Application of Musharakah Mutanaqisah Home Financing As an Alternative to Traditional Debt Financing: Lessons Learned From the U.S. 2007 Subprime Crisis

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Abstract

One of the causes of the 2007 U.S. subprime crisis in 2007 is the use of traditional debt financing whereby the bank does not take risk of owning the property. Furthermore, the bank does not share its profit with customer and monthly instalment is pegged against market interest rate. This paper will initially examine salient issues (e.g. interest charges, indebtedness) faced by customers and banks during the crisis. Secondly, it will propose an alternative model known as musharakah mutanaqisah or diminishing partnership whereby the bank jointly own the property with customer and real rental rates replaces interest rate as a benchmark to determine monthly instalment. In studying the rental rates, the hedonic pricing theory is discussed. It is argued that the musharakah mutanaqisah concept can address issues of the crisis through the application of the Shariah principles and necessary changes to the regulatory framework.

1. Introduction

The term U.S. subprime crisis is associated with banks’ approval of home loans to customers who are not qualified due to lack of income and capability of making their monthly instalments. To be specific, Kamil et al. (2010) define the term concisely as follows:

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Subprime lending is a general term that refers to the practice of making loans to borrowers who do not qualify for market interest rates because of problem with their credit history, p. 387.

Mirakhor and Krichene (2009) provide a comprehensive definition of subprime. They define subprime as a segment of the market in which mortgages are issued and credit are extended to buyers with low credit score, brief or no credit history, little or no assets and poor income earning prospects. Interestingly, Mirakhor and Krichene (2009) conclude subprime as ninja loans. Subprime crisis is closely viewed as a systematic risk where it is used to explain unexpected crises leading to collapse of banks due to lack of confidence as can be occurred in some US financial associated with the subprime mortgage predicament (Kayed and Mohammed, 2009). Further, Islamic banks are also exposed to risks such as credit risk and investment risk, to mention some (Abdul-Rahman and Shahimi, 2010). However but, in the case of mortgage the banks are relatively exposed to credit risk at a minimal level. For instance, Bank Islam Malaysia Berhad had introduced a proper measure to handle those clients with low credit score in obtaining financing. The bank is pioneer in developing such measure prior to the introduction of a guideline introduced by Bank Negara Malaysia in tackling default problem amongst households. The bank manages to choose only qualified debtors for mortgage products based on their creditworthiness. This makes an Islamic mortgage provider is more ethical than that of conventional mortgage provider.

This research focuses on the features of musharakah mutanaqisah home financing compared to the existing debt based home financing namely conventional interest rate home financing and BBA fixed rate home financing. The latter modes are criticized by scholars as its operations do not promote justice and fairness and thus do not conform to the purpose of the Shariah (maqasid al-Shariah) (Al-Ghazali, 1937). Furthermore, Anwar (2003) asserts the current practice of BBA home financing is haram and thus cannot be classified as an Islamic banking product. Conversely, he views that the musharakah mutanaqisah concept possesses ‘Islamic identity’ reflecting the philosophies, values and precepts of Islamic society such as promotion of individual and society well being. In supporting this view, Kuran (1996) claims that the establishment of Islamic banking is to strengthen the Islamic identity. According to the scholar’s thesis:

Islamic economics makes muslims’ inevitable economic adaptations appear to conflict with maintaining an Islamic identity. One of the effects of Islamic economics is thus to heighten the clash within individual muslims, the clash that pits two selves against each other, Homo Economicus against Homo Islamicus, p.440.
Dusuki (2008) further emphasizes that the operations of Islamic banking are based on two main objectives namely fulfilment of social welfare and profit. The scholar stresses that the both objectives are important and can be achieved simultaneously by promoting Islamic values and social responsibilities towards their staffs, clients and general public. These efforts would enhance the corporate image of the Islamic bank, thus generating positive attitude from the society on the Islamic banking operations.

Based on the assertions made by Kuran (1996) and Dusuki (2008), Islamic financing is seen as meeting the tenet of Shariah which emphasise on justice and fairness by avoiding the elements riba (usury), gharar (uncertainty) and maysir (speculation). Mydin-Meera and Abdul-Razak (2009) further argue that interest rate should be replaced by real rental rate as the benchmark in determining the monthly instalments for musharakah mutanaqisah home financing. This is because rental real rate reflect the market value of the house which varies based on the locations, size and amenities. In other words, the use of real rental rate represents the real asset value of the property unlike interest rate which is riba (usury) as it reflects the value of money.

Nonetheless, there is to date scanty literature that discuss on the use of rental rate for musharakah mutanaqisah home financing. So far the authors have only found Mydin-Meera and Abdul-Razak (2009; 2005) who emphasize on the importance of rental rate as the benchmark for musharakah mutanaqisah. Other scholars who write on the subject have not captured the pricing issue (See Osmani & Abdullah, 2010; Shuib et al., 2011; Mohammed-Naim, 2011). Hence, this paper will also focus on the possibility of using actual rental rate to replace interest rate for musharakah mutanaqisah home financing. Furthermore, we adopt an analytical approach based on past literature reviews to meet our research’s objectives (Sekaran & Bougie, 2010; Harahap, 2003).

This paper is organized in the following ways. The immediate sections review the literature of the study. The third section is on discussion and implications of study. It ends out with the conclusion and areas for future research.

2. Literature Review

2.1 Philosophy of Islamic economics and financing

Chapra (1985) stresses that spiritual values, socio economic justice and human brotherhood considerations are the divergence issues between Islamic economics and modern capitalism. Furthermore, he noted interesting allegations with respect to Islamic economics justice:
Islam reinforces its teachings of brotherhood and the social equality of all by a socio-economic system that satisfies the needs of all in keeping with their status as vicegerents of God on earth. It requires an equitable distribution of income, wealth and stipulates values of living that are in harmony with its goals...

According to Kazi and Halabi (2006), the use of interest rate is forbidden in Islamic finance due to the following reasons. Firstly, the interest helps accumulate the wealth in the hand of few, where rich will become richer and poor will become poorer. Secondly, interest rate presents an initial outlay of capital that give rise to a continuous accumulation of capital. In fact, money which is widely transacted should not be used to produce money (Ayub, 2007). This is the concept of trading in Islam where money cannot be viewed as a commodity (Kazi & Halabi, 2006). The abolition of interest in Islam is considered important to provide a check on the right of private proprietorship ending the oppression and exploitation of the labour force (Choudhury, 1983). In addition, interest based transaction has been argued as the factor that cause Asian financial crisis (1997) and subprime crisis 2007 (Kamil et al., 2010; Ahmed, 2010). 

Chapra (1985) suggests two alternatives concepts that can be used to replace interest based lending namely qardhul hassan and equity financing. The scholar further explains that the concept of qardhul hassan is based on loan without any interest charged to the customer. On the other hand, equity financing is based on profit and loss sharing between the two parties in business. The concept of equity financing can be further categorized into musharakah and mudarabah. In the light of the 2007 US subprime crisis, recent literatures have emphasized on the use of the musharakah concept (Osmani & Abdullah, 2010; Mydin-Meera & Abdul-Razak, 2009). In fact, Mydin-Meera and Abdul-Razak (2009) argue that the profit sharing mechanism in musharakah is better than the traditional debt based conventional and BBA home financing.

Another important aspect of Islamic finance is that the bank is required to take ownership of the property before it is sold to the customer (Rosly, 2005). In fact, the Shariah requires the bank to take risk, liability and effort to fulfill iwad or equivalent counter value in a legitimate sale transaction. Failing to do this would invoke riba in sale (Rosly, 2005). In conventional financing, the bank is not required to take ownership of the asset or property to be financed as money is treated as a commodity (Ayub, 2007). As such, conventional financing is free to leverage on money to make more money by providing loans to customers. Kahf and Khan (1992) provide a clear distinction between riba and bay (sale). The scholars affirm that capital involved in
bay may grow or decline through time but in a riba based transaction, the capital automatically increases over time. The argument on the differences between conventional loan and Islamic financing is further supported by Abdul-Razak and Mohammed (2011). The scholars argue that Islamic financing differs from conventional financing as the Shari'ah does not allow gain based on borrowed money. Moreover, according to Ayub (2007), money has no intrinsic value and can only be served as a medium of exchange.

The above studies share the common views of scholars with regard to Islamic economics and the transactions permissible under Islamic finance. We can conclude that the concept of financing in Islam differs with conventional financing as lending is not allowed in the former because Islam strictly prohibits the use of money as a commodity where interest is earned in a loan transaction. In ensuring that the sale is valid under Islamic finance, the bank must take possession of the asset before it is sold to the customer. The different approaches between Islamic economics and modern capitalism are reflected in the practice of Islamic banking and finance of which the salient features are the prohibition of riba (usury) gharar (uncertainty) and maysir (speculation).

2.2 Causes of subprime crisis: An Islamic perspective

As mentioned earlier, the subprime crisis is occurred due to banks’ unscrupulous lending to unqualified borrower. This is because housing loans are granted to the customers who have bad history of monthly repayments and excessive debt from multiple banks (Johnson & Neave, 2008). Furthermore, interest rate is used as a benchmark. This is subjected to variations and caused hardship and difficulties to the customers in making the monthly instalments (Johnson & Neave, 2008).

Many scholars have argued that the greed for profit maximization is one of the main factors that causes the US subprime crisis in 2007 (Abdul-Razak & Mohammed, 2011; Smolo & Mirakhor, 2010). “Greed” – the unbridled pursuit of wealth – has become the most popular slogan of individuals and particularly of the corporate world, leaving the masses to misfortune (Ayub, 2007). According to Abdul-Razak and Mohammed (2011), the crisis begins when the banks take advantage of the low interest rate of one percent offered by Federal Reserve in 2003 to leverage on loans provided to subprime borrowers. Smolo and Mirakhor (2010) further observe that when interest rate is increased to 5.25 percent in May 2006, the banks increase their monthly instalments. Customers’ inability to reimburse the instalments have resulted the bank to foreclose their houses and force customers to be home less (Abdul-Razak
& Mohammed, 2011). These scholars further argue that another cause of the subprime crisis is because of selling of debt against debt that is not allowed by the *Shariah* as debt like money does not have intrinsic value. They remark that debts such as the Collateralised Mortgage Obligations (CMO) and Collateralised Debt Obligations (CDO) which derive their values from the subprime mortgages are securitized and packaged using sophisticated financial engineering technique without complete and accurate information given to the investors on the quality of the securities. Hence, there is asymmetric information as only the issuer of the product possesses full control of information pertaining to the securities, without disclosing it to the investor. The process of selling debt to investors known as *bay al dayn bi al dayn* is forbidden. This is because it involves the transfers risk from the bank to the investor without taking possession (Chapra, 2008).

A work by Chazi and Syed (2010) provides invaluable insights with respect to risk exposure during the global financial crisis in the case of Islamic banks. They argue that Islamic banks are not involved in an activity of debt trading as it is Islamically prohibited owing to interest elements. It is further argued in this work that mortgage-backed securities (MBS) have been viewed as the cause of subprime crisis in the US. MBS is issued and priced using interest that is not Islamically accepted. On the other hand, Islamic banks are not permitted to buy debt securities are due to the fact they are composed of a number of interest elements in their modus operandi. This explains why Islamic banks are safer from the direct effect of the subprime crisis and thus can be deliberated as a way of out from the burdensome of conventional mortgages.

Ahmed (2009) views the subprime mortgage crisis as the most severe since the Great Depression (1930-1933). It has shaken the very foundations of the capitalist financial system as a result of banks’ greed for excessive profits by introducing dubious products taking advantage of the unregulated financial environment. By the end of 2006, a total of 55 percent of the estimated total of $10.2 trillion value of mortgage loans in the US is packaged and sold to local and global investors (Norges, 2007 as quoted by Ahmed, 2009).

On the same note, Ahmed (2010) also reports that the subprime mortgage crisis in the US is due to excessive and imprudent lending. Furthermore, Johnson and Neave (2008) and Ahmed (2010) are of the opinion that *riba* (usury) and *maysir* (speculation) are the major factors as the borrowers are affected by the increase in interest rate and speculation of interest. The prohibition of *riba* and *maysir* could have been the panacea that can address the financial crisis. What is asserted by Ahmed (2010) has also been mentioned by scholars in many publications pertaining to prohibition of interest and gambling in financial transaction (Chapra, 2006; Anwar, 2003; Zarqa, 2003).
2.3 Application of rental rate in musharakah mutanaqisah home financing

The pioneering work of Mydin-Meera and Abdul-Razak (2005; 2009) highlight the advantages of musharakah mutanaqisah home financing compared to existing debt based home financing such as conventional interest rate home financing and BBA fixed profit rate financing. Subsequently, the works of Osmani and Abdullah (2010) and Shuib et al. (2011) further support previous scholars on the viability of the musharakah mutanaqisah concept. Firstly, the concept is internationally accepted by scholars compared to BBA that is only accepted in Malaysia and Brunei. Secondly, the use of rental rate is fair as it is based on real rental value of the property and it is not based on market interest rate. Thirdly, the flexibility of rental rate can capture banks’ issue of liquidity risks. Lastly, the facility allows customers to own the property earlier by purchasing more of the banks’ share.

Two interesting studies have acknowledged the importance of using rental in musharakah mutanaqisah. The first study is done by Mydin-Meera and Abdul-Razak (2005) which proposes the use of rental index like the house price index as a mean to benchmark for musharakah mutanaqisah home financing. Unlike interest rate, the house price index will be directly linked to the usufruct of the asset (Mydin-Meera & Abdul-Razak, 2005). The authors further indicate scholars’ support of using the rental index in another paper (Mydin-Meera & Abdul-Razak, 2009):

In order to ascertain the validity of using actual rental value as an alternative to interest rate, we carried out five semi-structured interviews with scholars in Islamic economics, fiqh and Shariah advisors of Islamic banks regarding their opinion on using actual rental based on value of property for musharakah mutanaqisah home financing in place of interest as a benchmark. In general, they are agreed on the usage of actual rental value of property as an alternative to interest rate as the former reflect the real property value in the market, pp.7-8.

The use of actual rental rate as a benchmark is also advocated by a well-known Shariah scholar by the name of Usmani (1998):

Rental must be determined at the time of contract for the entire lease period. It is permissible that different amounts of rent 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, p.112.

Nonetheless, according to Al-Zuhayli (2003) if the rental rate is not determined at the point of contract, it is invalid. This is because “a sale without naming the price is defective and invalid” (Al-Zuhayli, 2003).
One of the limitations of the current *musharakah mutanaqisah* home financing is the prevailing use of interest rate as a benchmark Mydin-Meera and Abdul-Razak (2009). The scholars lament that such practice would make the *musharakah mutanaqisah* home financing to be similar with conventional home financing (Mydin-Meera & Abdul-Razak, 2009). The continuing use of interest rate as a benchmark for *musharakah mutanaqisah* home financing would lead to convergence between conventional and Islamic home financing.

In order to illustrate an example of the differences between the prevailing BBA home financing which is based on the traditional financing and *musharakah mutanaqisah* home financing, we take an example of a customer who wishes to purchase a house for RM 250,000 and paid (10 percent of the purchase price) to the developer as down payment. The bank provides financing for the balance of RM 225,000 for 20 years at profit rate of 9 percent per annum. Using the present value of annuities formula similar to conventional financing, the monthly instalment computed is RM 2,024.38 payable for 240 months and the selling price to the customer amounted to RM 485,851. The difference between RM 485,851 and the cost of financing of RM 225,000 which amounted to RM 260,851 is the total profit earned by the Islamic bank. The profit amount is capitalized upfront and remained fixed unlike under conventional loan where the interest rates varies and unearned until the elapse of time.

In the case of *musharakah mutanaqisah* home financing, rental rate replaces interest rate as the benchmark to determine the profit. Rental rate is based upon the market value of the property. The average rental rate is 5.67 percent per annum (obtained from the Valuation and Property Services Department 1984-2005 Property Market Report, Ministry of Finance, Malaysia). The rental rate differs between each type of house, location and amenities available. For example a single storey house would have lower rental in rural area than in town area. A condominium would have higher rental than single storey house due to the facilities available. The rental reflects real value and not interest rate (BLR) that is the price for money.

Hence, applying the same situation for *musharakah mutanaqisah* home financing, the customer initially owns 10 percent shares of the house amounting to RM 25,000. The bank owns the remaining 90 percent, i.e. RM 225,000. Based on the average rental rate of 5.67 percent per annum, the customer’s monthly rental is RM 1,181.25 per month. The customer pays another RM 388.18 per month to redeem the bank’s share.

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1. 5.67% p.a obtained by \( \frac{RM 1,181.25 \times 12}{RM 250,000} \)
2. RM 388.18 obtained by \( \frac{0.00473 \times (250,000 - (1.00473)^{240} \times 25,000)}{(1.00473)^{240} - 1} = RM 388.18 \)
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in 20 years (Meera and Abdul Razak, 2005). This gives the total monthly payment as RM 1,569.43. The payment schedule for the Musharakah Mutanaqisah home financing facility is indicated in Table 1 below:

Table 1: Payments Schedule for Musharakah Mutanaqisah Home Financing

<table>
<thead>
<tr>
<th>Month</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>≈</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly rent</td>
<td>A</td>
<td>1,181.25</td>
<td>1,181.25</td>
<td>1,181.25</td>
<td>≈ 1,181.25</td>
</tr>
<tr>
<td>Monthly redemption</td>
<td>B</td>
<td>388.18</td>
<td>388.18</td>
<td>388.18</td>
<td>≈ 388.18</td>
</tr>
<tr>
<td>Total payment</td>
<td>C=A+B</td>
<td>1,569.43</td>
<td>1,569.43</td>
<td>1,569.34</td>
<td>≈ 1,569.34</td>
</tr>
<tr>
<td>Customer’s ratio (%)</td>
<td>D</td>
<td>0.1</td>
<td>0.102</td>
<td>0.1041</td>
<td>≈ 0.994</td>
</tr>
<tr>
<td>Customer (Rental)</td>
<td>E</td>
<td>118.13</td>
<td>120.52</td>
<td>122.92</td>
<td>≈ 1,173.87</td>
</tr>
<tr>
<td>Financier (Rental)</td>
<td>F</td>
<td>1,063.12</td>
<td>1,060.73</td>
<td>1,058.33</td>
<td>≈ 7.38</td>
</tr>
<tr>
<td>Customer’s equity</td>
<td>G</td>
<td>25,000</td>
<td>25,506.31</td>
<td>26,015.00</td>
<td>26,526.10</td>
</tr>
<tr>
<td>Financier’s equity</td>
<td>H</td>
<td>225,000.00</td>
<td>224,493.70</td>
<td>223,985.00</td>
<td>223,473.90</td>
</tr>
<tr>
<td>Financier’s cash flow</td>
<td>I</td>
<td>-225,000</td>
<td>1,569.43</td>
<td>1,569.43</td>
<td>1,569.43</td>
</tr>
</tbody>
</table>

We also provide some comparisons between BBA home financing and musharakah mutanaqisah home financing. The details are provided in Table 2 which highlights the discrepancies between BBA home financing and musharakah mutanaqisah home financing:

Table 2: Comparison between BBA and Musharakah Mutanaqisah Home Financing

<table>
<thead>
<tr>
<th>Type of financing</th>
<th>BBA home Financing</th>
<th>Musharakah mutanaqisah home financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit rate/rental rate</td>
<td>9 % p.a</td>
<td>5.67% p.a</td>
</tr>
<tr>
<td>Cost of financing</td>
<td>RM 225,000</td>
<td>RM 225,000</td>
</tr>
<tr>
<td>Monthly installment</td>
<td>RM 2,024.38</td>
<td>RM 1,569.43</td>
</tr>
<tr>
<td>Total cost of payment in 20 years</td>
<td>RM 485,851</td>
<td>RM 376,663</td>
</tr>
<tr>
<td>Total profit earned by bank</td>
<td>RM 260,851</td>
<td>RM 151,663</td>
</tr>
<tr>
<td>Balance after 10 years</td>
<td>RM 242,926</td>
<td>RM 143,496</td>
</tr>
</tbody>
</table>

Further, Table 2 indicates that the use of profit rate of 9 percent in BBA home financing is higher than the average rental rate of 5.67 percent p.a for musharakah mutanaqisah home financing. This is because the profit rate is benchmark against market interest rate. However, rental rate is based on the real value of the property. As a result, the customer pays lower monthly instalment of RM 1,569.43 instead of RM 2,024.38 i.e. a difference of RM 454.95. The balance in BBA home financing after 10 years amounted to RM 242,926 is higher than musharakah mutanaqisah home financing of RM 143,496 because the bank capitalized its profit upfront.

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3 Total cost of payment minus financing amount
2.4 Theoretical studies on houses and rental values

Three interesting studies have significantly addressed the issue on property values (Mydin-Meera & Abdul-Razak, 2005, 2009; Mohd-Yusof \textit{et al.}, 2011). Mohd-Yusof \textit{et al.} (2011) examine the viability of rental rate to benchmark Islamic home financing products. These studies attempts to examine the importance of rental rate in pricing for Islamic home financing product. The study reveals that based on the long-run ARDL estimates, rental rate is significantly affected by the interest rate and income level, whilst the lending rate is significantly affected by the interest rate and exchange rate. The study indicates the importance of using rental rate as a benchmark for the prevailing Islamic home financing products. The result is consistent with an earlier work by Mydin-Meera and Abdul-Razak (2005; 2009) who stress the importance of rental rate when pricing Islamic home financing products based on the \textit{musharakah mutanaqisah} concept. Overall, this study has statistically proven that rental rate could be of an ideal pricing mechanism for \textit{musharakah mutanaqisah} home financing.

Unlike interest which depends on money, rental is more stable as it is based upon real value of property rather than interest rate which is based on the value of money.

Various studies on hedonic model focus on the determinants that influence house prices and rental values (Hong, 2011, Larsen, 2010; Liang & Wilhelmsson, 2011, Tse, 2002; Song, 1998). Hong (2011) provides evidence on neighbourhood preferences of house buyers in Klang Valley, Malaysia. The study uses the hedonic model to explain the neighbourhood preferences. The study finds that the gated-guarded neighbourhood with landscape compound could increase residential property values by 18.1 percent. On the same note, the positive perception of a freehold property in the neighbourhood could induce a price premium of 23.7 percent. Larsen (2010) examines the impact of buyer type on house price in various locations in the United States. The sample size of the study is based on 3,443 observations. The study develops hedonic regression comprised of structure age, fireplaces, number of square feet, living space, and central air conditioning, to mention some. The results of the study are interesting as the adjusted $R^2$ is 85.33 percent which explains the variation in the response variable. Furthermore, the structure age, number of square feet, living space, wood exterior, brick/store exterior and central air are statistically significant.

We further review three works by Liang and Wilhelmsson (2011), Tse (2002) and Song (1998). Tse (2002) examines the neighbourhood effects in house prices using a new hedonic model approach. In a hedonic model, all parameters are assumed to be constant. The data of the study are based on a moderate-size sample of 1000 actual transactions recorded in 1994 and are obtained from the Prop Folio’s homepage. On
the stochastic equation, net floor area ratio, age, floor, sea view, availability of a clubhouse and accessibility to the mass transit railway (MTR) are statistically significant. These variables are instrumental in determining house prices. In a similar vein, Liang and Wilhelmsson (2011) examine the determinants of the retail space rent in a particular city in China. The study employs hedonic model and spatial regression model in order to fulfil the research objective. The study discovers that age, retail space and distance to the Jing An CBD centre, are instrumental in determining the retail space rent. These two works, however do not take into account the home buyers’ characteristics and their effect on house prices.

A study by Song (1998) proves home buyers’ characteristics can determine the price for houses. This study employs linear regression model in order to estimate the research model. Selected variables such as age of the house, living space, size of lot, number of bathrooms, distance to downtown Reno, high school and mountain view are statistically found to be significant in determining the selling prices. Other explanatory variables like brick and sprinkler system are insignificant.

Based on the above studies using hedonic theory, it is thus possible to derive at rental rates for the musharakah mutanaqisah home financing although these studies have not paid attention on the determinant of rental rate per se. However, theoretically, we can deduce that the use of variables such as type of property, number of rooms, age of house, design, locations and amenities can be used as rental estimates.

The importance of rental in musharakah mutanaqisah home financing has also been emphasized by Ayub (2007) and Rosly (2005). Generally, the use of actual rental rates for musharakah mutanaqisah home financing has many advantages and are consistent with the spirit of Islamic finance as it is based on the value of the property. In summary the advantages of using rental rates are as follows:

1. Greater flexibility – pricing based on rental rate provides flexibility for the bank to revise the rental rate periodically (Abdul-Razak, 2011).

2. Cash flow management – the use of rental rates in musharakah mutanaqisah home financing enables banks to manage their cash flow more efficiently. This is because rental rates can be adjusted to meet uncertainty in the economic conditions (Rosly, 2005).

3. Profit sharing arrangement – in the case of musharakah mutanaqisah home financing, profit is shared based upon the real market value of the property which varies according to the types of houses and their locations and not predetermined upfront based on market interest rates (Abdul-Razak, 2011).
4. Fair pricing – a study by Abdul-Razak (2011) has shown that the customers perceived the use of rental rates as fair because it is based on the rental value of property. This argument is supported by various scholars (Mydin-Meera & Abdul-Razak, 2009). In addition, Usmani (1997) reiterated that the extra payment for a house is allowed because there is an exchange of real commodity and not based on time, for example price and rental for houses differ based on the market demand, location, size and amenities available. The arguments of both scholars are also related to the assumptions made in the hedonic theory which stated that rental rate can be determine according to the demand, location, size and environmental facilities.

5. Subprime crisis shield – using rental rate will help banks and clients mitigate the effect of subprime crisis sourced from the evil of interest rate (Ahmed, 2010; Kamil et al., 2010). This is because the rental rate truly reflects the real value of property and it is permissible by the Shariah.

3. Discussion and Implication

The study indicates that main cause of the subprime crisis is due to bank’s greed for profit using traditional debt financing techniques. The model enables banks to leverage on money as a commodity to acquire wealth without caring for the consequences. The Shariah lament such behaviour as it is against the principles of promoting justice and fairness. Profit motive is not the sole purpose of Islamic finance as equally important is the fulfilment of maslahah (e.g. public interest) and the needs of society (Dusuki, 2008). In order to achieve this purpose, the Shariah advocates the concept of equity as an alternative to the debt model.

The equity financing model in musharakah mutanaqisah is based on the real economy whereby the bank takes ownership and liability of acquiring the property (Rosly, 2005). This would prevent excessive debt expansion as money is not treated as commodity as in traditional debt financing. Furthermore, the asset being transacted must be real and not fictitious nor imaginary as the issuance CDOs and CMOs during the financial crisis. As debt cannot be sold and must be born by the bank itself, it prevents the transfer of risk from the bank to the customer.

The musharakah mutanaqisah financing concept requires bank to share risk with the customer, hence it promotes justice and fairness between both parties meeting the purpose of Shariah maqasid al-Shariah, (Al-Ghazali, 1937). The profit sharing model enables equitable distribution of income which can reduce the tendency of profit maximization that incurred in the financial crisis. The model further enables a customer to reduce the amount owing the bank by redeeming more of the bank’s share throughout the period of financing.
Using actual rental value is an exercise of fair pricing and acceptable by the Shariah as it is based on the attributes of the property. This reflects its real value and not the value money. The flexibility of changing the rental rates provides bank with better cash flow management to meet changes in economic conditions compared to the fixed rate pricing in BBA. Moreover, pricing based on real asset value can prevent asset bubbles that caused the financial crisis as it is not linked to interest rate.

4. Conclusion and Areas for Future Research
This paper has examined that the causes of the U.S. 2007 subprime crisis is due to the traditional debt financing practice whereby the customers owed the bank upfront by mortgaging their property to secure the loan. Interest rate is used to charge the customer and the subsequent increased caused hardship and difficulties for them to pay back their monthly instalments. The study has indicated that the musharakah mutanaqisah concept can address issues faced by customers during the crisis. This is because the bank does not charge the customers based on fixed profit rate. Moreover, the property is jointly owned by both parties until full settlement. As a partner, the bank takes risk of ownership and liability of the property required by the Shariah. Customer pays the bank monthly rental rate based on the real value of the property and not interest rate which has lead to the crisis.

Despite the advantages of the musharakah mutanaqisah home financing over the traditional debt financing, the implementation of this concept requires a paradigm shift of the mind sets of bankers and regulators. The bankers must be innovative and develop products that emphasize on customer values inherent in the equity principle. In so doing it also fulfils the maqasid al-Shariah (Al-Ghazali, 1937). However, the bank must also mitigate the risk within the prevailing regulations and environment. Hence, this call for the regulators to review the existing framework and indentify any impediments that need to be addressed such as banking regulations, policies, law, accounting and tax issues that could pose as stumbling block to the implementation of the musharakah mutaniqisah home financing in the industry. As this present study is limited to secondary data, future research should consider conducting survey and interview of bankers and regulators on the subject. Further investigation also needs to be carried out to determine the appropriate rental rate. There are two options available in this regard. The first one is the appointment of independent assessors to estimate the rental value based on variables such as locations, land size, number rooms and amenities Another method is to develop a rental index that is applicable for specified areas and geographical location e.g. for major towns and cities.
References


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