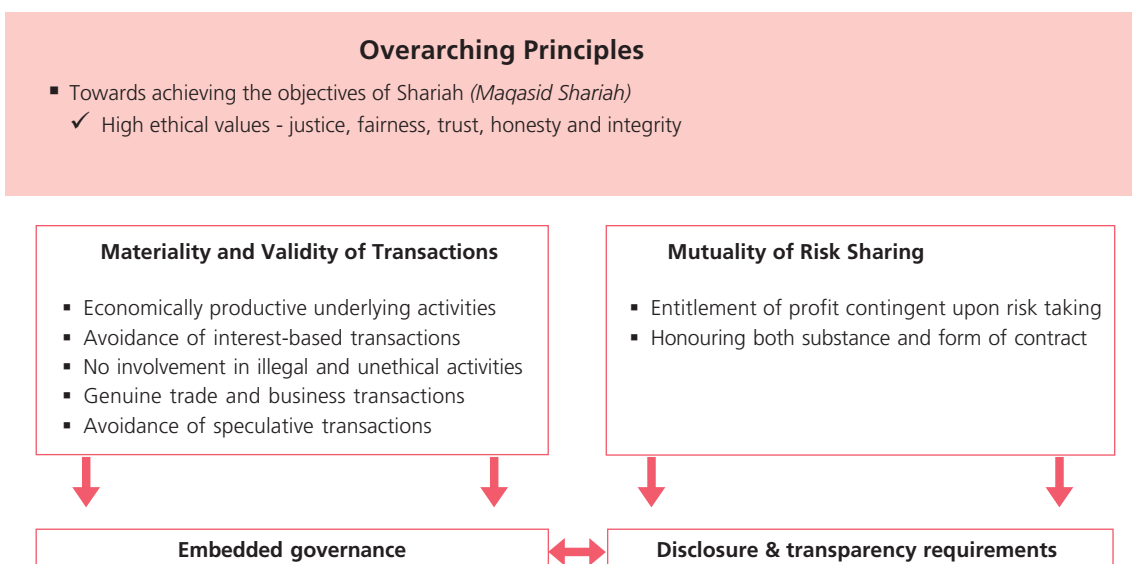


Distinct Features of Islamic Financial Transactions: Perspective on *Musharakah Mutanaqisah* (Diminishing Partnership)

"The very objective of the Shariah (**Maqasid Shariah**) is to promote the welfare of the people which lies in safeguarding their faith, their life, their intellect, their posterity and their property. Whatever ensures the safeguard of these five serves public interest and is desirable." - Al Ghazali

Islamic finance is founded on Shariah principles which express an explicit intention to meet the financial needs of participants with integrity and in a manner that is just, fair, trustworthy and honest, while ensuring a more equitable wealth distribution. Chart 1 briefly summarises the essential features of Islamic finance.

Chart 1
Essential Features of Islamic Finance



Unlike conventional finance, Islamic finance is governed by Shariah rules that prohibit interest-based transactions. Islamic financial transactions are also required to be accompanied by genuine underlying trade and business activities that generate fair and legitimate profits. This reinforces the close link between financial and productive flows which underpin Islamic finance, thereby insulating the Islamic financial system from risks associated with excessive leverage and speculative financial activities. The risk- and profit-sharing characteristics of Islamic financial transactions (such as in *mudharabah* and *musharakah* contracts) which are clearly defined at the onset, serve as additional in-built mechanisms that further strengthen incentives for the adoption of sound risk management practices by Islamic financial institutions. In particular, these features demand the exercise of appropriate due diligence by Islamic financial institutions and higher standards of disclosure and transparency to be observed which, in turn, act to enforce market discipline and minimise informational asymmetries.

Collectively, these intrinsic features and requirements of Islamic finance act as natural stabilisers and restraints against the risks and excesses associated with excessive leverage, financial speculation and mis-selling that can threaten the effective functioning of financial systems.

The range of Islamic financial products has broadened considerably in recent years in response to the more diverse and differentiated requirements of participants. For example, Islamic financing contracts have expanded from simple-mark up contracts to include those that are equity-based. While Islamic finance has continued to evolve rapidly, the distinct features of Islamic financial transactions have been preserved in the new innovations in order to ensure that the religious and ethical principles of participants are not compromised. This is illustrated in the following example of *musharakah mutanaqisah*, an equity-based contract which has been widely accepted in many jurisdictions.

A Study on *Musharakah Mutanaqisah*

Musharakah mutanaqisah – A form of partnership in which one partner promises to gradually acquire the equity share of the other partner until the share of ownership is completely transferred to the first partner.

Musharakah mutanaqisah can be applied in home financing products. Based on the joint-ownership concept, the banking institution and the customer contribute their respective shares of the capital required to acquire the property according to a pre-determined ratio agreed to between them at the beginning of the contract. The banking institution leases the property to the customer who undertakes to incrementally acquire the full ownership of the property from the banking institution over an agreed period. Once the customer has fully acquired the banking institution's share of the property, the partnership comes to an end with the customer becoming the sole owner of the property. This contract incorporates elements of both sale and lease (*ijarah*) contracts, which are integral in ensuring that no element of *riba* (interest) is involved in the *musharakah mutanaqisah* transaction. The dynamics, at different transaction stages, of a *musharakah mutanaqisah* contract for completed property is illustrated in Chart 2.

The application of Shariah principles in *musharakah mutanaqisah* contracts creates distinct relationships, rights and obligations of the parties to the contracts. As a result, banking institutions are exposed to both market risk associated with the joint ownership of the underlying asset, as well as credit risk associated with the obligation on the part of the customer to acquire, and on the banking institution to sell, its share of ownership in the asset. This distinct risk exposure requires the banking institution to adopt more robust methodologies supported by reliable and adequate data and systems that are able to detect and provide best estimates of potential losses arising from adverse developments in the credit profile of the customer. The risk management processes and infrastructure of a banking institution offering such a product must also be dynamic in identifying, measuring, controlling and managing all the relevant risks associated with *musharakah mutanaqisah* transactions. Chart 3 shows the key risk exposures and risk management practices at the different stages of a transaction in *musharakah mutanaqisah*, as well as additional risk mitigants that can be introduced.

Chart 2
Dynamics of *Musharakah Mutanaqisah* Contract for Completed Property

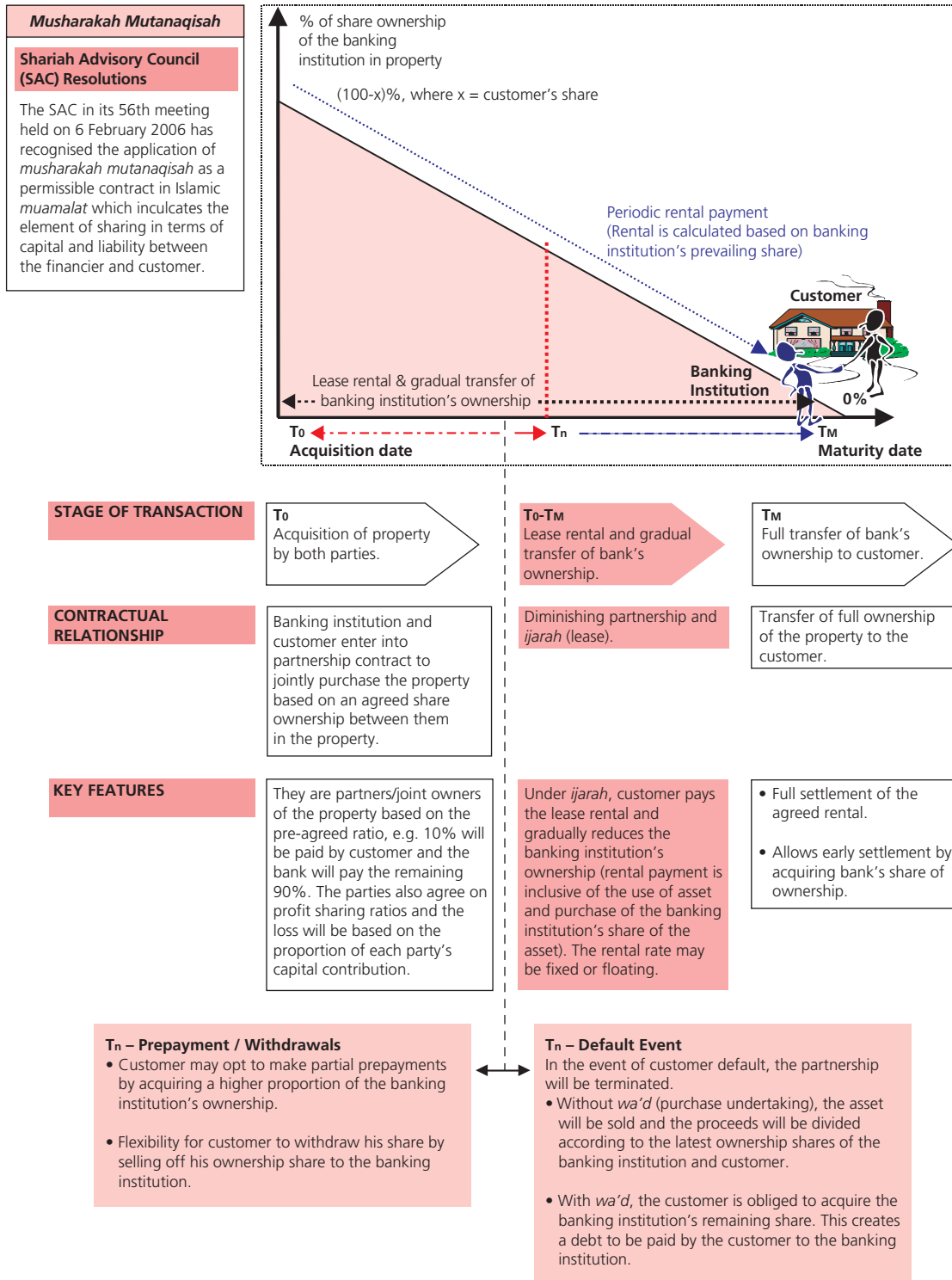
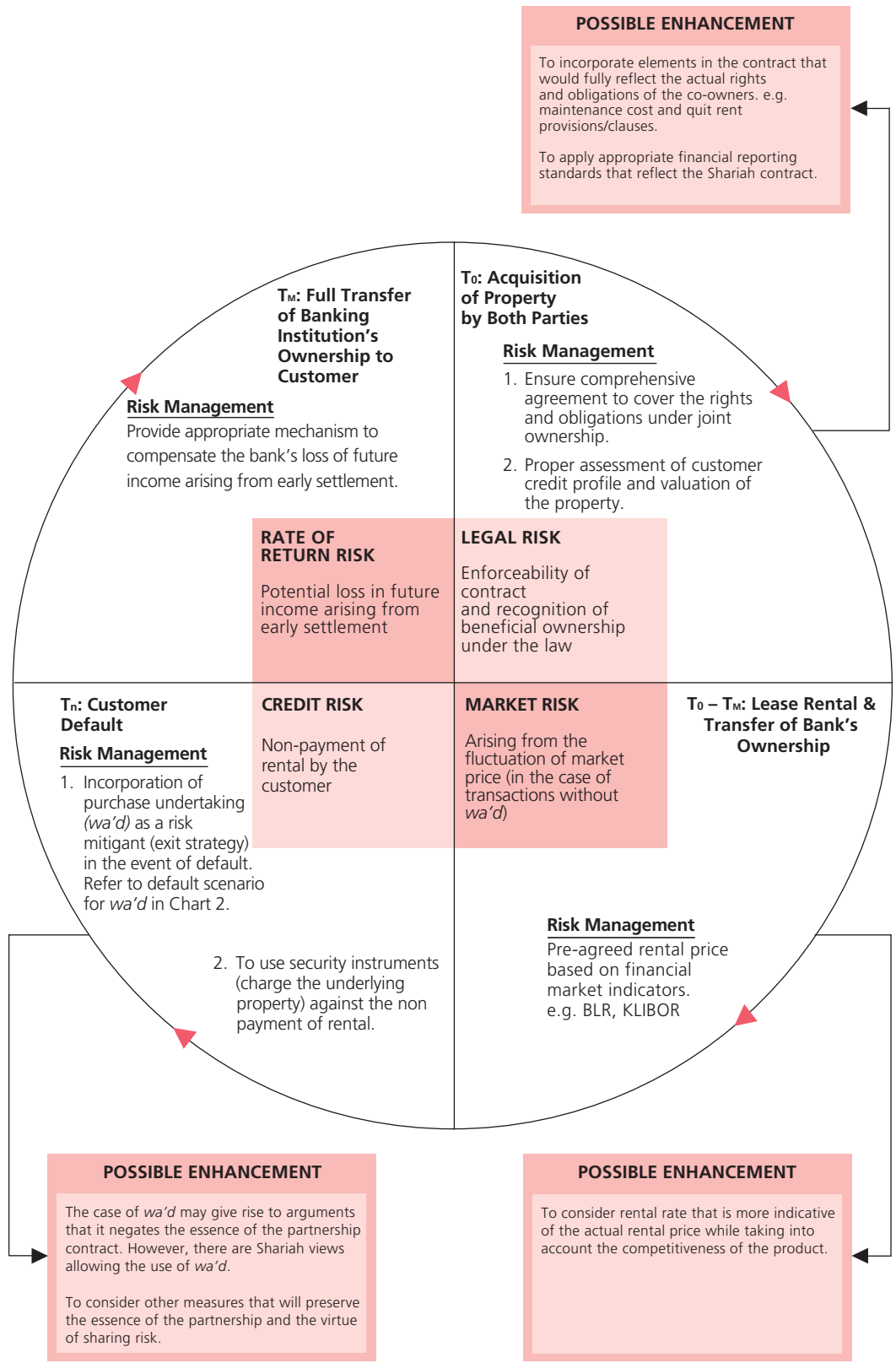


Chart 3
Management of Key Risks in *Musharakah Mutanaqisah* Contracts



Several jurisdictions have also applied specific regulatory requirements to ensure the appropriate management of risks associated with this type of contract. For example, in jurisdictions adopting capital adequacy frameworks based on the Capital Adequacy Standard issued by the Islamic Financial Services Board, Islamic banking institutions are required to allocate sufficient regulatory capital to cover the exposures to both the price risk based on the proportion owned by the banking institution in the underlying assets, as well as the credit risk arising from the outstanding rental payable by the customer. In tandem with the banking institutions' diminishing share of ownership in the asset, the capital requirement for the price risk would gradually decline over the period of contract.

With its distinct features, and in-built checks and balances, the development of Islamic finance as a viable form of financial intermediation is expected to contribute towards enhancing financial stability. Moving forward, further product innovations in Islamic finance can be expected. This needs to be supported by further in-depth research on Shariah issues relating to risk mitigation, liquidity management and hedging in order to ensure that the fundamental tenets of Shariah which underpin the stabilising factors inherent in Islamic financial transactions, are preserved.