

Does the Diminishing Musharakah reflect the spirit of Sharia?

Tariq Hameed analyses the most popular type of Islamic mortgage, the 'Diminishing Musharakah', and explains how it differs from conventional mortgages and its treatment from a tax and regulatory perspective

Since 2003, the government has introduced a number of measures equalising the tax treatment of Islamic mortgages with a view to creating a level playing field for financial institutions and customers. In 2007, secondary legislation bringing certain categories of Islamic mortgages into regulation will come into effect.

Islamic finance is perhaps one of the main emerging markets globally and the UK is no exception. Muslims constitute the second-largest faith group in Britain after Christians, and it is therefore unsurprising that Britain is one of the first Western states to have a detailed tax and regulatory regime addressing Islamic finance products. It is interesting to note that the progress made in Britain is more advanced than many countries with a Muslim-majority population. Many such countries are, as a consequence, following the experience of Britain in this regard.

Islamic mortgages

Over the last couple of years, a number of institutions have entered the market with often different or differing products. To an institutional newcomer, the variety of products and the level of complexity for particular products can be a steep learning curve. For customers, who have less financial sophistication than institutions, such variety and complexity can lead to scepticism and in some cases rejection.

Given the very specific prohibition of usury, or interest, in the Koran (the holy book of Islam), a financial institution cannot simply lend money with interest to its Muslim customers and must as a consequence devise new products that accommodate the rules, principles and parameters of Islamic law (i.e. sharia). However, product development in Islamic finance should be undertaken with a degree of caution. Some institutions make the mistake of seeking to repackage existing interest-based products with an 'Islamic character'. The more sophisticated financial institution recognises that Islamic finance is tangibly different from conventional finance and its resulting products are therefore really neither compliant with the spirit nor the letter of sharia.

It is for this reason that many customers and scholars object to the term 'Islamic mortgage', since the concept of a 'mortgage' brings to mind a conventional mortgage and its inherent unfairness to defaulting borrowers. The government has, as a consequence, referred to 'home purchase plans' when referring to some types of Islamic mortgages.

Of the various home purchase plans, the most popular - and in the author's view the closest so far to the spirit of sharia - is the 'Diminishing Musharakah' product. There are other types (e.g. murabaha (commonly referred to as a 'trade with a mark-up') or ijara wa iqtina (leasing with a purchase option)) but this article will analyse the Diminishing Musharakah product.

The Diminishing Musharakah product

Musharakah is the Arabic word for partnership, and as a consequence the financier and the customer are described as having entered into a partnership in respect of the property in question. The steps involved in a Diminishing Musharakah are outlined below:

Step 1 - the vendor of the property sells the property directly to the financier, in whom the legal title to the property is vested. The financier pays the full purchase price of the property to the vendor.

Step 2 - the financier and the customer enter into a partnership to co-own the property (constituted by a Diminishing Musharakah Agreement). The financier and the customer agree at the start that their respective shares in the property shall be pro-rata, concerning their contributions towards the purchase price paid to the vendor.

Step 3 - the parties also agree that during the course of their partnership, which has an agreed date of termination, the customer will purchase the financier's share in the property in instalments and for the price that the financier had paid for such share on the initial date of acquisition. As the customer increases its share in the property, the financier's share correspondingly decreases by the same amount.

Step 4 - in parallel to the Diminishing Musharakah Agreement, the financier grants to the customer a lease in respect of its share in the property. The lease is effective for as long as the financier has a share in the property. The prevailing view of sharia scholars is that it is acceptable for the rent (payable by the customer) to be a percentage amount of the financier's capital in the partnership benchmarked against LIBOR. The indexation against LIBOR allows the financier to charge a floating rate of rent.

Step 5 - as security for the customer's obligations to make payments of rent under the lease and acquire the financier's share in the property at a fixed price under the Diminishing Musharaka Agreement, the customer charges by way of security in favour of the financier, its interests in the property under the Lease and the Diminishing Musharaka Agreement.

Differences between a Diminishing Musharakah and conventional mortgage

A conventional financier will see a number of parallels between a conventional mortgage and a Diminishing Musharakah product. For example, the acquisition of the financier's share at a fixed cost would appear to be a repayment of the financier's capital. The rent payable by the customer under the lease would appear to be the interest on the

financier's capital. However, below is a selection of the main differences between a Diminishing Musharakah product and a conventional mortgage.

Sharia requirements for landlords

Sharia requires a landlord (i.e. the financier under the lease) to be responsible for major maintenance and repair and insurance in respect of its share of a property. Such responsibilities are not undertaken by financiers of a conventional mortgage. Under sharia, the customer (as lessee) is responsible for ordinary maintenance and repair only of the leased property and for remedying major defects caused by deliberate or reckless acts of the customer. In many Diminishing Musharakah products, the financier will therefore (as landlord) appoint the customer as its service agent to undertake major maintenance and repair and procure insurance on behalf of the financier in return for a service agent fee. The payment by the financier of the service agent fee invariably has an upward effect on the rent payable by the customer under the lease.

Issues for landlords under English law

As the financier is a landlord pursuant to the lease, it retains the risks that pertain to such status under English law. Therefore, if a customer fails to fulfil its maintenance and repair obligations and the financier (as landlord) exercises its rights under the lease to carry out such works, the financier will owe a duty of care to all persons who might reasonably be expected to be affected by defects in the state of the property. Furthermore, if the financier is at any point considered to have control over any parts of the property (perhaps only relevant when the financier enforces its security or the lease is forfeited by the financier), it will owe a duty of care to see that visitors will be reasonably safe in the property for the purpose for which they were invited or permitted to be there. Moreover, there are potential environmental risks for the financier as the ultimate owner of the property if it has not undertaken proper environmental due diligence or procured appropriate covenants from the customer.

Total loss

Under sharia, a lessee pays a landlord rent for the right to occupy a property. If a customer's use of the property is impaired, particularly if the property is destroyed, they can be denied the benefit of the lease and cannot be compelled to continue paying rent. This is in contrast with a conventional loan where the customer continues making payments under the loan if the property is destroyed until the insurance proceeds are received.

Floating rent rates

Under sharia, the amounts payable by the parties must be stated, otherwise the contracts will be void for uncertainty. There is a theoretical argument that floating rates of rent are potentially uncertain. However, to cater for such uncertainty in floating rent rate contracts there would be a defined 'rent period' during which the rate of rent payable by

the customer is fixed. The rent payable in a subsequent rent period would be determined prior to the commencement of the relevant rent period. The customer would be granted an option to settle their outstanding obligations early if they are unhappy with the revised rent, or they may accept the revised rent and the lease would continue.

Early settlement

If the customer were to purchase the financier's entire share in the property prior to the agreed date, the Diminishing Musharakah Agreement will be terminated. As a consequence, the reference amount of the rent (i.e. the outstanding investment of the financier) will be reduced and rent will no longer be payable. There is no justification under sharia, however, for the financier to charge the customer breakage costs for early settlement.

Usage screening

An Islamic bank providing a Diminishing Musharakah product, as a landlord, is required to take the extra step of ensuring that the use of the property leased to the customer is sharia-compliant. Although a conventional bank is not subject to such requirements by sharia, a financier must be wary of the reputational risk of providing a Diminishing Musharakah product to a customer who intends to use the property for a use that is not sharia-compliant (e.g. as a brewery).

Rule 6

The Law Society is reviewing the application of Rule 6 of the Solicitors Practice Rules 1990 to home purchase plans. Their current view is that the nature of Diminishing Musharakah and ijara products are radically different from a conventional mortgage and, accordingly, a solicitor would be in conflict due to being instructed by both the customer and the financier in such a transaction. The government is therefore considering making an exemption for home purchase plans from the application of Rule 6 as per conventional mortgages if the parties consent to a joint instruction.

Regulation

Home purchase plans are not currently a regulated activity within the meaning of the Financial Services and Markets Act 2000. However, home purchase plans become a regulated activity from 6 April 2007 pursuant to the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order SI 2006 No 2383. This will have a marked effect on the way such business is conducted and marketed to residential customers.

Stamp duty

Customers of Diminishing Musharakah products who were individuals have benefited from the 'level-playing field' legislation since 2005. Sections 71A of The Finance Act

2003 (as amended) exempted steps 2 and 4 (mentioned earlier) of a Diminishing Musharakah from incurring a stamp duty land tax (SDLT) liability although the financier will invariably require the customer to pay SDLT in respect of Step 1. Pursuant to s. 168 of the Finance Act 2006, such exemptions were extended customers who are "persons" and thus applicable to incorporated companies and partnership since 20 July 2006.

Conclusion

It is very clear that a Diminishing Musharaka mortgage is very different from a conventional mortgage and not just a 'window-dressing' exercise as claimed by its detractors. Whether a conventional bank is willing to accept these risks, which financial institutions such as Bristol & West and HSBC have, will be a commercial decision. There are ways to mitigate these risks such as the procurement of insurance that would have an upward effect on the pricing of the products. Furthermore, with greater emphasis on due diligence, the procurement of more detailed covenants and a larger deposit from the customer, it is possible that some of the 'risk' would only be theoretical.

There is further scope for developing products that are closer to the 'spirit' of sharia, but the above will have illustrated that perhaps Diminishing Musharakah is a 'fairer' product for the customer (not taking into account pricing considerations) in contrast with conventional mortgages and as a consequence there may be a market for such products among the ethical non-Muslim market.

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