SHARED RISK & REWARD

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My Reading List

- What does Islam say about Corporate Social Responsibility? (pdf)
- Doing business with Islam: Can corporate social responsibility be a bridge between civilisations?
- Re-considering CSR and sustainability identity of Islamic banks in Malaysia: An empirical analysis (pdf)

Blog Posts This Week

- The "Immunity" Myth, debunked by the IFSB
- Would national Shari'ah boards help Islamic finance?
- Could there be an Islamic whale?

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Replacing Diminishing Musharaka?

During the week, I read a proposal for a replacement for the diminishing musharaka (musharaka mutanaqisah) home finance product (see the basics, and a numerical example). The basic argument given against the diminishing musharaka structure is that it is identical to a conventional mortgage because it incorporates compound interest, which is avoided by the alternative.

However, upon closer examination, the alternative, which INCEIF's Dr. Zubair Hasan calls the Zubair Diminishing Balance Model (ZDBM), misses a key feature of the musharaka agreement it is based upon. Instead of joint-ownership, the ZDBM assumes a fixed rate of return on the financier's invested capital in the property being financed and equal payments to reduce the financier's invested capital (with return on that capital paid out as rental income).

The buyer pays an equal amount each period to reduce the financier's stake, plus a percentage of the outstanding balance (8% per annum in the example). The relationship between the parties is not one of a partnership, but a lending relationship with non-compounding interest.

The basis for a diminishing musharaka is supposed to be a structure similar to a joint venture, where each party has an ownership stake in a venture, which owns an asset that is leased with the lease payments split between the parties according to ownership. To see the difference, think of the diminishing musharaka as venture between two investors who buy a building and lease it for 10 years to a third party. They will charge the tenant a fixed amount per month for the right to use the building, and will split the proceeds amongst themselves according to the share of capital contributed.

If one party wants to acquire over time the interests of the other, he could use the rental income he receives to pay for a portion of the other partner's ownership and would, in future periods, be entitled to receive a greater portion of the rental income (corresponding to his ownership share).

The same relationship could be done if the renter is the same person as the owner with the smaller ownership share. The real question, in my mind, is not about whether this builds in compound interest; it is whether the minority owner/tenant should be entitled to have the value of the building reassessed periodically and the buy-out amounts adjusted accordingly.

Until next week,
Blake Goud