

# Regulatory Framework and Practice of Musharakah Mutanaqisah in Islamic Banks of Jordan

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## Abstract

*Islamic financial institutions (IFIs) emerged to fulfil the Muslims' aspiration of engaging in Shari'ah compliance financial transactions. Since its inception it has gained ground worldwide particularly in the Muslim countries and Europe such as Britain. Islamic banking products or tools have proven effective in financing nationally and internationally. Jordan, as a Muslim nation, is not exempted from the great benefit. Although, there are dual banking systems in Jordan, nonetheless Islamic banking which is recent has been proven as a popular and effective model of finance. One of the famous models of finance is Musharakah Mutanaqisah (MM) particularly in home financing. This MM model seems to be widely accepted, however, its application among existing Islamic banks appears not symmetry. Therefore, this paper analysed the trend of MM in Islamic Bank of Jordan and studied regulatory framework in Jordan. This paper applies qualitative research method in analysing those practices. The results showed that Islamic bank of Jordan less favoured MM for its home financing. It is recommended that there should be a review of this practice for modesty and accountability purposes.*

**Keywords:** *Musharakah Mutanaqisah, Home Financing Tool, Islamic Bank, Regulatory.*

## Introduction

Islamic financial institutions particularly Islamic banks have witnessed tremendous developments and various successes beyond the Arabian Peninsula. These successful stories are partly from the very nature of Islamic banks as were based on Allah's commandments with unique and outstanding features as founded on Islamic commercial transactions' philosophy that observes both physical and mental aspects of economy. Thus, it promotes an act of progress and unified society as well as peace and fortunes that are pleasurable to human existence.

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Islamic bank's ideology has spread and robustly developed because it helps retain returns from financial transactions in the Islamic nations that were significant in the economies of countries such as Qatar, Saudi and United Arab Emirate (UAE), etc. Of all the distinguished features of Islamic banks, the avoidance of usurious dealings which was prohibited and grounding of transactions in a non-interest by replacing it with partnership in sharing of profit and loss. These developments, however, were not universal and uniform. Similarly, they are achievements at different periods of historical phases across the Muslim nations and around the world. Establishment of this type of financial system entails financial and political willingness and commitments.

Therefore, this study aims to explore the trend of development of Islamic financial system with global view notwithstanding focuses mostly on Jordanian Islamic banking industry. The major motivator is the fact that few percentages of the Islamic banks' transactions were based on partnership. Despite literature had shown that Musharakah particularly Musharakah Mutanaqisah (MM; diminishing partnership) is the most effective and Shari'ah compliant mode of home financing. Previous literature such as Olorogun (2012) indicated that majority of Islamic banking financing across the Muslim countries uses Murabahah as tool of financing. It suffices that something is wrong and it needs re-evaluation of the model and practices of MM in the contemporary Islamic banking system. The researcher chooses Jordanian Islamic bank industry as the population where sample would be drawn randomly. After adequate evaluations of the existing full fledged Islamic banks in Jordan, the researcher chooses Islamic Bank of Jordan (IBJ) and Islamic International Arab of Jordan (IIAJ) to be the samples of study. Hence, the study is arranged as follows: the next section is on the trend of developments in Islamic banking industry at global level, this is followed by Jordanian banking experience, regulation of financial institutions in Jordan, Islamic Bank of Jordan, Islamic International Bank of Jordan, critical issues and conclusion.

### **Global Trends in Islamic Banking Industry**

The above stated the broad function of Islamic banks, Islamic financial transaction emerged around 1940s in Malaysia. According to records, this was based on contingency savings designed on non-interest mechanism. By 1950s, a formal arrangement of Islamic bank appeared in Pakistan which formation was based on educational funding which aimed to ease learning and Islamic knowledge acquirement (Sharkawy,2000). In 1963, the first Egyptian Islamic bank was established where accounts were opened

upon requests of the customers. These accounts ranged from annual investment account to social responsibilities accounts such as zakat, social funding, etc. this experience was unsuccessful which led to the intervention of Egyptian Central Bank and Egyptian Bank in 1986 (Fisal, 2011;Kasawinah, 2008; Al-Hiti, 1998). In 1971, Societal Nasr Bank was established as a subsidiary of government bank to encourage savings and social insurance program among citizens. In addition to fulfil of needs and extension of interest free loans, there was a partnership with advancement of financial assistance(Fisal, 2011;Kasawinah, 2008; Al-Hiti, 1998). In 1974, Islamic Development Bank (IDB), an independent international bank was formed in the Kingdom of Saudi Arabia and began operation. The major objective of IDB is to serve as bank of resort for all Muslim nations' central banks across the globe. It also advances benevolent loans and fund projects based on partnership principle of profit and loss sharing. In 1975, Dubai Bank was founded which marked the beginning of a full fledge Islamic bank operation. This development led to the creation of other Islamic banks and financial institutions such as Kuwait Finance House and Faisal Islamic Bank (Fisal, 2011; Kasawinah, 2008; Al-Hiti, 1998).

MM is relatively a new technique that is not found in classical literature. It is formulated by contemporary Muslim scholars to facilitate investments among Muslims through the IFIs. However, it is a financing technique that is relatively very little used by Islamic banks as revealed by previous literature (Smolo, 2010). Although the mechanism of MM partnership had been approved by the First International Conference on Islamic Banking, held in Dubai in 1979 (Smolo, 2010), it has not been widely implemented throughout Islamic financial system. Reiterating that MM's discussions only related to the modern transactions that have no direct legal rulings in the traditional Islamic jurisprudence. Thus, the researcher would delve into this research by referring to those earlier legal rulings to contrive relative legal rulings for MM problems.

## **Development of Jordanian Financial Institutions**

The aspiration of the Jordanians to join its counterparts at the global financial village materialized with the establishment of Jordanian Central Bank at the end of 1950. The Jordanian Central Bank's regulation was legislated in 1959. The bank began its full operation in 1964 where it replaced the monetary council of Jordan which was formed in 1950<sup>3</sup>. This granted the bank a whole ownership and authority. This autonomous

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3. The information here was directly obtained from the Central Bank of Jordan website, retrieved April 28, 2014 for more kindly see [www.cbj.gov.jo](http://www.cbj.gov.jo)

role led to increase of its capital above 28 millions Jordanian dinar. Despite the government ownership the central bank yet maintains its constitutional right to operate independently. The central bank, like its counterparts round the globe, provides services such as bankers' bank, government bank, control currency in circulation, guarantee exchange of dinar, encourages commercial activities that aids economic development and services as bank of last resort.

For the sake of brevity, banking operation was successful in Jordan as at 2001 there were nine commercial banks and five investment banks. In addition to these banks were the two Islamic banks i.e. Islamic Bank of Jordan and Islamic International Arab Bank of Jordan. Tremendous development in the banking sector serves as an indicator of advancement in economic situations in Jordan where, as at 2014, total banks reached 26. This includes 13 commercial banks, 9 foreign banks, 3 local Islamic banks and one foreign Islamic bank. Before going into exploration of the two sampled Islamic banks, it is important to state here that Islamic banks operation in Jordan had begun almost four decades ago. Thus, the next section positions the advent of Islamic banks in Jordan and its legality<sup>4</sup>.

### **Regulations of Islamic Financial Institutions in Jordan**

Islamic financial activities, particularly Islamic banking operation made a significant appearance in the Jordanian economy where the Islamic Bank of Jordan was founded in 1978. Ever since, the industry had recorded number of successes and test of time that led to issuance of different regulations and amendments made to checkmate the industry's activities. The recent and current regulation was the year 2000's regulations aimed to protect the customers, investors, and the economy as a whole. The Islamic bank regulation 28 section 50-59 stated the Islamic bank's aims and objectives. Among these objectives is to aid financial and investment activities based on non-interest procedures. In addition, Islamic banks are required to assist in spreading and organizing of social assurance aimed on shared benefits, that is, partnership<sup>5</sup>.

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4. Ibid.

5. Law No. (28) for the Year 2000 Banking Law, the information here was directly obtained from the Jordan Legislation and Opinion Bureau website, retrieved April 28, 2014 for more kindly see [www.lob.gov.jo](http://www.lob.gov.jo)

The above said regulation highlighted clearly preconditions that an aspiring institution must fulfill before recognition as Islamic banks. Importantly among these preconditions is that the activities of the institution must comply with Islamic legal rulings specifically grounded legal rulings and its transactions must not be based on interest making motives. Adding to this general condition, other regulations are on services and assistance it provides for the citizens which are:

- 1- Acceptance of Deposits and Accounts: The operating currency could be the Jordanian dinar, foreign currencies depends on type of account requested as well as investments accounts.
- 2- Protection of Investments: These are pools of savings that the bank is charging certain amounts for its custody and investment such as an account for a specific project or an investment.
- 3- Investments: The Islamic bank is permitted to invest its funds in various ways such as Mudarabah, Musharakah and immediate investments like buying of assets, renting the property to the customer the contract which ends in and sale of the property to the customer.
- 4- Other banking services that are usurious free intended for charity for itself or the populace within the kingdom or elsewhere.
- 5- The banks serve as advisors for management of partnerships and implementation of conditions that are Islamic compliant and its regulations.
- 6- The banks serve as agents/trustees in serving the community that promotes unity and progress among the populace such as advancement of interest free debts, or creation of common pools specifically for development of the population.
- 7- Founding of organization and ownership of fixed and current/non-fixed assets etc. At the same time, it has the right to sales of asset, investment of assets, rentage of assets for the purpose of utilization, protection of lands for farming, tourism and housing.
- 8- Arrangements of personal insurance for the purpose of the Islamic bank, its employees and/ or its customers at all levels.
- 9- To act as custodian by fees for properties of the bank.

The year 2000 regulation No. 58 mandated the Islamic banks compliance to the Islamic legal rulings in their dealings. Therefore, Islamic banks are required by law to include

in its management team the council of Islamic legal professionals that must at least make up of three men. This three-man Shari'ah committee's rulings are binding on the Islamic bank. The three-man Shari'ah committee responsibilities include:

- a- To oversee that the Islamic bank's activities are in line with Shari'ah dictates.
- b- To advise on the substances of the contract on its Shari'ah compliant.
- c- To observe whether the Islamic bank has fulfilled the central bank's conditions and regulations<sup>6</sup>.

While all Islamic banks are expected to implement these regulations, the approaches of Islamic banks' vary. Thus, the next section account explores the background and services of the sampled banks i.e. Islamic Bank of Jordan and Islamic International Arab Bank of Jordan in this study.

### **Islamic Bank of Jordan**

Jordan Islamic Bank was established in 1978, as a public shareholding limited company to carry out all kinds of banking, financing and investment business operations in compliance with the glorious Islamic Shari'ah and in accordance with the provisions of Jordan Islamic Bank's Special Law which was in effect as of 2nd August, 2000. Its authorised capital was JD (4) million and began operation in 1979 with about JD (2) million paid-up capital. The advancement in Jordanian economy and global trends as mentioned earlier have transcendent these capitals to paid-up JD 125 million equivalent to USD 176.5 million in 2012. In July 2010, Islamic Bank of Jordan acquired AlBaraka banking group which led to modification of its logo/trademark in order to incorporate the new subsidiary. It has 69 branches and 15 cash offices, and up to 143 ATMs services across the country. The bank serves about 887.3 thousands account holders with efficient and competent staff. All its activities are *Shari'ah* compliant<sup>7</sup>.

### **Islamic Bank of Jordan's Services**

With long experience in banking services, the bank provides numerous services to the general populace broadly fewer than two groups. The accounts are either individual or corporate account<sup>8</sup>.

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6. Ibid.

7. The information here was directly obtained from Jordan Islamic Bank website, retrieved April 28, 2014 for more kindly see [www.jordanislamicbank.com](http://www.jordanislamicbank.com)

8. Ibid.

**Individual Account:** In compliance to the regulations, the bank offers accounts for individuals such as current accounts, salary current accounts, call accounts, saving accounts, term accounts, notice accounts, specified investment accounts (Restricted accounts), investment portfolio accounts/muqaradah bonds, investment by proxy accounts, Al-Qard Al-Hassan fund accounts.

**Corporate Account:** Similar to the individuals' accounts stated above the bank provides services and funding for companies and organizations such as current accounts, saving accounts, term accounts, notice accounts, specified investment accounts (Restricted accounts), investment portfolio accounts/muqaradah bonds, investment by proxy accounts, Al-Qard Al-Hassan fund accounts.

### **Financing and Advisory Services**

As a professional corporate entity, the bank provides both physical cash funding and soft products. The funding is by financing a project or purchase of fixed like house, land, farm, etc. or non-fixed assets such as rights, guarantee of funds etc. Specifically, Islamic Bank of Jordan provides funds for:

**-Murabahah sale:** This contract involves the bank buying an article and selling it to the client with a mark-up (profit). Often this contract dictates that the bank owns the property before selling it to the client. The total acquisition cost is levelled with the bank's expected profit wherein payment is done at an instalment.

**-Lease ending in Ownership:** This applies to real estates, machinery and others. These are purchased then rented for a certain period in a way that enables lessee to own them at the end of the lease period according to the regulations and Shari'ah arrangements in this regard.

**-Instalment Sale:** This applies to real estates and commodities. These are purchased then sold and abandoned for the buyer on the basis of paying back its price – partially or fully – in instalments during a specific period.

**2-Investment Services:** Based on its professional orientation it includes in its overall services for individuals and organisations that are craftsmen financing such as providing finance for diploma holders, professionals, craftsmen, technicians, doctors, pharmacists and engineers who are on a high level of fidelity and experience in all economic activities in accordance with the glorious Islamic Shari'ah principles. The financing could be new projects for those starting up business or upgrading of existing projects. Others are:

**-Musharakah(Partnership):** This is a partnership where the bank engages as partner in individual or corporate investment where profit and loss are shared in pre agreed ratio. In the contemporary Islamic banking system Musharakah is divided into:

**a- Permanent Musharakah:** This type of investment means a long term relationship exists between the bank and the client. Both parties contribute a certain amount or the client provides capital and the bank uses its investment knowhow as capital. The bank and client share profits on a pre-agreed ratio according to a portion of each.

**b-Diminishing Musharakah Ending in Ownership:** This investment or financing formula dictates that the parties i.e. the bank and the client contribute percentage of the cost of the project. However, there are chances that the bank wholly financed the project. This project is expected to be tangible and has a long-term life span which has an expected return. The agreement often is that the bank obtains a relative ratio from the realized net income. The share of the bank in the property reduces as the client repays back the bank its proportion ownership right to the property. After that, the project is wholly financed and owned by the other party or client. The bank's MM procedures for MM house financing are as follows (Al-Kawamelah, 2008):

- 1- Customer must own a land and approaches the bank to finance the construction of specific design dwelling home. The bank makes feasibility study of this application from social and economic perspectives.
- 2- The will requests the customer to fulfil certain conditions such as pawn the land in the name of the bank until the customer discharges all his financial responsibility. On the bank's part, it guarantees the rightful ownership of the land by double-checking the customer's background and connection to the land as to legal ownership or not. The customer is requested to uphold the contract and avoid entering into another contract on the same land either renting, sale or leasing the land to another party. The customer is also requested to provide a guarantor who stands for to assure the discharge of liabilities and fidelity of the customer.
- 3- After the completion of the MM housing contract on the subject matter, the customer is requested to pay handling cost of the project such as administrative expenses (postal cost, legal cost, engineer sundry expenses). These expenses are considered as the customer's capital contribution to the project.
- 4- There would be an agreed percentage of capital contribution. Thus, the bank provides its portion of the total amount to the customer or trustee if any.

- 5- The bank would open an account for the customer where the bank deposits in batches the amounts where all responsibilities of the customer as regards to the project are met.
- 6- The parties agreed to appoint a manager for this project wherein all rights and responsibilities of the project transfer to the manager. This includes rights to rent out the property or its part, and has rights to dictate terms and conditions of the rentage contract.
- 7- The parties agreed to the share of profits' terms and conditions based on the ratio of capital contributed. This is after the completion of the project.
- 8- The customer must discharge the responsibility of paying the government's required taxes in regard to the project.
- 9- The customer continues to buy the bank's ownership portion of the contract in order to own the entire property leading to total elimination of the bank in the ownership.
- 10- In case of loss in the project, losses are shared according to parties' capital contributed.
- 11- The bank owns the right to stop the contract of the project where it appears unfavourable to the bank (Al-Kawamelah, 2008).

**Mudarabah:** The bank offers to finance a project wholly or contribute a percentage of the capital to execute the project. Often in practice the capital provider is the client and the bank is the professional who uses its professional experience to oversee the execution of the project. The partners share for a certain commercial operation which the bank performs on the basis of sharing the profits and loss. Any accrued losses are borne by the capital provider in the case of Islamic Bank of Jordan, the bank bears losses arising out of the project under this contract except if they are caused by the second party i.e. the customer/client misconduct or violation as long as he does not participate in it through his special funds.

**Investment in Real Estates:** As a professional financial services provider the bank is engaged in investment on real property. The bank sells, buys and rents real estate's after studying the feasibility of each project suitable to the real estates to achieve safe returns on a long term in compliance to Islamic Shari'ah principles.

### **Islamic International Arab Bank of Jordan**

The Islamic International Arab Bank of Jordan like its counterpart discussed above commenced its banking operations in accordance with Islamic Shari'ah rulings on the 9th February 1998, to meet the growing demand for Islamic banking services and products in the local, Arab and Islamic markets. It is a public liability company under the Public Shareholding companies No. 327 on 30 March 1997. Its mission and vision is to provide financial services to the Jordanian populace and aims to be the role model of Islamic finance in the Arabian countries. This includes the banking services, professional and ethical services in accordance with Islamic and global banking standard<sup>9</sup>.

### **Islamic International Arab Bank of Jordan's Services**

The bank is much younger to its counterpart who is with longer experience in banking services; the bank provides numerous services to the general populace broadly fewer than two groups. Similarly, to its contemporary, the accounts are either individual or corporate account<sup>10</sup>.

**Individual Account:** In compliance to the regulations, the bank offers accounts for individuals such as saving accounts that provide participating in investment net profits in accordance with announced participation ratios, profits are distributed every end of accounting year, Free VISA Electron and Phone Banking Service. It also provides current accounts service with augmented services such as phone banking services, payment orders and transfers to other accounts, auto-covering from/to other accounts. An ample of attention is given to retail banking such as real estate financing through Ijarah (IjarahMuntahiah Bi Tamleek program), land Ijarah/lease to own, Ijarah for Jordanian expatriates on both land and apartment acquisition, Murabahah apartment financing etc.

**Corporate Account:** Similar to the individuals' accounts stated above the bank provides services and funding for companies and organizations such as Murabahah Financing for purchase of fixed assets, Lease Ending in Ownership Financing (Ijarah), Mudarabah Financing a profit-sharing contract consisting of a capital investment from

9. The information here was directly obtained from the Islamic International Arab Bank of Jordan website, retrieved April 28, 2014 for more kindly see [www.iiabank.com.jo](http://www.iiabank.com.jo)

10. Ibid.

the Bank (as a Principal) and a labour investment from the client (as Mudarib), Istisna' Financing, Mosawamah Sale etc.

**Musharakah Financing:** Musharakah (partnership) is a contractual agreement between the partners. In this contractual agreement it is dictated that partners contribute certain percentage of the capital and profits are shared according to capital's ratio. Musharakah is one of the most important models of Islamic investment practised by Islamic International Arab Bank. The bank plays an effective role with its partner in conducting studies and deliberating over the intended project from technical, Shari'ah, and social aspects. The bank also allows the client the chance to take full ownership of the project, by purchasing shares in instalments when possible.

### **Critical Issues in the Services of the Sampled Banks**

It is evident from the previous analysis that the two banks offer almost common products. Although applications and managerial systems might be different, both banks strive to provide the needed services in accordance with Islamic commercial laws. However, as it appears Islamic International Arab Bank of Jordan explicitly stated the kinds of Musharakah service they offer. Basic Musharakah is their product while owning the property is an option which the client might want to extend. On the contrary, Islamic Bank of Jordan provided Musharakah funding nevertheless, it was not explicitly stated on its official website the mode and procedure it adopted in constructing Musharakah contract for its client. Another concern is that it is clear that Islamic Bank of Jordan does provide MM services to its clients. However, some of the procedures are not justified. For example, the customer is required to pawn the property i.e. land on behalf of the bank or for the benefits of the bank. Similarly, it is unfair to delay profit sharing until the profit is equal to the capital. The issue here is how long it would take to recuperate the profits equivalent to the capital. Other issues are total right of the bank to the property, compulsion of the customer to pay for all initial expenses such as administrative, engineer's sundry expenses etc. In fact, total right of the bank to dictate the managerial decisions regarding the project is not totally appropriate considering the right of the customer.

### **Conclusion**

Despite vital role MM can play in the financing programs of Islamic banks, it appears from the reviewed literature that Islamic Bank of Jordan, at least by limited information available, has not favoured this contract. It would have been better if MM is extensively

exploited and such activities transfer of pawn, authoritarian power of the bank to determine future of the contract, as well as longer terms on profit sharing etc. reported for accountability purposes. It is believed that MM risk exposure can be controlled if real Islamic financing model is applied compared to Murabahah contract which most banks use as financing model (Olorogun, 2012) and the total expose of the bank to risks. The most concerned is lack of implementation of MM for home financing which has been proven by previous studies as deviates from Shari'ah compliant.

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