracts in different jurisdictions as mentioned earlier. These cause the Bank to the risk of breaking the confidence of the investors/depositors and leads to the withdrawals of funds, voiding of contracts which leads to a diminished reputation or the limitation of business opportunities. Therefore, the Bank is required to give high priority to insuring transparency in compliance with the *Shari'ah* and take necessary actions to avoid non-compliance risk.[230] Shari'ah compliance is a critical principle to Islamic Bank's operations and must permeate throughout the organization, products and activities. The perception regarding Islamic Banks compliance with *Shari'ah* rules is of great importance to sustainability of Islamic financial institutions as it is a necessary characteristic in relation to attracting their potential Muslim customers.[231]

To ensure this necessity, Islamic Banks shall comply at all times with the *Shari'ah* rules and principles as advised by the *Shari'ah* Supervisory boards (SSB) within Islamic Bank itself or through external institutions such as the central Bank, with respect to their products

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[229] See, Bhatti, M. Ishaq and Khan, M. Mansoor, *Developments in Islamic Banking - The Case of Pakistan*, CPI Antony Rowe, Chippenham and Eastbourne: Great Britain, 2008 p. 71
[230] Iqbal and Mirakhor, Op.cit, p. 245.
[231] See, IFSB (2005).

and activities.[232] This compliance includes all necessary processes during the implementation of the contract such as the awareness regarding the implementation of several related agreements executed in parallel manner, all components of the financial structure are contractually independent, clear format of documentation, performance, termination and the possible elements affecting contract such as fraud, misrepresentation or any other rights and obligations.[233] The *Shari'ah* board usually issues a report to certify the *Shari'ah* compliance of all financial transactions on annual basis.[234] The objective is to ensure that the financing operations are executed in adherence to the Shari'ah rules and principles as per the *fatwa*, policies and procedures approved by the SSB.[235]

4.1.2.5.2 Uniformity of *Shari'ah* Standards

Given the urgency of the SSB, however, it raises some issues that need to be solved accordingly in respect to its independence, confidentiality, competence, consistency and disclosure.[236] One of the pivotal issues in all times is regarding the non-uniformity among the *Shari'ah* boards in providing legal judgment on some *Shari'ah* issues. This has led to an unsettled state amongst these Islamic financial institutions, and it has moreover confused many people regarding the truth they are looking for. To some extent too, it may have given them the false impression that the difference between truth and falsehood and the permissible and the prohibited in issues of Islamic law in general and economic issues in particular is the result of subjective concepts and ideas developed by the experts in the *fiqh* of transactions, which they adopted and made the parameters by which to judge between the valid and the invalid and the permissible and the prohibited (Al-Buti, 2008). The absence of non-standard nature of Islamic products and the lack of a reliable Shari'ah legislation system to enforce financial contracts lead the Islamic Bank to some operational risks. Therefore, it is suggested

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[232] For more detail of SSB, see Al-Qattan, Muhammad Amin Ali, *Shari'ah Supervisory Boards: Selection of Their Members and Their Regulations,* Seventh Conference of the Shari'ah Boards of Islamic Financial Institutions, AAOIFI, 27-28 May 2008 CE, at Kingdom of Bahrain (2008).
[233] Greuning and Iqbal, Op.cit, pp. 288-289.
[234] See, Ibid, 189.
[235] See, IFSB (2005) "Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)".
[236] Greuning and Iqbal, Op.cit, p. 189.

that some of the possible way to achieve uniformity among the *Shari'ah* experts on financial issues, is that the members of SABs must be consistent with in transmitting the *Shari'ah* rulings for any issue from its sources, either the issue is agreed upon or there is difference of opinions on it, it should be honestly transmitted and presented as it is. Being apprehended with this situation, in case there is unavoidable difference of opinions, there is no objection to give preference to one opinion which is considered the most correct and more in line with the objective of the *Shari'ah* and current economic systems. This is to show that the boards have juristic proficiency in financial transactions and awareness of banking services and hence understood as a result of natural difference in *ijtihad* that does not create confusion and contradiction for the financial institutions or the public (Al-Buti, 2008).

Furthermore, Al-Buti (2008) proposes that a single organization such as AAOIFI should be established which can represents all the supervisory boards internationally, with one member from each board serving as its representative to the organization, and the task is given to supervise the activities of all the boards. The initiation of a single regulatory body can hold a series of conferences that combines all these boards of different and dispersed representatives to bring all their efforts and expertise come together on a single comprehensive method under the legal and moral rules which would provide a working plan for all.

4.1.2.5.3 Profit derived from non-Shari'ah Compliance

It is admitted that the failure to comply the *Shari'ah* rules renders the transaction null and void in Islamic point of view. Therefore, it is suggested that if a Bank fails to act in accordance with the approved Shari'ah principles, any profit derived from it should not be distributed to the investors-depositors particularly the Bank itself rather to distribute it for charitable purposes.[237]

4.1.2.5.4 Legal risk due to cancellation by client.

[237] See, Iqbal and Mirakhor, Op.cit, p. 245.

As mentioned before, due to non-uniformity standard of a contract and the possible option to rescind from a transaction such as in case of *istisna'*, Islamic Bank is exposed to legal risk that enables its counterparty in raising litigation, refusal in the payment and to some extent leads to cancellation of a contract that will expose the Bank to financial loss. To mitigate such type of risk, Islamic Bank shall secure legal position of the contract by which the Bank is ensured that the promise to purchase is properly documented and is legally enforceable through the court.

4.1.2.5.5 Impaired asset

In case the asset is damaged or impaired for some reasons, the Islamic bank shall have in place a system to ascertain the surrounding causes behind it. If such impairment is caused by no-default of the client (lessee), the Islamic bank either has to provide the lessee with a replacement asset with a similar specificity or has to refund the additional rental amount. This is because the Islamic banks (as lessors) retain ownership of the leased asset throughout the contract and are liable for the consequences of any damage to the asset that is not caused by the lessee's misconduct or negligence. Accordingly, if a loss arises from negligence by the lessee, the Islamic bank is permitted to claim compensation from the lessee.[238] So risk mitigation process depends on the finding from whether there is negligence on the part of the customer or some natural disaster.

4.1.2.5.6 Impairment and Failure of Delivery from Supplier side

Considerable damage to manufactured products will cause the refusal of the client. Facing this risk, Islamic Bank may require quality guarantee from the original supplier. Further, in case if there is failure of delivery with regard to the quality and time of delivery from the supplier's side, the Islamic Bank's penalty can be imposed on the supplier through a reduction in the price to be paid by the purchaser. *Shari'ah* scholars, on the basis of

[238] Greuning and Iqbal, Op.cit, pp. 290-291.

shart-al-jazai[239] allow a clause to be inserted in the contract to that effect. This is to act as a fine to the manufacturer when he may not have devoted sufficient time to complete the product causing problems to the purchaser.

4.1.2.5.7 Treating Non-binding contract

Cancellation risk in the non-binding *istisna'* and *murabahah* contract will expose the Islamic Bank to an operational risk. Obviously the financier is exposed to cancellation risk only if the manufacturer does not start the work. So, before it, any contracting client may cancel the contract by giving notice to manufacturer. However, if the manufacturing process has been started, the contract cannot be cancelled by the buying client unilaterally.[240] The issue is then with regard to defining the event whether it before or after starting of the manufacturing process which requires verification by a third party such as a court to define and how much funds have already been advanced by the Bank (Ali, 2004). Then, the current practice of *istisna'* is much in line with this condition that according to the majority of contemporary *Shari'ah* scholars,[241] instead of above condition, the manufactured asset must also conform to the specifications agreed at the time of the *istisna'* contract to render the contact binding upon the client so that the cancellation risk could be treated accordingly.

4.1.2.5.8 Misconduct by Client in *Murabahah*

In *murabahah*, the legal ownership of the asset must be firstly owned by the financier. But the problem arises when the assets have been owned, or consumed by the client before financing take places which renders the practice invalid in the *Shari'ah* point of view. In this case, the Bank must have proper diligence on the asset to be financed and may conduct

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[239] *Shart-al-jazai* is a penalty clause which states the condition that in case there is a delay in the delivery of the subject matter the price will decrease.
[240] Ibid, pp. 266-267.
[241] Similarly the prevailing Civil Law in some Muslim countries and the Fiqh Council of OIC hold the same view and practice.

physical inspection to ensure its legal position, quality, damage, defect, related risks etc. as all of which must be clearly identified.[242]

4.2 RISK MANAGEMENT IN CONVENTIONAL HOUSE FINANCING

4.2.1 Credit Risk:

It has been highlighted before, all financial institutions either Islamic or conventional are exposed to credit risk caused by the default of their clients. As the operation in conventional Banks is based on debtor-creditor relationship in all cases, they face credit risk in almost of their operations including housing finance sector. Credit risk can be known from two primary measures: first, from the probability of default which will measure the likelihood that the borrower will fail to make payments over the duration of the loan, and second is from loss given default which will measure the net cost that the lender will suffer in the event of default and foreclosure.[243] For this regard, the management of credit risk is not considerably different from above explained technique of Islamic financial institutions. Elgari (2003) summarized some prevailing measures taken by conventional Bank in dealing with the default of client include strict regulation, taking collateral or security, analyzing the economic circumstances and environment, sound policy and recovery, conversion of debt into mortgage backed securities and imposition of penalty. Here we would describe some relevant measures by which most of the conventional Banks use in their credit risk management process. These are as follows:

1. Chiquier and Lea (2009) gives general view regarding underwriting process on credit risk which is of three categories, viz.: 1) the ability and willingness of the borrower to repay the loan; 2) the value of the collateral relative to the loan amount; and 3) the lender's ability to efficiently enforce the mortgage lien in case of default. Each of these is assessed at the time the loan is originated, and periodically throughout the life of the

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[242] See, Ayub, Op.cit, pp. 228-229

[243] Chiquier, Loïc and Lea, Michael (Ed.), Housing Finance Policy in Emerging Markets, Washington: The World Bank, 2009, p. 178.

loan.[244] The ability of the client to pay is usually measured from the ratio of mortgage payment and the monthly income of the borrower by which the debt-to-income ratio is calculated by dividing total monthly debt by gross monthly income. The higher the ratio the greater the debt payment on the client. However, beside these measures, setting maximum limit of LTV is also used in mitigating the credit risk. Most of the countries worldwide set the maximum limit ranging between 60-75% except in case of subprime mortgage and some specific countries like Mexico, Thailand and Poland which set LTV ratio more than 80%.[245]

2. Strict regulations for granting the loans which is based on the creditworthiness of the client (Elgari, 2003). In this stage, the lenders generally asses the willingness of the client and to ensure that he is able to abide by his obligation and conditions agreed upon. This includes collecting information on the financial reputation of the client, the borrower's historical record of payment of other debts such as consumer loans and auto loans (credit history), financial standings, legal ability to raise loans from the Bank, his ability to generate sufficient income in future. Relevant credit rating agency often plays important to assess the credibility of the client.

3. Any redeemable collateral, personal guarantee or tangible securities which the Bank deems necessary for its claim is also used to mitigate credit risk of the client. However, the general principle from almost financial institutions consider that the credit is not granted on the basis of the collateral or guarantee but on the ability and creditworthiness of the client to fulfill his financial liability.

4. The Bank also put consideration with regard to general socio-economic atmospheres as well as special circumstances of the sector that generates the income of the client. This way is to anticipate unpredicted changes of situation and environment that may force the borrower to default due to reasons beyond his control.

[244] Ibid, pp. 178-179.
[245] Ibid, pp. 179-180.

5. The Bank also undertake strict regulations and policies to follow up recovery by which the contract of loans may contain conditions and terms that enable the Bank the right to collect installments such as authority to take over the other accounts of the client in the Bank or even in other Bank without an order from the court.

6. Besides, the conventional Banks also develop instruments for converting debt into negotiable instruments that can be transacted or sold to third parties for cash such as mortgage backed securities (MBS) which are familiar in subprime mortgage case.

7. In case the client is default, as if he delays the payment within certain period of time as per agreement, the debt increases according to proportion of the extended period, and the amount is deposited into the account of the Bank as source of income. The increased payment of loan is considered as a performing debt of the client if the interest is paid continuously. Nevertheless, in case the debtor is unable to make payment in a timely manner and he wants to maintain a good business relationship with the financier/Bank, the Bank has rescheduling method of debt by which the debtor will bear higher rate of interest.[246] As also noted earlier that the late payment affects the creditworthiness of the client which will be recorded in the credit history.

8. In case of subprime mortgage, the situation shows there is low credit risk management towards the client as the underwriting criteria and process was relaxed, no documentation of borrower income is required and the lenders rely more on the rising value of collateral (mortgaged home) to secure the loan than the borrower's ability to repay from income.

4.2.2 Liquidity risk:

Liquidity risk may be defined as an inability of the Bank to raise funds before it is due. In case of conventional mortgage, the lender is exposed to liquidity risk as the housing

[246] In Islam, this is considered as *riba al-jahiliyyah*, in which the debtor says to the creditor, "Increase the period for me and I will increase the debt (amount) for you," or conversely the creditor says to his debtor "Will you pay me or increase the amount." This kind of agreement is prohibited in Islam and therefore is not practicable in Islamic financing operations.

operation is deemed to be long-term financing in which the Bank may face difficulty to adjust its short term cash flow. CRR and SLR are similarly applied in the conventional system as all commercial banks are obliged to surrennder the reserved amount to the State Bank though it may differ from one country to another in term of its percentage. Furthermore, the conventional Bank fortunately has flexibility to involve in the interbank money markets for short term borrowing shock or mismatches in maturity. Besides, the availability of secondary markets in financial instruments could also become source of fund to overcome the liquidity risk (Rais and Majid, 2003). Deposit insurance is also another way to reduce the possibility of massive withdrawals from depository institutions. Finally, the central Banks also can play important role to provide the ultimate financial backing body for liquidity problem.[247]

4.2.3 Operational risk:

Operational risk stems from several causes that we mention here only some: risk of loss from incomplete documentation, data entry errors, rogue traders, and computer security breaches. In mortgage financing, the transaction intensity and the long term maturity increase the likelihood of these errors. Hence, the institution must have: sound systems to have proper management, automated systems and controls to administer the monthly cash flows, effective operational systems and internal controls, separate participants specialized in elements of the process for example, origination, servicing and securitization.[248]

4.2.4 Market risk:

Lending for a long term such as the operation in housing sector may cause market risk due to the following factors: uncertainty with regard to the actual and expected inflation, exchange rates and real interest rates. The different types of interest rate such as teaser rate or ARMs are the determinant factors that cause the risk and consequently expose to credit risk when the client is defaulted. The floating or fixed rate allocates market risk between borrowers, lenders, as well as investors. Fixed rate places market risk in the hands of the

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[247] See, Chiquier and Lea, Op.cit, p. 182.
[248] See, ibid, 187.

lender and requires matched funding and protection from prepayment risk. Floating rate places some market risk in the hands of the borrower, and require proper attention to payment shock which then has to be treated under credit risk management by the Bank.

CHAPTER V

COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL HOUSE FINANCING

This is the final phase that will conclude the discussion on this research pertaining to 'housing in financial institutions' and this section will discuss matters relating the comparison of the two competing housing schemes namely Islamic and conventional system.

5.1 Objectives

Economically, there is no difference in respect of underlying objectives of the Islamic and conventional financing system. Both have similar direction towards the maximization of profit at the end of the operation and both verily care about realizing final output that favors the contracting parties' mind. But there are some differences between the two in terms of the objectives pertaining to the ethical and spiritual matters. Instead of profit, the Islamic finance products tend to achieve and actualize ethical value and norms of humanity that concern with certainty, transparency, fairness and justice. The prohibition of *riba,* uncertainty and speculation is the core example of this issue. In conventional system, the requirement of charging interest in its various forms of finance often leads to the speculation and uncertainty in the implementation of the contract. The contracting parties are uncertain while the ARMs rate is obtained for financing a house and it evidently caused many defaults in loan payment.

Furthermore, the whole products available for house financing that necessarily follow the norms and guidelines of *Shari'ah* principles indicate that Islamic housing system is meant to objectify specific rules of Islamic financing system which are derived from the available texts recognized by majority of Muslims. So, it also promotes and maintains the spiritual aspects of individual's life and peaceful mind particularly for Muslims. By contrast, the conventional formula misses this angle which emphasizes mostly on maximizing wealth and profits regardless it may contravene the important aspects of fairness, justices and spiritual

values. Summarily, the Islamic financing process is the implementation of dual objectives viz. *Shari'ah* as well as gaining profit.

5.2 Product Specifications

The available products of house financing in Islamic financial institutions include *murabahah, istisna', bay' al-muajjal,* diminishing *musharakah, ijarah muntahiya bi-al-tamleek e*ach of these has their own rules and principles under *Shari'ah* purview which then characterize them as unique different models of housing system. In case of conventional housing system, the instruments available are differentiated basically through the different types of interest rate applicable in the contract whether variable rate or fixed rate or the combination between the two. Moreover, there is capped variable rate mortgage in which interest decreases/increases are capped during the term. However, in Islamic mode of financing such as in *musharakah* and *ijarah*, the rental payment which is subject to adjustment in each term according to the rental market, this mode may be considered as floating rate which is similar to the conventional interest-based system. The only fixed rate applicable in Islamic housing technique is through *murabahah* as the price is fixed during the term of the finance. Commenting this issue, the re-fixed payment of rents is applied only on the rent which is legally permissible and not applied on the loan or the price of the property. So, both systems have similarly floating rate in the sense that in conventional system the floating rate is applied on the loan the financier extends and in Islamic financing the same is found in the form of rent which is adjusted following the rental rate in the market. Regarding the fixed rate in the conventional system it may be seen similar to the Islamic system, but mostly the fixed rate applies only within certain period of time as mentioned in the early chapter of conventional housing system.

5.3 Operational Process

The differences in respect of operational process are as follows:

1. In Islamic house financing (as in *murabahah for example*), the Bank itself –though it can appoint an agent/client on his behalf- purchases the house from developer and resells it to its client on credit with no interest charged, while in conventional housing, technically Bank grants loan with certain interest to buy a house from a developer.

2. Mode of contract: The contract is also different, in Islamic system it is based on sale mode financing, manufacturing or lease to own contract under *Shari'ah* principles which do not involve direct lending and borrowing, while in conventional, it is interest-based instrument / debt contract with predetermined interest charged upon the client.[249] For example, the application of diminishing *musharakah* requires that the Bank and the client co-own the property on the basis of a debt equity ratio 70:30. The Bank shares is further divided into equal units such as eight or seven units for calculation of the repayment. Both agree that the client will buy the units on periodic installment basis, thus increasing the share of the client and reducing the share of the Bank. The Bank gets profit from the rental payment of the client according to its proportion of ownership in the property. In conventional housing system, the loan of the Bank is also divided into equal installments but the thing to be noted is that there is predetermined fixed interest charged upon the borrower instead of the principal loan provided by the lending Bank.

3. The above illustration also shows that the relationship between the financier and the client in the conventional Banks is formed under the principle of creditor-debtor basis the consequence of which the debtor is obliged to repay the loan with interest, while in Islamic Banks, it is based on partnership, leasing and sales which concern a lot about the involvement of real asset.

4. The LTV ratio in Islamic Banks is usually up to 80% but in conventional system it is probably up to 100% and more.

5. The profit of the Islamic Bank is generated from the profit margin of the sale price as in case of *murabahah* and *istisna'* or rental payment as in case of *ijarah muntahiya bi-al-*

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[249] See, Gozali, Ahmad, *Jangan Ada Bunga di Antara Kita: Serba-Serbi Kredit Syariah (Never be an Interest Among Us: Sundries in Shari'ah Credits)*, Jakarta: Elex Media Komputindo, 2005, p. 28.

tamleek and diminishing *musharakah* while in conventional Bank is from the interest. Further, the price and of an asset and profit is fixed except in very specific circumstances such as in case of long term *istisna'* or diminishing *musharakah* related to rental payment as discussed in the previous chapter. In conventional Banks, the payment of interest is subject to change and volatility either it decreases or increases specifically in ARMs.

6. Mode of payment: the different types of Islamic housing system determine the model of payment. As mentioned above, in case of diminishing *musharakah* the payment is done by purchasing Bank's shares plus rent periodically till the end, similarly as in case of *ijarah muntahiya bi-al-tamleek* the client pays periodic rental payment of the property as per contract and ended with transferring the ownership of the leased asset while in *murabahah* and *istisna* the principal and profit is used to determine the amount of payment. In conventional system, mode of payment is mainly determined by the type of interest rate the borrower obtains.
7. In Islamic Bank, the payment is fixed during the finance as it is determined since the outset till the end of the term as in case of *murabahah* while in interest-based system, credit payment which is based on floating or hybrid rate is always uncertain depends on the floating interest in the market. However, in Islamic housing based on *musharakah* or *ijarah*, the rent rate that can be adjusted following the prevailing rental rate in the market may be regarded similar to adjustable interest rate in term of its volatility.
8. Monthly payment in Islamic Banks consists of two components: unit price and monthly rental payment as in the case of diminishing *musharakah* or fixed profit as in case of *murabahah*, while in conventional institutions consists of principal payment and interest. The *murabahah* differs from *musharakah* because the payment is fixed and not subject to adjustment during the whole term from the making of agreement.
9. The ownership is created in Islamic housing agreement by the Bank through some specific instruments such as diminishing *musharakah* in which the Islamic Banks own some while in case of *ijarah* and *murabahah* own all. But in conventional system it merely gives loan to customer and the lenders/banks never own the underlying property.

10. Undertaking contract is required from the client to purchase the property which is considered as unilateral promise from the client to his financier (Bank). In conventional system, there is no such undertaking requirement as the borrower is obligated to furnish his debt with specific interest during the life of loan term.

11. The imposition of penalty. The penalty imposed by conventional Banks as in the case of rescheduling is in the form of interest and will be credited directly to the institution while in Islamic Bank, the material penalty may be imposed as penalty on late payment of the client but it is donated in charitable purposes and not for the benefit of the Bank itself. However, the Islamic Banks can sell the property if the client is unable to purchase the unit shares of the Bank according to schedule and in conventional system, the Bank has the right to auction (Shaikh, 2006) or foreclose and then sell the property. In conclusion, both systems differ each other in the usage of amount of the penalty but both have same intention in that deterrence on the part of the client.

12. The profit margin charged by the Islamic Banks is fixed during the term of agreement specifically in the *murabahah* model and therefore the total amount to be paid by the client is known from the beginning of a contract while in conventional system the interest which follows ARMs rate will not be known to the client as it is floating rate depending upon the market rate. However, the rent-based financing in Islamic system such as *musharakah* and *ijarah* the rate would be unknown as it is subject to re-fixation and adjustment as already highlighted.

13. The application of Islamic financing contracts is under the supervision of *Shari'ah* Supervisory Board (SSB) in order to conform with the *Shari'ah*-complaint criteria the result of which the system is labeled as an 'ethical banking' in Europe. So the Islamic Banks rules and regulations stand to compromise between the local regulatory bodies as well as *Shari'ah* standards. This is not so in case of conventional finance as the adopted rules and principles are merely regulated by the prevailing law of the land which is based on the imposition of interest.

14. It is required to take property *takaful* from an Islamic insurance operator in case of Islamic financing products, as for the conventional model the customer is required to take property and life insurance from conventional insurance companies. However, the conventional insurance is sometimes allowed in case of extreme need and legal requirement only.

15. Termination of contract: regarding the termination of a contract both system has almost similar rule, that is if any party contravenes any term of the contract such as the client does not fulfill his financial obligation under the contract, the other party has the right to terminate the contract unilaterally. If there is no contravention, the contract can be terminated by mutual consent. In case of the death of the client the contract will be terminated and it will be renewable by his successors. Furthermore, in Islamic Banks, the contract is terminated in normal way by purchasing all the Bank's shares in the property and in conventional formula it is terminated by paying the whole principal and interest due at any time.

5.4 Associated Risks and Their Management

In the followings, I would highlight the basic and key differences pertaining to risks and their management prevailing in Islamic and conventional house financing system which is commonly practiced in the housing market industries:

1. Islamic bank shares the loss in the property in case of any type of natural disaster except in case of *murabahah* because since the property has been already transferred to the client any arising risk would be borne by the client. The conventional bank does not share in the losses in case of any type of damage to property as it has given a loan to the customer.

2. Non-performing loans (credit risk) are the main problem that associates the conventional financing resulted from high interest rate. Credit assessment is similarly used in both Islamic and conventional system to determine the eligibility of the prospective client and to avoid the risk of default. However, in conventional system,

credit criteria may be lowered like in case of subprime mortgage in USA. In Islamic system such discretion can be considered as speculative way that must be carefully reviewed. Therefore, the maximum LTV ratio up to 80% is mostly used in mortgage markets worldwide to mitigate the risk of default in Islamic financial institutions. Furthermore, in case the default occurs during financing process, both Islamic and conventional system have specific measures to mitigate the risk. In Islamic Banks, it is allowed to charge penalty on late payment of the client which is then donated to charity and subject to *Shari'ah* Board approval. The Bank may deduct certain amount to cover the administrative costs relating to late payments recovery process. In conventional system, non-legal measures may be taken by lenders in the form of direct communication with the borrower to address the problem, and for legal recourse can be taken by way of suing for possession, foreclosure, and sale.[250] Basically, the property itself is considered as collateral to protect the financier in case of default.

3. Interest rate: the conventional housing system is definitely faced by volatility of interest rate which depends on the market situations. It benefits the lenders (Banks) in case of high interest rate, and it benefits the borrowers in case of low interest rate. ARMs might be a clear example in this case. On the contrary, in Islamic housing based on *murabahah*, interest rate can be avoided as the system fixes the payment during the terms on financing. The Islamic house financing faces interest rate risk in the sense that it can not generate same profit as conventional system when the interest rate is high. But it gives certainty in the mind of the client regarding his financial obligation during the term of the finance. However this consideration is subject to the previous issue pertaining to the volatility of rental rate that applied on diminishing *musharakah*. That is to say the fixation in the Islamic housing system in not in absolute sense in order to mitigate price risk that may appear.

[250] See, *Principles of Mortgage Financing*, p. 160

4. Early payment risk: the client can easily purchase the additional Bank's units of shares on its rental payment date (in case of *Musharakah*) during the transaction tenure by giving notice few days before as ruled by the agreement. In conventional system, usually it restricts the borrower to make early payment such as by imposing time limit during which the early payment is prohibited and by imposing some financial penalty in the form of pre-determined fees Mark-to-Market fees.

5. *Shari'ah* risk: The *Shari'ah*-related risks have been described in the earlier chapter. To address this issue, the practice of house financing is under the supervision of competent experts found in the SSB. The SSB is the body whose tasks are to overcome any arising *Shari'ah*-related issues so that it would not contravene Islamic principles pertaining to commercial transactions. Besides, uniformity of *Shari'ah* standards is necessarily projected to provide satisfactory answers to the public. Due to this characteristic of *Shari'ah* it causes more complexities with regard to the operational procedures in each of the models offered by Islamic housing finance. In conventional housing system, such type of risk is nowhere found as the system is not regulated by any form of Islamic formulas rather it is based on purely human discretion which is oriented in payment of interest and often the maximization of wealth and profit.

6. Impairment risk: Instead of credit risk, both systems are associated with risk of damage in the property, particularly due to natural disaster. However, both require clients/borrower to take insurance (property insurance) to protect the possible damages of the property.

7. Price risk: The Islamic Banks are exposed to price risk when more expenses are necessarily required during the term of finance such as in *istisna'* where the manufacturing costs increases. This risk is not certainly known as the financing process is long term in nature. Therefore, the Islamic Banks may increase the price of underlying asset with mutual consent. In case of rent-related financing such as

diminishing *musharakah* and *ijarah* ended with ownership the rent is also subject to adjustment or annual review according to rental market price as noted earlier. For conventional housing system, the Bank does not incur this special kind of price risk as the Bank is not involved with the maintenance and manufacture of the property.

8. Markup risk: in case of *murabahah* house financing model, markup risk occurs due to the benchmark rate volatility that makes the bank unable to benefit from higher rates as also mentioned earlier. In this case, Islamic banks simply use the LIBOR as the benchmark which aligns their market risk closely with the movement in LIBOR rates. Though it does not provide maximum benefit as compared to the conventional Bank but at least it gives considerable solution to make the Islamic Bank remains competitive among the financial institutions. In conventional system which is based on interest, such risk is easily solved by imposing floating interest rate as in case of an adjustable rate.

9. Equity investment risk: this risk is less exposed to most of Islamic financial institutions as the LTV ratio offered by the Banks is typically maximum up to 80% of the property and the client is liable to buy out the Bank's equity at the pre-agreed price and as per-agreed schedule. In conventional system, the possibility of low down payment structure in subprime mortgage leads to riskier exposure and this is mitigated through private mortgage insurance (PMI) that guarantee the default risk.

10. Liquidity risk is treated similarly in term of CRR and SLR as it had been mentioned earlier that the conventional and Islamic Bank is required to set aside liquid assets in the State Bank and in their own reserve. However, the Islamic Banks differ from the conventional system in term of treating interbank market that still deal with usurious formula which can not be justified and impermissible upon Islamic Bank, but if there is Islamic interbank market with no interest bearing operation then it would be permissible. Besides, there are certain other means with respect to the management of

liquidity risk by Islamic Banks such as Islamic bonds or *sukuks* as alternative to the conventional bonds.

11. Islamic vs. conventional formula: the basic differences between the Islamic and conventional house financing system can be traced out through its models itself. The Islamic housing system is fairly clear to be in line with the Islamic financing principles which must avoid *riba* (interest), uncertainty, deceptive and speculative activities (*gharar*) such as the adjustable rate. Therefore, the system requires certainty of payment models, asset-based financing which necessitates the involvement of ownership of the Bank itself as to promote risk sharing principle. This will clearly differ from the conventional housing system which impose different types of interest which may be considered as uncertain system. In result of this, the risks associated with both systems will be automatically different though to some extents they are similar.

CONCLUSION AND RECOMMENDATION

Finally, the study derives the following concluding points:

1. House is basic need of human life, therefore financing services offered by financial institutions are always necessary to meet the need of the people.
2. Currently, there are two types of financing model offered to the demanding consumers: Islamic and conventional. Islamic financing is characterized by the following criteria: no interest, certainty, not involving any prohibited activities/commodities, it has various contractual relationship, participation and -risk sharing and lastly under *Shari'ah* supervision. While the conventional house financing is characterized by the imposition of charging interest.
3. The prevailing instruments used in Islamic house financing services include: *murabahah lil-amiri bi-al-shira',* diminishing *musharakah, istisna', bay' al-mu'ajjal*, and *ijarah muntahiya bi-al-tamleek*. The predominant mode is by *musharakah* financing as commonly adopted in middle east countries as well as Pakistan, while *murabahah* and *bay' al-mu'ajjal* are mostly used in southeast countries like Malaysia and Indonesia. The *qard al-hasan*-based financing is very rarely used in most of Islamic financial institutions because its nature is non profit-generated service.
4. There are several issues criticizing the ongoing practices of the different products on housing that requires proper consideration in Islamic perspective.
5. The key features of Islamic house financing are: *riba*-free financing, different techniques of Islamic contracts, asset-backed financing, flexibility and combination of several contracts, the product of integration between Divine and human reasoning.
6. There are some underlying principles that can be derived from current Islamic house financing formula. These principles are the concept of fairness, justice and prohibition of fraud or uncertainty (*gharar*).

7. Instead of Islamic housing system, there is so-called conventional house financing product which has its own formula characterized by the imposition of charging interest, uncertainty with regard to teaser rate or adjustable mortgage rate, profit maximization minded and financing based on lending-borrowing a debt and not based on trade-based financing.
8. Subprime mortgage is one of conventional house financing models which is characterized by relaxed underwriting criteria, loan-to-value ratio up to 100%, ARMs or teaser interest rate.
9. Risk management is undertaken to anticipate some necessary changes and to act in such a way that a bank's business can be properly managed to gain profit from the changes or at least to minimize the possible losses.
10. The associated risks found in Islamic house financing products to some extent are similar to conventional housing system which includes: credit risk, liquidity risk, operational risk, market risk, but in some cases there are special risk associated with Islamic housing system such *Shari'ah* risks. However, the risk of default is considered as the most severe risk associated with both Islamic and conventional instrument because the product and services provided in housing finance is actually providing loans to the clients, though in Islamic mode of finance it requires the ownership in the property of the Banks.
11. The special *Shari'ah* risk requires special expertise and sound knowledge of Shari'ah rules in order to maintain the Islamic characteristics as well as public trust with regard to the product available in the financial institutions.
12. The Islamic house financing system differs from conventional product in the objectives, product specifications, operational process, and the risks associated in it with their management as well.
13. Islamic house financing is not merely interest-free financing. Besides, Islamic financing needs to avoid other elements of fraud and uncertainty such as volatile interest rate which is prevalent in the conventional mortgage.

Further, the followings are the recommendation of the study:

1. Muslim scholars and academicians are the backbone of the development of Islamic financing formula. As the Islamic banking industry is growing and getting its shining prospect nowadays the more detailed instruments and theories would be necessarily required by all concerning individuals particularly the financial institutions themselves. So, the educated Muslims with their local areas and disciplines are always required to comprehend their understanding in Islamic banking practices in order to meet the more challenging dynamic situations pertaining to finance.

2. Education is always main source of knowledge. Therefore, it must be continuously incited among the Muslim generations since early as possible to provide an awareness and good faculty concerning the ongoing need of Islamic finance. Hopefully, Muslims and other consumers will be familiarized with the development of new products and forms in this competing financial system.

3. The different forms of products offered in Islamic housing finance still often make many consumers and outsiders confused and therefore it is suggested that Muslim scholars and whoever of capable writers having this concern to familiarize Islamic finance along with its terms by contributing more research and work investigating each prevalent products in any form of writing and media.

4. There is still divergent understanding of Islamic legal rules pertaining to Islamic financing operations which result in differences in the implementation in the field. This leads to a number of questions and criticisms with regard to the consistency, characteristic, principles and certainty of Islamic *Shari'ah* products. So, more training cooperation and general meetings among Muslim scholars and practitioners as well as academics are absolutely required to unify their understanding, perception and implementation. These all are the effort which is attempted to standardize the regulations of Islamic finance acceptable by all international and local bodies across different financial institutions around the world.

5. It is also demanded that the Islamic Banks can provide sufficient publications in the form of printed or online materials that provide clear information of their available products to the desiring client so that it will be easily known by the public and moreover it can boost the value of Islamic banking products and industry.

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