

RESTRUCTURING RENTAL RATE COMPONENTS TO BE MORE INNOVATIVE SHARIA COMPLIANCE PRODUCT IN ISLAMIC HOME FINANCING*

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Abstract— This study attempts to restructure a more innovative Sharia compliant product in Islamic home financing. By examining the components of residential rental index and addressing some unresolved issues particularly in *Musyarakah Mutanaqishah*, the study seeks to propose rental index as an alternative benchmark to current interest rates. This paper employs library research derived from the pedigree of Islamic home financing. However, some mathematical modelings are employed to strengthen the analysis. The paper proposes a new structure of rental rate as a benchmark instead of the conventional interest rate in pricing of loans. This structure comprises of Islamic rental rates, risk premium, overhead expenses and profit margin. Our findings suggest that these components are better-able to capture the market conditions as compared to the element of interest in BLR (Base Lending Rate) as practiced by banking industry. This paper also recommends the solution for default payment and at the same time addresses inconsistencies of MM contract offered by Islamic banks. Since rental index is regarded as new approach in Islamic home financing, this study limits its scope with one contract namely *musharakah mutanaqishah*. This limitation might wreak different views from industries for implementation and thus needs to be further tested. The findings also reveal some future challenges in applying more innovative Sharia compliant approach since up to date, there are no general consensus derived from different schools of thought in resolving the issues of pricing in Islamic home financing. Islamic banks might be resistant in accepting this newly proposed structure of rental rate since it generates lesser amount of profits.

Keywords; *Sharia, Innovative Sharia Product, Islamic home financing, musharakah mutanaqishah*

I. INTRODUCTION

A. Background

The rapid growth of the industry reflects the increasing demand for *shari'ah*-compliant financing products throughout the world. Continuous efforts are undertaken to further refine and improve the products and services offered by the Islamic financial institutions. This has resulted in the focus on ensuring

the *shari'ah* compliancy of Islamic banking products, developing new banking products and services, measuring performance of the Islamic banks, and evaluating the social and macroeconomic implications of developing the Islamic financial system (Yusof *et al.*, 2009).

Musharakah Mutanaqishah (MM), a hybrid contract, where it comprises of three contracts namely *musharakah* (partnership), *ijarah* (leasing) and *bay'* (sale). According to AAOIFI (Accounting and Auditing Organization for Islamic Financial Institution) Shariah Standards, it is permissible in *Shariah* to combine more than one contract in one set, without imposing one contract as a condition on the other and provided that each contract is permissible as its own. This type of contract combination is acceptable unless it contravenes with Shariah principles.

The vast compendium on MM hitherto remains an arduous problem to be resolved. The recourse of this contract varies in respect to policy of respective Islamic banks where many of them are reluctant to apply MM particularly the local Islamic banks in Malaysia. Although *Musharakah Mutanaqishah* is believed to be more Sharia compliant, there are some issues that impede the implementation of this contract. This phenomenon wreaks dire dispute among muslim scholars on how to embrace MM into more sharia compliance. Many studies have been conducted pertaining to the issue of MM but few of them ended with more comprehensive resolutions. Some of the issues are documentation approaches to default, early settlement, abandonment of the project, *wa'ad*, type of *Syirkah* (*aqd* or *al-milk*), risk sharing, rental index, maintenance and issue of charges and fees. Against this backdrop, it is therefore imperative to investigate the unresolved shariah issues of MM and at the same time, understand why its implementation by banks are still with reservations..

Among the most contentious issues of MM is the determination of rental rate in pricing of Home financing. To date, the existing rental rate adopted by banks regardless the mode of financing is still benchmarked against the conventional practices. There are two reasons for this. Firstly, profits that banks earned are indeed linked to cost of funds

which are inevitably associated with the conventional interest rates. Secondly, the conventional interest benchmarking cannot be avoided as the country is adopting dual banking system.

A fairer basis to determine the rate based on actual data is lacking in Islamic home financing as this rate reflects justice, fairness, resembles mutual consent and understanding and uplift the spirit of cooperation and risk sharing. However, these values are not found in any Islamic home financing pricing. As result, home ownership and affordability remain an unresolved issue and even Islamic banks tend to have similar pricing structure as opposed to those of conventional practices.. Affordability and Sharia compliant products now become a trending topic that hitherto remain an arduous to resolve.

The component of rental rate however is inseparable with the interest of bank for banks to earn higher profit. In addition, Islamic and conventional banks are exposed to similar structure of cost of funds, risk premiums and other risks that are already embedded in calculating the profit rate. Furthermore, no general consensus by *Fiqh* scholar son how to determine the rental rate that comply with Sharia principles have been derived and according to Obaidullah (2005), it is merely a profit rate or mark up for the interest rate and hence, leads to the convergence of both the Islamic and the conventional home financing. In order to generate profit, Islamic banks tend to mitigate the risk by securing the profit in the beginning and avoid the loss regardless of the Sharia compliance element. Islamic banks also in practice, transfer the risk of loss to the customer particularly in the event of default of customer. In this case, the bank will ask the customer (with *wa'ad*) to purchase all shares of bank.

In line with these observations, Islamic rental rate is an imperative issue to be resolved in Islamic home financing albeit suggestion that might wreak dispute and further discussion. This study therefore attempts to restructure the existing rental rate by way of formulating more appropriate components that mostly comply to the tenets of Sharia and propose a solution to replace the interest rate with more innovative Sharia compliant product in home financing.

B. Objectives

In order to determine the structure of rental rate, this paper attempts but not limited to:

- a. Substitute interest rate into RRI (Islamic Rental Rate) to eliminate the element of Maysir/Gambling, Gharar/Uncertainty, Riba/Usury.
- b. Propose a pricing model or a comprehensive structure of rental rate which includes risk premium, over-head expenses and profit margin. These components will hopefully better-able to capture the interests of banking institutions but at the same time offers a fair-priced financing to the customer which in turn leads to greater affordability of home ownership

II. LITERATURE REVIEW

As a preamble, this paper seeks to first highlight some unresolved issues in Islamic home financing particularly pertaining to Sharia compliance. This section then deliberates on the rental rate in conventional practices followed by discussion on existing studies address the issue of rental rate in Islamic home financing:

A. Unresolved Issues in Islamic Home Financing

There are numerous issues in MM pertaining to its Sharia compliance in Islamic home financing as offered by Islamic banks. This paper only focuses on assessing and examining the unresolved is-sues in MM contract for home financing. Naim (2011) finds that at initial stage of the MM contract, comprises the elements of Shirkah al-milk (co-ownership) . However, it does not fulfill the spirit of partnership in the event of default. In this case, the bank is not willing to share the risk with the customer and customer is forced to buy the share of the bank. He also argued that the second undertaking to purchase the bank's share by the customer explicitly contradicts the Qur'anic verse which obliges the debtor to postpone the debt repayment when the borrower is genuinely unable to pay.

Besides the unresolved issues, a study on the potentials of MM contract also has been conducted by Smolo and Hasan (2011). Smolo & Hassan (2011) compared MM with Murabahah and Bai Bithaman Ajil in home financing. However, they acknowledged that MM is not a perfect contract as they raised the issue of double taxation, the price of both rent and shares. According to the AAOFI standards, it is prohibited to sell shares in MM contract at a price that is fixed in ad-vance. In this case, the partners do not share profit and loss of their investment (AAOIFI, 2004, p. 214). In addition to that, they argued that it is an imperative for the Islamic bank to share the loss with the customer in the event of default. This can then be regarded as an avenue for corpo-rate social responsibility, of which banks these days are expected to perform.. Current laws and regulations may be not in support of MM but as long as there is political will from the government and private sectors, the modification of MM to be more innovative and Sharia compliant is possible.

A case study conducted on MM conducted by Asian Institute of Finance (2013) by highlighting the issue of documentation, approaches to default, early settlement and abandonment of the pro-ject. In addition to these issues, AIF (2013) also raised the issue of wa'ad (unilateral promise) as legally binding and enforceable and whether the bank had the right to seek legal enforcement of the promise in the court of law. If the wa'd is immediately enforceable, it is no longer a promise. Instead it is a contract, which rendered the MM partnership to be in conflict with the Shariah.

Meanwhile, on the other side, the spirit of partnership in equity financing has been disputed among the scholars. Initially, Mustafa al-Zarqa (2004, p.354) was among the scholars who pio-neered the discussion of shirkat al-milk. He has elaborated this issue in the topic of 'undivided ownership' (al-milkiyyah al-sha'iah) and explained that where a shirkat al-milk is "subject to a condition that there is no contract jointly benefiting it in profitable means, or to jointly invest it in

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business or leasing and etc from any commercial activities.” This means that any guarantee of cap-ital or profit is not permitted (Naim, 2011)

B. Rental Rate Determination.

Since the practice of benchmarking home financing to interest rate is indeed the pulse of any transaction, Islamic banks are therefore free to determine the own rental rate according to their own pricing structure. On average, house prices tend to be more volatile in markets. Fluctuations in residential property prices tend to have a bigger wealth effect than those of financial assets. This will have an impact on the residential rental market and consequently impacts the rental rate in pricing of home financing. Meanwhile, the issue of benchmarking to interest in Islamic banking remains one of the contentious issues which impedes the purity of contract to be deemed as shariah based.

They are many factors to determine the rental rate as highlighted by Linz and Behrmann (2004), who provided at least three factors in determining house prices, namely physical, location-al and generally price variables. The similar study with different factors are also conducted by Day (2003), Can (1990), and Palmon et al. (2004).

The significance of demographic attributes to determine the rental rate has also been found by Marco (2007), Hui et al. (2007) and Ibrahim et al. (2005). They provided evidence that factors such as location, crime rate, age, total floor area, floor level and occupancy rate significantly affect the rental rate. These demographic attributes derived from diverse countries also explain the differences in rental rates across types of properties, location and other identified attributes. Macroeconomic variables that significantly determine rental rate have been analyzed by Chow et al. (2002), Matysiak and Tsolacos (2003). They posit that selected economic and financial variables can be used as leading indicators in explaining the monthly variation in property rent.

Variety of methods have been employed to quantify and determine the property rental values. Broadly categorized, these methods can be divided into two approaches: the Hedonic Pricing Model and more recently, the econometric analysis (Yusof et al, 2009). According to Dunse and Jones (1998), Ibrahim et al. (2005), the Hedonic Pricing Model (HPM) is one of the most widely adopted methods to quantify rental values. Hedonic regression analysis is a statistical technique which can be applied to a series of property values, together with their associated characteristics to identify and quantify the significance of the characteristics in determining the property's value. These findings are in line with the study conducted by Hofmann (2004) and Tsatsaronis and Zhu (2004) who examined the determinants of house prices in a number of industrialized economies, and find that economic growth, inflation, interest rates, bank lending and equity prices have significant explanatory power.

The scholars generally agree on the usage of actual rental value of property as an alternative to benchmarking to conventional interest rate. (Meera and Razak, 2009). However, they argued that the formula used in MM is similar to that of

conventional loan where conventional financing uses the standard formula for present value of annuities to compute for the monthly payments. In this case the opinion of Taqi Usmani (2004), which is supported by Wahaba al-Zuhayli (2003) which said that “A sale without naming the price is defective and invalid “One cannot agree to buy or rent something without knowing the price one must pay.

Furthermore, (Meera and Razak, 2009) raised the issue of tendency to substitute rental rate with market interest rate. The issue is based on the ground that the bank's cost of funds is likely to be tied to market interest rates. Second, under convergence, the use of interest rate instead of rental rate would give an amortization schedule similar to conventional financing. Meera & Razak (2009) also asserted that the interest rate is usually higher than the rental rate. Rentals can be cumbersome and impose additional costs particularly if services of independent value are sought unless there are already national or regional rental indices.

III. UNRESOLVED ISSUES IN ISLAMIC HOME FINANCING

A. Default Payment

1) The current practice of MM in home financing in Islamic banking industry is believed not to be perfect in terms of the elements of partnership. In the event of default payment, bank is reluctant to share the risk whereas, the customer suffers the loss. In this case, the bank does not implement Shirkah al-milk (joint ownership) as the main value of MM. Although there are diverse views on the implementation of Shirkah al-milk but most banks would prefer to undertake Shirkah al-uqud on the ground that it is not contradicting with Sharia rulings. The preference of this contract is given to middle-upper income customers to mitigate the risk of default among lower income customers. In the beginning of the contract, bank will anticipate the worse case scenario by extending this contract based on the concept of Shirkah al-uqud and not with Shirkah al-milk as required in MM contract where a joint ownership of the house is established. Banks will try as much as possible to avoid losses by way of making others (customer) worse off. In other words, Islamic banking industry today apply Shirkah al-uqud since the banks generate profit and will not incur losses since the customer is liable to buy all shares of the bank.

2) As for abandoned project, most of Islamic banks are reluctant to switch from “sell then build” (STB) rather than “build and sell” (BTS) principle as a way out to alleviate default payments by customers. This preference becomes apparent especially in the case of abandoned projects by its developer and where Islamic banks possess more shares and thus have to bear more losses compared to the customer. In the end, the customer is forced to buy all the bank's share. This indeed, is not coherent to the principle of profit and loss sharing as propagated by the concept of Shirkah al-milk. In this case, Islamic banks practice is similar to that of the conventional banks. This issue can actually be resolved by

taking prudent financial reform to mitigate the risk. The selection of customer and potential investor (developer) is an imperative to successful projects. Islamic bank should not totally discard its responsibility as a partner with the customer. Proper and close monitoring of the housing project is needed to ensure completion of the project. As agreed by all schools of thought, all parties involved must contribute towards the completion of the project and not mere extending the financing.

3) The issue of wa'ad (purchase undertaking) also remains unresolved in MM home financing. In this case, the customer promised to buy the bank's outstanding share of ownership in the event of default such as non-payment, breach of facility's terms and conditions, and bankruptcy. At this juncture, the bank will terminate the contract and oblige customer to buy the bank's entire out-standing share of ownership and pay the settlement amount in full. If the customer fails to do, the bank will sell the property to the market by way of auction. Any proceeds of this sale will be used to settle all outstanding payment by the customer, legal and other fees. If there is short, then the bank will ask the customer to pay the remaining short. This practice is totally unfair to customer. The implementation of MM should not carry the obligation of wa'ad. Without wa'ad is thus more recommended for both parties since all proceeds of this contract is the liability of all parties involved. Although Islamic bank is a commercial entity but they are binded with the concept of partnership, cooperation and mutual consent without making others worse off.

B. Inconsistency

Islamic banking industry today is said to be inconsistent with the elements of MM as practised in home financing. Many Islamic banks are not able to implement traditional MM due to complexity, agency problem, trustworthiness, duration and termination of the contract (Bacha, 2006). Although this inconsistency does not deviate from the tenets of Sharia ruling but in reality it is found to make the customer worse off while banks are generating profit and therefore there is a question and dispute on this matter. As MM is a joint partnership in equity financing, Risks and losses are also to be shared by both the customer as well as the bank. In other words, the concept of Shirkah al milk should be preceded regardless the outcome of the project financing. In this case, the bank must not be inconsistent in terms of the implementation throughout of the contract, i.e., undertake Shirkah al milk but in the event of default switched into Shirkah al-uqud. In addition, the spirit of partnership must not lapse in the event of default payment by the customer.

In fact the customer has to be guided to resolve the issue of default and possess the right to share the proceed of MM in case where the property appreciates in value or profits are generated. This spirit of partnership is in line with the initial definition of MM where according to Al-Fayruzabadi, al-Qemus (1997), and al-Munjid (1992), MM is a combination of two words, musharakah and mutanaqisah. Musharakah is derived from the root word sharaka, meaning 'one joining others' as supported by al-Kasani (2000), Ibn Rushd al-hafid

(1995) and Ibn Qudamah al-Bajuri (1999). In fact according to Haneef et al (2011) and Naim (2011) the MM was arguably in the form of shirkat al-aqd if the intention of at least one of the parties was to earn returns. The Malaysian banking practice, however, considered MM to be shirkat al-milk from the commencement of the contract until the end of its tenure. However, many Islamic banks argue that MM is permissible as long as all contracts (aqd) are independent (al-uqud al mustaqillah) therefore, in the event of default, it is justifiable to opt for Shirkah al-uqud rather than Shirkah al-milk as both are inherent in MM. Nevertheless, this reason is not acceptable as it makes the other partner (customer) worse off while the bank enjoys the benefit. The other inconsistency is derived during re-scheduling or refinancing as requested by the customer to avoid the default. In this case, the bank still insists the customer to pay the charges and other fees since the customer fails to abide by the payment schedule although the customer's intention is to pay the monthly payment according to their capability.

As mentioned by Shuib et al (2013), the bank in this case once again is inconsistent with Sharia compliance process in home financing. The bank does not implement the real concept of equity financing where all cost of this contract are the liability of both parties and all risks should be shared accordingly. Although the ownership of the property belongs to the customer upon maturity, but the process of joint ownership is still binding and at the same time enforceable. In this regard, all parties involved incorporate the spirits and values of brotherhood, partnership and mutual understanding as well as consent.

IV. FINDINGS AND DISCUSSION

The word "rental" is derived from the understanding of MM concept as it comprises of three contracts namely; musharakah, ijarah and bay'. It also refers to the purchase of bank's share of usufruct of such property to the customer where the share of rental for the customer increases until maturity. As of now, rental rate determinations that comply with the tenets of Sharia remain unresolved. There is no such consensus on how to determine Islamic rental rate. In fact, it was only a suggestion for future study as revealed by Meera and Dzuljastri (2005, 2009). They acknowledged the dire problem of MM in rental rate determination since most of countries which adopted MM are in fact dual banking system that always refers to interest rate albeit for small transaction. In fact, IIBR (International Islamic Banking Rate) which is currently adopted as reference for many Islamic banks is dominantly derived from Islamic banking that hitherto confined its usage for certain banks. As long as countries adopt dual banking system, Islamic rental rate wreaks dire problem and remains an arduous task to resolve. In other words, the power of interest rate albeit small portion is still inherent in Islamic banking system.

There are increasing concerns about the ability of many stake holders to determine more appropriate rental rates in Islamic home financing to cater for more Sharia compliant product. The price of home financing can therefore be fairer

and just to the consumers. Price determination to yield more appropriate components of rental rate is an imperative that must be preceded prior to price determination of home financing. The time has come for the quest to model a structure that is totally free from any unlawful element of home financing.

To recapitulate the above discussion, consider the following formula as being practiced now in MM home financing:

$$A = \frac{x[P - (1+x)^t C_0]}{(1+x)^n - 1} \quad (1)$$

where:

x = rental rate

P = Price of property

C_0 = Customer's share

Equation (1) as revealed by Meera and Dzuljasti (2009) merely gives the formula to the extent that x is given with the assumption on the price of rental. This formula is also being practiced by bank regardless of the mode of financing. The weakness of this formula is that, it is unable to resolve the existing issue of MM in home financing since there is no alternative thus far can replace x . However, by introducing new innovation in MM home financing, x can be replaced by RRi (*Islamic rental rate*) where this paper attempts to propose a new component of rental rate as follow:

$$RRi = \frac{RPI}{HPI} \quad (2)$$

RPI is the monthly rental price of the property market across the types, and locations in a specific country. RPI measures changes in the price charged for renting private housing while HPI measures average price changes in repeat sales or re-financings on the same properties. In order to replace x , the new component of rental rate is given as follow:

$RRi + \text{Risk Premium} + \text{Overhead Expenses} + \text{Profit Margin}$ (3)

In this case, Risk Premium comprises of credit risk, liquidity risk and market risk and RRi is given to replace BLR (Base Lending Rate) as practiced in conventional loan. Risk premium in this case would be the same as in conventional since Islamic bank also possess identical characteristic to play as financial intermediary. However, BLR now still remains as benchmark but is not taken into account in this formula due to its prohibition in shariah. Equation (3) resembles more just and fairer price for consumer since it removes BLR. The output of this formula is expected to be more expensive compared to conventional approach but deemed to be more Islamic. In addition, Islamic bank still earn profits even in the event of default payment by customer. The issue here is whether Islamic bank can opt to be better off without making others worse off (externalities). The other issue is whether Islamic banks are willing to earn smaller profits but adopts full

sharia compliance with higher profit but having shariah legality issues.

Although RRi is additional component to replace BLR, it has to undergo some simulation and scenario to examine precisely the Sharia issues. As this component uses indices, there is a possibility of loss accuracy. Prices and rental of real estate properties are sensitive to many factors. Even within the same locality, particular location can affect prices and rentals. However, these changes can be managed to avoid the inclusion of uncertainties and speculation.

V. CONCLUSION

This paper highlights the practical issue of rental rate to wreek more Sharia compliant product in Islamic home financing. In addition, this paper also points out some unresolved issues that affect changes in rental rate such as default payment and inconsistency of Islamic banks in the implementation of comprehensive MM.

This paper has proven that current practice of MM in Islamic bank still contains the element of interest particularly in determining rental rate. Although rental rate might be affected by element of uncertainties and speculation, but these issues can be resolved. Islamic bank has to be consistent with the real value of MM and upholding the spirit of partnership and mutual consent. In the event of default, the loss that incurred by the customer should be shared proportionally with Islamic bank albeit fees, charges and other cost. Therefore all parties involved share the value of brotherhood, partnership and mutual understanding and consent.

As for rental rate, this paper has restructured a new component of rental rate that comprises of rental price index and house price index. In this case, in order to replace interest and Base Lending Rate (BLR), the new structure would comprises of Islamic rental rate, risk premium, over-head expenses and profit margin. The new price of this component is expected to yield more expensive price compared to existing component but believed to be more Sharia compliant product. However, Islamic bank does not incur any losses but only a slight change in profit. In this case, stimulation by regulators and other relevant stake holders to support Islamic bank is an imperative action whilst Islamic bank attempts to have more Sharia compliance product.

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